S-CORP

KNOW MORE THAN YOUR ATTORNEY

IN 15 MINUTES

by Scott Royal Smith

S CORPORATION

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INTRODUCTION

OVERVIEW

An S Corporation isn't so much a legal entity so much as it is a set of tax rules that can be used by a wide range of entities: corporations, limited liability companies, or limited liability partnerships. As long as it is what the IRS considers an eligible entity that's made an S election with the IRS, it's an "S Corp" for the purposes of this book.

With the S Corp election, profits allocated to shareholder-employees aren't subject to payroll taxes. **Small business owners (including real estate investors) use the S Corps election to save thousands in payroll taxes.**

So .. What Is an S Corporation?

The Internal Revenue Code (IRC) is organized into subtitles, chapters, subchapters, and parts, each of which contains related provisions on a particular topic. Subchapter S of Chapter 1 of the IRC (sections 1361 through 1379) is the group of tax laws that deal with S Corps.

To receive this status, a business must be physically located in the U.S., and its owners must meet residency requirements. S Corporations may have up to 100 shareholders and must conform to other regulations regarding payroll.

Why It Matters

While there are many complicated provisions in Subchapter S, the basic feature is easy to understand: taxable income or tax-deductible loss is allocated to the S Corporation owners based on their ownership percentages.

An S Corporation pays no income taxes on profits. Instead, the shareholders include the profit on their returns. So if two shareholders equally own an S Corporation that makes $500,000, for example, each shareholder adds $250,000 of income to his or her return and then pays the tax on that $250,000.

The key factors in determining whether S Corporation status will help you include everything from the size of your company, revenue, and of course, your personal ambitions. As with all things asset protection, there isn't a one-size-fits-all solution. You need to know that an S Corporation is the most suitable structure for you. For instance, a Series LLC may be a more appropriate structure for a beginning investor.

Benefits

Here are a few benefits of using an S Corporation:

Pass-Through Taxation

We already mentioned how investors and business owners can use S Corporations to save on taxes. This is because S Corps election allows profits and losses to "pass through" to the personal tax returns of the shareholders.

Tax Freedoms

When you use an S Corporation, you aren't obligated to pay federal income tax or corporate taxes. It can also be structured to minimize or avoid the self-employment tax altogether. Distributions, for instance, are exempt.

Asset Protection

An effectively structured S Corp paired with an entity such as an LLC can limit personal liability and the liabilities surrounding your real estate holdings. S Corp taxation works effectively alongside other asset protection tools, and can even be applied to series within a Series LLC.

Downsides

Creating a taxable entity with an S Corp election may lower your tax liability, but that doesn't mean it's for everyone. Every tool that has benefits will naturally have drawbacks. Downsides of S Corp elections include:

More Paperwork

Incorporation is a great organizational tool for larger companies needing a tax shelter, asset protection, and stocks. It's also inherently more complicated from an operational standpoint and might be overkill for say, the investor who is starting out with their first rental property and operating with less capital, knowledge, and experience.

You'll need to prepare payroll checks and payroll tax returns (even if the only employee is the business owner). Of course, you'll need to file all relevant federal and the state income tax returns. You'll probably no longer be able to do your tax returns yourself. Electing S Corporation status means you'll need an accounting system (something like QuickBooks) and a formal payroll (even if the only employee is you, the owner). It may be time to start using a real tax accountant if you've relied on the DIY/TurboTax in the past.

FUTA/SUTA Obligations

The IRS requires companies with W-2 employees to pay an extra payroll tax called the **federal unemployment tax** (or FUTA), 6% on the first $7,000 in wages that you paid to an employee during the calendar year, adding up to $420 to your annual tax bill just because you've become an employee. In some states you could also be subject to the **state unemployment tax** (SUTA).

Potential IRS Scrutiny

Service companies are more likely to be scrutinized by the IRS when using an S Corps because most of their earnings come from personal efforts, and not that of other employees. Remember: The salary you set for a shareholder-employer needs to be **reasonable** or the IRS will come knocking.

Form 1120S (Informal Federal Return), which is what an S Corporation files, makes it easy to see when shareholder-employees aren't paying themselves enough. The first deduction that appears on the return is the shareholder-employee salaries. Work with a CPA to research and document the reasons behind the reasonable salary you decide to pay yourself to make sure it will pass the smell test.

Tax Savings Aren't Guaranteed

As I said, investors use the S Corps election to save payroll taxes However, there are cases where an S Corps election won't save money, including:

- If you have substantial personal income (your top tax rate is 40% or higher) but your corporation makes $50,000 or less. In this case, the corporation may actually save tax by operating as a C Corporation. The first $50,000 of a C Corporation's taxable income each year is taxed at 15 percent. The rate jumps to 25% on the next $25,000 of income.
- If shareholders live in a no-tax or low-tax state, the S Corporation approach may not save enough payroll tax to pay for higher out-of-state, non-resident individual income tax on out-of-state profits.

