How do I start a real estate company? Should I use an LLC or a Corporation?

When you are planning to purchase a rental property, you need to consider how you will own this property. Of course, you may own a property in your own name; however, if you are going to be renting the property to tenants, it makes sense to limit your personal liability by taking the steps to form a limited liability company ("LLC") with the secretary of state and own said real estate in the name of the LLC. There is a lot of information out there on entity selection, but when it comes to the type of entity that you will use to own real estate, you need to choose a limited liability company, aka an LLC. This is the best option, not a corporation.

1. Taxes on transferring real estate to an entity

Corporation

If you own 100% of a corporation, then this isn't going to be an issue, but as you add more and more shareholders, the more complicated this analysis gets. Timing is everything here. You need to be concerned about which shareholders are contributing property to the corporation at a given time in exchange for shares of the corporation and what percentage of the shares contributing shareholders own of the corporation. Basically, those contributing appreciated property to a corporation need to own at least 80% of the corporation after the transfer for the transaction to be tax free.

LLC

Contributing property to an LLC is much simpler, in that it is not an immediate taxable event, so the basis that members have in contributed property is going to carryover and be the same for the LLC. There are no control requirements that need to be met like the above 80% threshold.

There are additional considerations if the real property being transferred is subject to a debt that I will not cover in this article.

2. Transferring property out of an entity

Corporation

Let's say you never transferred property to a corporation, you formed your corporation and then purchased property in the corporation's name and 1 doesn't apply to you. Down the road, you are going to be forced to recognize gain when you either sell the property, move the property out of the corporation for estate planning purposes, or distribute the property to a shareholder, regardless of whether or not you are liquidating the corporation.

LLC

When you transfer real property to a member, there is generally no recognition of gain or loss until the member actually disposed of the real property. The member will maintain the LLC's basis in the property prior to the distribution and allows the built-in-gain to remain with the real property.

3. Distribution of Profits and Classes of Units

Corporation

If you have a corporation, owners can file an "S Election," which means it will only be subject to one level of taxation. If you hear people use the term "S Corporation," this is what they mean, a corporation that filed a valid S Election. The alternate to an S Corporation is the default and is referred to a C

Corporation. A C Corporation is taxed at both the Corporate and individual level.

You certainly don't want two levels of taxation for your real estate company, so you most let's assume you would file the S Election. Even then, there are other limitations on how profits can be distributed because the S Corporation is subject to the one class of stock rule. There are certain exceptions to this rule, but, in general, it means that all of the shares must confer identical rights of distribution and liquidation proceeds.

LLC

In contrast, the LLC offers pass through taxation by default, meaning (i) you don't need to file an election for a single level of taxation, and (ii) the profits are taxed to the individual members only. Additionally, there is much more flexibility on how profits can be distributed because there are no restrictions on the types and classes of units that an LLC can have.

Creating multiple classes of units can be very desirable at times. For example, let's say there are two people who own an entity. One of the parties contributes more or a larger portion of the capital to purchase a certain property. The members want the voting rights to be equal, but when it comes to the financial success of the company, the members want this split to reflect the unequal contribution of capital. With an LLC you can have two classes of membership units, so that one class would be voting units and be split equally. You can issue an additional class of membership units to reflect the financial ownership of the company. Here you can structure the LLC so there are preferred returns and the member that contributed capital will get a certain amount of the profits until they have recouped his investment, and then be split 50/50 thereafter.

You cannot similarly differentiate these benefits between shares of an S Corporation due to the one class of stock rule. If you do, you will probably be treated as a C Corporation and subject to two levels of taxation.

4. Flexibility of ownership

Corporation

There are a lot of limitations on who can own stock in an S Corporation. For example, another corporation, partnership, or a non-resident alien are prohibited from owning shares of an S Corporation.

LLC

The same is not true for an LLC. A corporation, partnership, or non-resident alien can all own shares of an LLC. This can be helpful if you plan to own multiple properties and plan to place each property in a standalone entity, grouping them all under one parent LLC for ease of administrative burden.

5. Flexibility of management structure

Corporation

When it comes to Corporations, those who own shares of a Corporation are referred to as "Shareholders." The Shareholders have to elect at least one Director, per Ohio law. The Shareholders carry out some duties required by law, but in large part the Director(s) exercise the powers of the Corporation. A corporation also needs Officers, which minimally include a president, a secretary, and treasurer. The same person can hold multiple titles, but you can imagine, being a sole member is a much easier.

LLC

When you own units of an LLC you are referred to as a "Member." Members can fully manage the LLC. In other words, it is easy for the people who own the company to manage the day to day operations of the company. When you have more members than just yourself, perhaps with varying ownership percentages in the LLC, you need to consider whether you will be Manager managed, rather than Member Managed. We will discuss in another article the difference between a Member Managed and Manager Managed LLC.

As you can see, there are numerous benefits to owning real property in an LLC. As always, each situation is unique, so reach out to an attorney at CPM to discuss your circumstances and the course of action that makes the most sense for you and the real estate you own or plan to own.