SECTION I: SOLUTIONS

BUSINESS CLASSIFICATIONS

Before you can understand why you, a real estate investor, may need an S Corp (or an LLC with an S Corps election), you need to understand the basics of how businesses are classified. There are two different levels of classification:

- Legal structure
- **Tax status**

Let's look at each in turn.

Legal Structures

There are four common ways to structure real estate investment businesses:

- Sole Proprietorship
- Partnership
- LLC
- Corporation (S-corp or C-corp)

Let's take a look at each one.

Sole Proprietorship

A sole proprietorship may be adequate for a self employed digital worker, but when you begin investing in something like real estate, it will do nothing to protect you. By operating under this structure, your personal assets are indistinguishable from the business's assets and thus at risk if you are hit with a lawsuit.

Converting a sole proprietorship to an S Corps can cut your self-employment taxes since you'll pay those taxes on your salary—not on the distribution to the S-Corps shareholders.

Partnerships

A partnership can be either limited or limited liability, but this structure is available only to businesses with two or more owners. The liability will depend on each partnership's structure, but at least one partner will have limited liability.

Limited Liability Company (LLC)

An LLC can legally separate your business and personal assets, so the only assets at risk are those owned by the LLC if a lawsuit happens.

LLCs can be formed by individuals (single-member), partners, or even large groups (multi-member). By default, single-member LLCs will be treated as sole proprietorships, where owners report income or losses on their personal returns. LLCs with two members or more will be treated as partnerships. Members possess “membership interests, and there are strict limitations on transferability of these interests.

LLCs are managed by the members (usually) or by a non-member manager and aren’t subject to the same record-keeping requirements as corporations.

There are different types of LLCs, so do your homework! If you need a legal structure to hold multiple real estate investments, you may want to consider forming a Series LLC, which allows you to hold your investments in separate “series” within the same LLC. This lets you quickly create an infinitely scalable network of mini-LLCs, building a formidable asset protection structure.

Say you own five properties. Instead of holding all five properties in one LLC, you can create a “series” within your LLC. Each series will hold one property. The benefit of this is if someone sues one of your series and wins, only the property in that series will be affected. The majority of your wealth and assets would be protected.

No matter how many series you have within your LLC, they can all be filed on the same income tax return. This is a huge cost saving benefit you can’t get with a regular LLC.

LLCs are beloved pass-through entities for investors, because profits and losses are simply recorded on the company members’ respective personal income returns. Pass-through tax treatment is still available if you elect to be taxed as an S Corp.

Note: You may hear discussions of the S Corp vs. the LLC as if this is an either-or proposition. It isn’t; you truly can have it both ways. One could in theory form a separate S Corporation entirely, but for most investors, opting to use an LLC taxed as an S Corporation is a simple choice that preserves the beneficial features of both entities. Even better, the LLC taxed as an S Corp is easier to run than a fully separate S Corporation (complete with its many legal requirements).

Corporations (C Corp and S Corp)

As with an LLC, forming a corporation creates an entity separate from your personal life. This gives an additional layer of protection in that corporation owners are protected if a lawsuit is filed against the corporation.

The primary difference between an LLC and a corporation is in taxation and how salary is handled. Real estate corporations can be held liable for corporate actions and earn profits that are considered the business's income and not the owners.

Generally, corporations are:

- Owned by shareholders, who possess freely-transferable "shares" of the business
- Managed by a board of directors and officers
- Subject to strict record-keeping requirements and corporate formalities

For the purposes of this book, an S Corporation is not an entity, but a tax status. Many investors get confused on this topic because a C Corporation is a type of entity and S Corporations are often mentioned alongside entities. We suspect this is the source of the confusion.

Note: A C corporation is what someone thinks of when they think of a traditional corporation. All the publicly held corporations whose names you know are C corporations, and they pay income taxes on the profits they make. That's the difference: S Corporations don't pay income taxes on profits, their owners do.

So, you can elect to be taxed as either an S or C corporation. Why would you choose one over the other?

The short answer: If you are going to bleed your company dry, an S Corp may be better. If you are building a business and need to leave funds with the company to grow the business, a C Corp may be better.

An S Corporation works really well when you're taking all the money out because there's only one tax level—at the shareholder level. That means the owner is the only one that's taxed—the company is not taxed. This is the best option if you're going to take all the money out of the business.

There are also many advantages to going the C Corp route, including a 21% corporate tax rate. In a state like Texas or Wyoming or Nevada (where there aren't corporate taxes), you're getting a 21% flat rate on all the money you leave in the company. The more you can keep in a C corp, the better off you will be because of the 21% tax rate.

In a C Corp, the corporation is taxed, and then, when money is distributed, it's taxed again at the shareholder level. If you're taking money out of the company, it probably should be as salary, because otherwise, you're going to be double taxed.

After you decide how to tax your business (S Corporation or a C Corporation), you need to pay yourself a reasonable salary. You're going to want a bookkeeper.

You're an independent contractor employed by your business now, but you'll have to correctly handle the withholdings. This includes filing the payroll tax reports.

Ultimately, the only way to know which structure is best for your business, portfolio, and plans will be through conversations with personal advisors.

Tax Status

Once you've decided on a legal structure for your business, you'll also have to choose how you want to be taxed. The IRS will assign a default tax status to your corporation or LLC if you don't tell them that you want them to do something different. What your default tax status is depends on the type of entity you formed and how many owners there are.

For example, when you form a corporation, the IRS will automatically consider you to be a C Corp. To be taxed as an S Corp, you can file Form 2553 with the IRS to change your corporation's tax status.

C Corporation Taxation

The IRS acknowledges C Corps as distinct taxpaying entities. This means that the business pays income taxes on its profits and any profits that are distributed to the owners will be taxed again as their individual income.

S Corporation Taxation

S Corps are "pass-through" entities. They don't pay taxes. Instead, the company's profits (or losses) are passed through to its owners for tax purposes. Each owner will include their portion of the company's profits and losses on their personal tax returns and pay taxes based on their individual tax bracket. Additionally, any distributions are not subject to Social Security taxes as long as you're paying yourself a reasonable salary.

Most investors who elect to use S Corporations do so for the tax benefits. Owners are exempt from federal corporate income tax, and are instead taxed at a flat rate that is substantially lower than the standard C Corporation tax.

C Corp income is taxed twice: once at the corporate level, and once at the individual level (as a dividend). S Corps avoid this double taxation by passing all of their income through to their owners. The business doesn't pay taxes; only the owners do.

Pass-Through Taxation

A pass-through entity is a business structure, such as an LLC, series LLC, or S Corporation. We use the term "pass-through" because you can claim the income of these types of businesses on your personal income tax returns instead of a separate business tax return. Normally, other business structures have to file a business tax return.

That means you won't be taxed twice and or have to pay thousands of dollars to a CPA to file a business tax return.

Do you and your spouse file joint income tax returns? That's no problem, the above would still apply. But there are some instances where you will have to file a separate return, despite using a pass-through entity.

What about multi-member LLCs? Some states require at least two members in an LLC. Let's say, for example, you and your partner have an LLC. You're going to file what's known as a partnership return—a separate return for the business itself.

Due to the complexity of a partnership return, you're most likely going to want somebody to help you prepare it. I suggest you hire a CPA who is also a real estate investor.

Remember: An LLC may be taxed as a corporation. It may make sense in terms for your operating company to have your LLC taxed as an S Corporation. This is the "election" we'll be looking at in the rest of this book.

SECTION II:
OWNERS MANUAL

HOW TO SET UP

An S Corporation can protect your assets and save taxes. Of course, to reap these benefits it must be professionally created. To make the election, a business files a **2553** form with the IRS naming the corporation, limited partnership or LLC and stating that all the owners agree with the election. You need to have the corporation or LLC already in existence. You also need to make the election by March 15.

Cost to Create

There are also costs to creating an S Corps and filing a separate tax return if you're not already a partnership. There are also administrative requirements such as setting up a board of directors and holding meetings.

There are costs involved with setting up and maintaining an S Corp, which will have to be weighed against any tax savings. In many cases this strategy will make sense for higher income earners (people earning at least $50,000 from their business).

Discuss the advantages and disadvantages of this strategy with your CPA to find out if an S Corps election makes sense for you based on your personal circumstances.

Finally, S Corporations are required to have an Employer Identification Number (EIN). At tax time, they file a Form 1120S (Informal Federal Return) … Not to be confused with Form 1120 for C corporations). Every S corp needs to file one, including LLCs that are taxed as S corps

The Shareholder's Agreement

S Corporations with multiple shareholders usually need a shareholders' agreement that reduces the chances of voiding the S Corporation's "S" status. A well-drafted LLC operating agreement or set of corporate by-laws may contain language that works as an S Corporation shareholders agreement if the LLC owners anticipated becoming an S Corporation.

Here are some things that should appear in the shareholders' agreement:

Prohibited Actions

Anything that would terminate the S corp status can be enumerated here. For example, selling stock to an ineligible S Corporation shareholder.

An Indemnity Clause

For example, if a shareholder does do something that damages an S Corporation or its shareholders, that shareholder promises to pay any taxes resulting from any accidental or intentional termination of “S” status.

Remedies

The shareholders agreement should outline how an accidental termination should be handled. Shareholders should agree to take remedial action as needed. Correcting the ineligibility (and perhaps a little pleading with the IRS) will usually fix the problem. If shareholders immediately correct the problem, the S Corp should not lose its status.

Corporate Compliance

You want to be sure to do everything you can to protect your business. One thing you simply can’t afford to ignore as a business owner is compliance.

The consequences of noncompliance aren’t pretty. If your LLC or S Corp are noncompliant because you used cookie-cutter documents from the likes of LegalZoom, you may have no real lawsuit protection. With so much on the line, why play around?

Broadly speaking, corporate compliance describes how closely your company adheres to the law. You can break it down into two basic categories:

- Internal compliance
- External compliance

Internal compliance allows you to control your “in-house” liabilities. It refers to founding documents, company policies, and operating procedures. Setting up the proper type of company, asset protection, contractor and property manager issues—internal compliance refers to all these.

External compliance, on the other hand, is more focused on the legal pieces of your company needs. It relates to the laws, ordinances, and any other regulations from other bodies you must follow. For investors with property in multiple states, you may be dealing with multiple state-level agencies for compliance reasons.

If you’re skilled in compliance, say, because you’re a real estate agent, CPA, or lawyer (thanks for reading, by the way--we love our attorney readers!), you can save serious cash by DIYing the services you provide and simplifying paying for the rest. The value of a full-service firm is greater for real estate investors who don’t have the time or inclination to research all their options. Or if you only need specific services, many firms offer a la carte financial, legal, and tax services. You can pick and choose what you need. If you only need tax services from a real estate-experienced CPA, for instance, this is usually an option.

Trained real estate attorneys and other tax experts can let you rest easy, knowing your legal structures are properly formed. Attorneys can help you satisfy the most critical pieces of external compliance, which in our opinion are:

- **Federal law compliance.** Keep the Department of Labor and Taxman happy! You can prevent lawsuits by being familiar with legislation like the Fair Housing Act.
- **State law compliance.** State laws determine which entities you can access most easily and which will ultimately offer you the greatest protections. You may wish to form out-of-state if you and your lawyer determine another state is friendly to your business.
- **Local ordinances and regulations.** Local laws can screw you over if you get it wrong. Chat with another local investor for free advice, or rub elbows with a local pro at a networking event to get some free tips on "stuff you didn't know about your city's rental property quirks."

Losing S Corps Status

Doing something that an S Corporation is prohibited from doing may result in termination of the S election. The IRS has several restrictions for S Corporation ownership:

- The S Corporation cannot have more than 100 owners (shareholders). By contrast, LLCs have an unlimited number of owners, they are also allowed to have unlimited subsidiaries or series.
- All shareholders must be one of the following:
    - U.S. citizens
    - Permanent residents
    - Single member LLCs owned by a US citizen or a permanent resident
    - Qualified subchapter S trusts
    - Some voting trusts
    - Testamentary trusts created by a will
    - Grantor trusts
    - Bankruptcy estates

- Revocable trusts created as part of an estate
- A qualified exempt organizations

Note: If you are a U.S. citizen or permanent resident and the single owner (or single member) of an LLC, tax law ignores the LLC because it is a pass-through tax entity. If your single-member LLC owns an S Corporation, tax law sees you as the "real" owner of the S Corporation—not the LLC.

In addition to tax benefits, a major advantage to forming a corporation is the protection it offers your personal assets in case the business gets sued. You should never use business money to pay for personal expenses; you could lose the protection of the corporation in the event of a lawsuit because you have **commingled assets**.

If an S Corp shareholder sells shares to a partnership or C corporation, that new ineligible shareholder may terminate eligibility. Remember: only U.S. citizens or permanent residents can own shares in an S Corporation.

Likewise, if a permanent resident shareholder loses his or her green card, that can terminate eligibility.

Other compliance issues to note:

- An S Corporation can have only one class of stock. This means shareholders must receive the exact same per-share distribution amount. The majority shareholder, for example, can't get more because preferential treatment creates a second class of stock. which terminates the entity's eligibility to use the Subchapter S status.
- In some situations, an S Corporation can own another S Corporation. The subsidiary S Corps is called a qualified subchapter S Corporation, or QSUB. The parent S Corporation owes federal and state taxes; the QSUB income and deductions get bundled with the "parent's" income and deductions.
- Partnerships and regular C corporations can't own shares in an S Corporation, but an S Corporation can own shares in a partnership or C Corporation.
- An S Corporation can own an interest in a partnership. A partnership that includes S Corporations can sidestep shareholder eligibility requirements. For example, two 100-shareholder S Corporations could form a partnership and not be subject to the 100-shareholders-or-less rule.
- An S Corporation can form a partnership with partners who would normally be ineligible S Corporation shareholders (such as a nonresident alien).

HOW TO STRUCTURE

You don't necessarily get tax deductions or tax benefits by incorporating as an S Corp or by forming a limited liability company. However, businesses and their owners may pay different amounts or types of tax with different types of entities.

Improperly established, noncompliant or mismanaged business structures are pointless at best and costly at worst. Your entire asset protection plan can be undermined by one poorly structured or managed entity.

There are a number of ways to go about setting up these structures. Let's look at some common approaches.

The LLC/Series LLC Combo

Many investors love the tried-and-true method of pairing the Traditional LLC with the Series LLC. Under this model, the Traditional LLC serves as an operating (or shell) company. It manages day-to-day activities like collecting rent and paying employees.

Meanwhile, the Series LLC functions as an asset-holding company. It must never interact with the world, because that's what the operating company does.

That Traditional LLC is the company we actually want a would-be litigant to target. It doesn't own anything. The company that does own all your assets is the Series LLC, which is never exposed to those liability-magnet business operations. By separating these functions structurally, you prevent lawsuits before they even begin simply because it's harder to sue this structure than a person. The system works, and your assets stay under your control.

To maximize the Series LLC's effectiveness, you may create as many series as you have assets, directing your attorney to help you make the appropriate transfers so each asset is in its own series. This gives you a basic two-company structure. Use it correctly, and it can protect your real estate assets for life.

No matter what kind of LLC you use—Traditional LLC, Series LLC, a combination of both, a special variation like a Qualified Joint Venture LLC (for married couples), or even multiple LLCs with other structures on top—it's important to set it up correctly. All your business choices must be clearly conveyed in the operating agreement, along with any agreements between partners specifying rules, expectations, and plans for dividing profits and losses.

Corporate LLC Management

LLCs are a simple way for small businesses and investors to structure their business. They don't need much more than an operating agreement to get started, and they require less formal governance than an S Corporation.

Usually people ask me if a corporation can own an LLC, but this is an example of someone asking the wrong question for the information they seek. Of course a company can buy an LLC, but they're usually referring to using a corporation in lieu of a single human manager.

So yes, a corporation *can* manage an LLC. So now the question becomes: How do you decide if corporate LLC management is right for you?

Most of the time, LLCs are hands-down quicker, easier and cheaper—one filing fee, one Operating Agreement, no meetings or minutes or board members to handle or worry about paying. With an LLC treated as a sole proprietorship or partnership, you keep your accounting easier and deductions flow more easily to your personal return.

Corporations are best suited to larger businesses. By "large," we mean the kind where a C-level executive team, board of directors, and stock options aren't just given but are important details. For starters, corporations require more legal steps than LLCs, including:

- Naming a board of directors.
- Mandatory meetings (complete with required minutes).
- Maintaining corporate compliance (which is far more challenging than with alternative entities, almost always requiring some form of professional legal or financial help).
- Tax, legal, and regulatory compliance concerns.

That said, some businesses need the benefits of corporations, so the increased regulations are simply the price of admission. Others are just fine with cheaper entities.

When a corporation manages your LLC, you can think of the corporation as standing in for a human manager. There's a long history in American law of treating corporations as people, a concept known in legalese as **corporate personhood**.

A corporation only helps protect your assets if it's in lock-step with your business plans. For this reason, many investors choose to form their own corporation that is friendly to the LLC. It's best to assess your members' basic needs and study corporation management before making this call.

To form a corporation to manage your LLC, you've got two options: the C Corporation and S Corporation. Of the two, the S Corporation is far more popular.

Depending on the type of corporation you form, you may have several individuals collectively making decisions. In fact, your corporation can actually have an unlimited number of managers internally.

For most investors, using a corporation is overkill. An LLC or two-company Series LLC and shell corporation structure is more effective. Although this book is about the S Corps, a corporation-managed LLC is not the most common way to go.

LLC With S Corps Election

At some point, however, *the S Corporation election may give you pass-through benefits that can possibly save thousands in taxes*. Real estate investors may also opt to tax their LLC as an S Corp because asset protection for active businesses is ideal for this structure. House flippers or vacation renters are examples of "active" real estate businesses, as we will see.

With a limited liability company taxed as an S Corp, you retain the simplified governance procedures (the operating agreement).

There are some significant differences between LLCs and S Corporations. For example, S Corporations are required to file business tax returns. LLCs only need to do so if they are owned by multiple individuals.

S Corporations have several internal formalities that must be fulfilled in order to maintain their limited liability. Bylaws, stock issuance, meetings and meeting minutes are all required. This is not so for an LLC or any of its series.

Finally, there are a few rules of thumb when incorporating a sole proprietorship or a partnership as an S Corporation:

- A sole proprietorship that incorporates into a one-person corporation should not contribute any personal liabilities (such as credit card balances) to the new corporation.

- You also shouldn't contribute more liabilities than assets to your new corporation; doing so may leave you on the hook for tax on liabilities you offload.

- If a partnership incorporates, the partners need to be aware of liabilities. Make sure your accountant is comfortable working with "Section 351 Transfers," referring to the tax law that specifies how incorporation can not trigger income taxes. Be aware of how the IRS defines "control." The incorporating shareholders should own at least 80% of stock to be considered in control.

- You can give a proprietor or a partner stock in the new corporation for the assets and services they contribute, but that transaction will be taxable to the recipient. It's not unlike paying someone a wage using company stock.

Managing an LLC Taxed as an S Corp

Then there's the question of management. An S Corporation must have a board of directors and officers. With an LLC, owners can choose to manage their business or they can elect to hire an outside person to act as manager.

- **Member-managed LLCs.** These are by far the majority. Power tends to be divided equitably among the members. A single-member LLC is essentially managed this way by default.
- **Manager-managed LLCs.** An LLC that appoints a manager will legally give that manager certain powers. Doing so is essential so the manager can run the LLC's daily operations. Managers may buy or sell assets, hire and fire employees, and take other actions that directly impact members. Members must have confidence in their manager and protect themselves with a well-crafted Operating Agreement.

If you have a great person in mind and nobody on your team will rise to the occasion, a manager's a great way to go. If each member has confidence the manager is trustworthy, and all ensure that the Operating Agreement of the LLC accurately reflects their desires, then a manager can be a great thing for a real estate LLC.

HOW TO CONTROL REAL ESTATE

If you are an **active** real estate flipper or wholesaler, you are more than likely subject to the self-employment tax. Since a flipping or wholesaling business is considered an active business, you are subject to the full 15.3% self-employment tax, which can lead up to an $21,068.10 tax on your earnings for 2020!

Typically, rental real estate is a **passive** activity, reported on Schedule E. Profits are subject to income tax—not self employment tax (currently 15.3%)

An active trade or business, on the other hand, is subject to the self-employment tax—and that's where the S Corps election comes in handy.

Flipping

Some real estate investors aren't really investors (at least according to tax laws). They are really property developers who renovate and rehab. They're **flippers**. Not every flipper will even benefit from S Corp taxation, but enough do that you should consider it as an option.

Profits from flipping real estate may be subject to both income tax and self employment taxes. Flipping is an active business. Compare flipping to buy-and-hold investing, where investors are relying on passive income. Just as with any other active trade or business, an S Corps may be a good idea in this case.

Flipping is different from other investing strategies. There are a few things flippers should know about organizing and defending their real estate portfolios. Chief among these is how to construct an asset protection strategy that adequately defends against lawsuits and forms a sound structure for active real estate businesses. LLCs taxed as S Corporations are popular with flippers.

You may set up a separate property management company that operates as an S Corporation for benefits of incorporation (like pension plans and health insurance). In this case, the S Corporation wouldn't own the real estate. You would own the real estate directly or through an LLC. You're using the S Corporation for an active trade or business—not to hold your real estate.

A few things to consider:

- **How frequently do you plan to make transactions?** Many flippers will have a property bought and sold inside of a year, for example. Certain entities are better for frequent transactions vs. rarer ones.
- **Licensing and other operations issues.** There may be reasons for a savvy house flipper to get a real estate license (or work with a team member who has one), even if doing so isn't legally necessary. What's best for you in terms of daily operations will come down to many factors, including personal preference.
- **What percentage of business is your flipping activity?** If you are exclusively a flipper, you will almost certainly require a different approach than an investor with only minor flipping activity or who doesn't rely on flipping transactions for profit.

It's vital that those engaged in active real estate flipping find a way to limit inherent liabilities. For many flippers, the LLC helps square both the issue of liability and how to formalize the flipping business.

AirBnB

If you have Airbnb properties, you may have an active trade on your hands (rather than a passive real estate investing business).

For starters, if you are renting part of your home as an Airbnb for 14 days or less, you do not have to report or pay taxes on that income at all. Nice, right? Of course, you cannot deduct related expenses either.

The duration of the average stay at your Airbnb also does not cause you to be subject to the self-employment tax.

However, when your average stay is less than 7 days, it is considered a business and not a rental activity, and is reported on Schedule C. Normally, income reported on Schedule C is subject to the self-employment tax, but that's not always the case for rental properties.

Schedule C is the tax form filed by most sole proprietors. As you can tell from its title, "Profit or Loss From Business," it is used to report both income and losses. Many times, Schedule C filers are self-employed taxpayers who are just getting their businesses started.

So if you are renting out a property using Airbnb or a similar service, and want to completely avoid the self-employment tax, then it is important not to provide **substantial services** to your guests. As long as you are simply renting out your Airbnb and providing no additional services, you will avoid the 15.3% self-employment tax, even if it is reported on Schedule C.

For a rental property to be subject to the self-employment tax, you would provide substantial services such as:

- Changing linens
- Providing fresh towels
- Cleaning the rooms during a guest's stay
- Providing hotel-like conveniences such as a coffee maker and coffee
- Providing vehicles, bikes, or excursion options.

This is because you are now providing a more hotel-like service, which is considered a business and subject to the self-employment tax.

So what if you do provide substantial services to your guests, now what?

Well, there are a handful of things that can help you mitigate the self-employment tax. The first is making sure you are properly tracking and deducting all your rental expenses, including depreciation. As we know this "phantom expense" can cause a property to show a loss for tax purposes, or at the very least significantly reduce the net income.

The next is putting your Airbnb properties in an S Corp, or an LLC taxed as an S Corp. By doing this you can split your income between W-2 wages, which are subject to the self-employment tax, and distributions which are not.

Something to keep in mind: If you're already earning $137,700 or more before your Airbnb income, you will only pay the 2.9% Medicare portion of the tax (1.45% for the employer and 1.45% for the employee, or 2.9% total) because the Social Security portion of the tax is capped on $137,700 of income.

Transferring Property

One reason to avoid using an S Corporation for real estate investing concerns the problem of later on getting the real estate out of the Corporation.

Section 351 of the Internal Revenue Code requires that you contribute "property" to a corporation in exchange for stock. You can put real estate into a corporation you own without tax consequences as long as you follow the rules of Section 351, but you can't typically remove real estate from an S Corporation without tax consequence. The distribution of property from an S Corporation means any appreciation of the real estate gets taxed when you remove it.

However, if you put real estate into a partnership or an LLC treated as a partnership, you can pull the real estate out without tax consequences. You may eventually want to transfer ownership of your real estate to some other family member.

You can not gift real estate to a family member from the S Corporation without paying tax at the time the asset is removed from the S Corporation. If you own real estate through an LLC, you can gift the property without paying any income tax.

SECTION III:
BIGGER PICTURE

TAXES

One of the appealing aspects of the LLC or Series LLCs is that you get to choose the manner in which it is taxed. In fact, if you own a Series LLC, you can tax each Series differently if you want.

You may make your pick from any of the following three tax status elections when forming an LLC (or Series within a Series LLC):

- Disregarded Entity
- Partnership
- S Corporation

Disregarded Entity

A pass-through entity, also commonly referred to as a flow-through entity, allows taxes to be passed onto your personal tax return. LLCs with one owner, or "member", can be disregarded (or ignored) for tax purposes. This simply means that the owner reports the LLC's activities on his or her regular income tax return. Single-member LLCs and married couple LLCs are typically treated this way automatically in most jurisdictions.

Partnership

Partnership taxation is the default status of multi-member LLCs. Each member receives a Schedule K-1 and reports their share of the profits and losses. This information, along with a completed Form 1065 for partnership taxation, will be attached to members' tax returns. In this way, the company isn't billed, but the members each pay self-employment taxes.

S Corporation

By electing to have a multiple-member LLC treated as an S Corporation, the LLC saves the owners self-employment taxes in the same way that an LLC treated as a sole proprietorship saves its owner self-employment taxes.

This election makes sense for anyone who would benefit from the lower tax rate on the entity's first $75,000 in income. It's treated more like a corporation, albeit with different provisions than the more complex C Corporation. It also comes with a super sexy form called **Form 8332**. Filling it out might not be a blast, but the savings sure can be for certain investors.

It is important to be aware that the above are simply tax classifications—not types of entities. It can be easy to get the impression that an S Corporation is an entity when indeed it is a tax status. A C Corporation is an entity, and the similar names are probably where this confusion comes from.

S Corps Election Tax Rates

As we covered earlier, if you are an active real estate flipper or wholesaler, you are more than likely subject to the full 15.3% self-employment tax. You calculate your self-employment tax on Schedule SE of IRS Form 1040, but here's the basics:

Self Employment Tax Rates					
Year	Social Security (SS) Tax (%)	Medicare Tax (%)	Total (%)	Max Earnings Subject to SS Self-Employment Tax	Total Tax
2019	12.40	2.90	15.30	$132,900	$20,334.34
2020	12.40	2.90	15.30	$137,700	$21,068.10
2021	12.40	2.90	15.30	$142,800	$21,849.10

Creating an LLC taxed as an S Corp allows you to hire yourself as a W-2 employee and split your earnings between salary and distributions. In this strategy, you only pay the 15.3% self-employment tax on the part of your income considered **salary**, and not on the **distributions**.

As we already stated, it is important to note that the wage or salary you pay yourself must be reasonable, otherwise the IRS might charge you back taxes and penalties (i.e. your wages can't be $1 and dividends $99,999).

If you are simply a sole proprietor (or partner) and all your real estate investing profits are considered active, up to $137,700 would be subject to the 15.3% self-employment tax, totaling $21,068.10.

However, if you set up an LLC and elect to be taxed as an S Corp, you can split the earnings between salary and distributions. With the help of a CPA, you determine $65,000 to be a reasonable salary. This means you will only pay the self-employment tax on $65,000, saving more than half.

TAKING MONEY FROM YOUR S CORP

So how do you access the money that your S Corp makes? I'm assuming you didn't start a business for your health: you're doing it to make money to cover personal expenses.

If you want to take money out of your S Corp, you have three options:

- Take a distribution
- Pay yourself a salary
- Give yourself a loan

Take A Distribution

Distributions are the best way to get money from your S Corp. Because you'll report it as "passive income" on your income tax return, it won't be subject to employment taxes. This saves you money!

Because S Corps are pass-through entities, you have to report your business's income on your personal return whether you actually receive it as a distribution or not. The upside of this is that you won't have to pay additional taxes on a distribution unless it constitutes a capital gain. A lawyer or tax accountant can help you determine the most advantageous way to take your distributions.

Pay Yourself A Salary

Unfortunately, Uncle Sam won't let you take all of the money out of your S Corp as distributions, because the government wants your tax money. This is why the IRS requires that you pay yourself a "reasonable" salary for your contributions to the company. You should try to minimize the amount of salary you take while still meeting the "reasonable" standard.

True to form, the IRS doesn't give any specific guidance as to what "reasonable" means. Some factors that courts have considered when deciding whether a salary is reasonable include:

- Your training

- Your experience
- The type and quantity of work performed
- Prior distributions received
- The time and effort devoted to the business

Another way to look at it is to pay yourself what you would pay somebody else to do your job.

Give Yourself A Loan

When you're taking money out of an S Corp other than your salary, you can set up a line of credit between you and your business. Then, you'll take cash out as a loan against that line of credit. At the end of the year, you and your accountant can decide if you should convert some of that loan to a distribution or leave it as a loan (you'll need to pay interest on the loan). If you borrow money from the corporation (via a loan), you're never going to have capital gains.

However, even if you list your withdrawal of funds as a loan on your financial statements, the IRS can recharacterize it as a distribution. If Uncle Sam recharacterizes your loan, you'll have to pay income taxes on it just as you would a distribution.

If you take out a loan from your S Corp, you need to dot your i's and cross your t's to make sure it stays characterized as a loan. For example, creating a legally enforceable promissory note helps prove that the transaction was actually meant to be a loan. Before you take a loan from your S Corp, you should seek advice from your lawyer and your accountant.

ASSET PROTECTION & ESTATE PLANNING

With Land Trusts

We've looked at how an LLC taxed as an S Corps can help you with taxes. Now, let's look at what happens when you upgrade your LLC (with S Corps election). Using a trust, you add anonymity to your business dealings and you can increase your level of protection.

If your Land Trust or its members are part of an entity like an LLC, S Corp, or Series LLC, some states will allow you to incorporate the Land Trust into these other entities and agreements. All of these entities also receive pass-through tax treatment. You'll want to ensure your operating agreement distributes profits and tax benefits equitably.

Again, an improperly structured operating agreement can effectively cancel out your pass-through benefits.

A Land Trust can be created and signed by a "nominee trustee" (your attorney), and that is the name that appears on the public record. You transfer your property into the Land Trust and assign the LLC (with S Corps election) as the beneficiary.

With Retirement Plans

Real estate investors, like anyone else, need peace of mind and financial security by the time they retire. Luckily, there are a lot of great retirement plan options available today. The most well known types include an individual retirement account (IRA) or a 401(k) plan as offered by an employer. These plans allow account owners to invest in mutual funds, bonds and stocks.

However, did you know both types of accounts come with another option? A self-directed IRA (SDIRA) or self-directed 401(k) plan offers many more investment options than regular IRA or 401(k) accounts do. This includes real estate, life insurance, private placements, precious metals, renewable energy sources and much more.

If your business has been incorporated as an An S Corp or C Corp, and you've filed all the proper paperwork to be considered a separate legal entity, then you qualify for a self-directed 401(k) or IRA.

CLOSING

A full-service entity formation firm like Royal Legal Solutions helps take some of the guesswork out of forming your real estate business entity. We also give you a place to go with your questions.

Don't fall for the cheap allure of one-size-fits-all online LLC-in-a-box services. They give you the same thing all their clients get: a one-size-fits-all entity. Remember: lawyers are more effective than LegalZoom and other template companies!

A full-service entity formation firm will listen to, understand, and explain things, making a genuine assessment of what is best based on your situation and their own expertise. Document services usually won't even mention, let alone offer, these nuanced options.

A full-service firm means legal experts draft your legal documents, file the appropriate information with the state, and customize your entity to your needs. Say you want to bring in a partner on one deal, but not another. Or maybe you'd like a Series LLC because you plan to grow your portfolio. These are simple goals to accomplish when you have a full range of legal tools and experts who know how to use them.

A personalized consultation gives you the chance to explain your business and your ambitions, The entity formation firm will need time to do your legal work, make appropriate filings with the state, and ensure your entity will work for you. The process may take about six weeks, but your project may take more or less time depending on its complexity and the components of your strategy.

Once your entity is formed, an entity formation firm can also advise you on the best way to use your new structure. This level of personal attention, and your ability to ask real experts your personal questions, is what makes full-service formation far more worthwhile than a quickie online service. Other companies may be happy to form your entity but will gladly go silent when it comes to how to use it. Most of the time, this is because these companies aren't allowed to give you legal advice like lawyers can. Giving advice isn't what they do. Selling pre-fabricated LLCs is.