



Mary Hanson



## About the Business Advisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

Mary Hanson has a law degree from the University of Wisconsin and an MBA from the University of Southern California. She has practiced business law exclusively for 26 years.

She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

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## LLCS AND S CORPORATIONS: Points and Considerations

by Mary Hanson

**I**n 2004 I wrote an article about why the S corporation is typically the best entity choice for an active operating business and the limited liability company (“LLC”) is typically the best choice for real estate investment.

Since then I’ve seen a number of situations in which errors were made in choosing an entity.

I’ve seen more problems with active operating businesses operated as LLCs. I’ve seen corporate businesses in which the owners were not prepared to properly operate the business as a corporation. And I’ve seen a trend in which real estate investments are really real estate development. The tax treatment for real estate DEVELOPMENT is very different from the tax treatment for real estate INVESTMENT.

Each of these underline the need for business owners to be more cautious in the selection of the entity to be used for a particular business or investment activity.

The typical reasons for using an S corporation for an active operating business are:

- An active operating business (sales, services, manufacturing) does not have much need for the

partnership tax treatment of the LLC. Both an S corporation and an LLC will flow profits or losses to the shareholders or members in the same manner.

- The S corporation is easier to structure than the LLC, because corporation law sets out a structure for the corporation, while the flexibility permitted for the structure of the LLC requires much more work by the participants in an LLC to define the structure of the LLC.
- An active operating business should aspire to gross over \$1,000,000 per year. As an S corporation, the gross income subjects the entity to no tax. As a California LLC, the same business with gross revenues in excess of \$1,000,000 would be subject to a gross receipts tax of \$6,000.
- The corporate structure is more familiar to lenders, vendors, customers, and others dealing with the business.
- An S corporation does not subject shareholder/employees to self-employment tax. A business owner operating his or her business as an LLC that is taxed as a partnership will be subject to self-employment tax, just as partners in a partnership are.

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*“An active operating business (sales, services, manufacturing) does not have much need for the partnership tax treatment of the LLC.”*

- In California a business providing services requiring a license, certification, or registration under the Business and Professions Code, the Chiropractic Act, or the Osteopathic Act (which includes construction, painting, landscaping, law, accounting, medicine, cosmetology, etc.) cannot be operated as an LLC.
- If one partner buys out another in an S corporation, there is no change in the tax treatment as a result of the buyout. In contrast, an LLC that is taxed as a partnership must sometimes be treated as liquidated as the result of a buyout. The tax provision that applies requires the deemed liquidation of a partnership entity that has a 50% or more change in ownership within a year.

## LLCs

The typical reasons for using LLCs for real estate investments are:

- The LLC’s partnership tax treatment flows all taxes to the members. The members get protection from personal liability along with true partnership taxation. In contrast, the S corporation tax treatment is SIMILAR to partnership tax treatment, but has a number of differences that result in taxes at the corporate level. The LLC more completely avoids two levels of tax.
- The LLC can be structured to be managed by all the members, by one manager, or by several

managers, with the powers of the managers set out in the operating agreement. The corporate requirements of a board of directors, authorization by vote of the board, and annual meetings, do not apply to an LLC.

- Most real estate investments don’t even get to the \$250,000 threshold for the California gross receipts tax. A real estate investment can avoid the gross receipts tax until the year that real property is sold, generating revenues subject to the gross receipts tax.
- California law regarding LLCs makes it difficult for a creditor of a member to take over the member’s interest. Both California law and the LLC agreement created by the members in structuring the LLC usually provide effective obstacles to a creditor who would otherwise like to become a participant in the LLC. In contrast, a creditor of a corporate shareholder could get a judgment against the shareholder, foreclose on corporate stock, and begin voting the shares of stock as their owner.

Despite the good reasons to use an LLC for real estate investments, there are a number of reasons that the LLC can be a poor choice of entity. These include:

- (1) California’s gross receipts tax is applied to California LLCs and also to foreign LLCs (e.g., an Arizona LLC formed to hold Arizona rental property) if the

## LLCS AND S CORPORATIONS: Points and Considerations

managers are residents of California. Unless managers who are California residents can make a persuasive argument that all their management decisions were made in another state, the Franchise Tax Board will impose the California gross receipts tax and the annual \$800 tax on the foreign LLC.

(2) Self-employment taxes apply to an LLC member's portion of LLC income if the member manages or actively participates in LLC activities, unless the LLC only receives rent, interest, and other PASSIVE income. There is no problem for the typical use of an LLC for ownership of rental real estate. But for any active business or trade, including development of real estate, this tax treatment can make the LLC a poor choice. Self-employment taxes are the same taxes that sole proprietors and partners pay on income up to \$94,200 for Social Security at 12.4% and on all income for Medicare, at 2.9%. A corporate shareholder is only subject to these payroll taxes on income he or she receives as an employee of the corporation, and these are split between the corporation and the employee.

(3) If an investor decides to go into the business of purchasing, fixing up, and selling properties rather than holding properties for rent, the use of an LLC to do so subjects the owner to the self-employment tax described in (2) above. Whether the entity is an LLC, a corporation, or any other

type of entity, the nature of this activity is considered DEVELOPMENT of real estate for sale, which is a "trade or business" for tax purposes, and not a passive INVESTMENT activity. The tax treatment changes dramatically. Sales of real property by an entity so engaged in the "trade or business" of real estate sales, will result in ORDINARY INCOME TAXES rather than capital gains taxes.

The determination of whether the activity is development rather than investment is based on whether the property is held for sale to customers rather than for use by the owner or for the purpose of generating rental income. This determination is not black and white, but depends on factors such as: the purpose for which property was purchased, the extent of improvements made, the frequency and number of sales, the extent of advertising and promotion for buyers, and the purpose for which the property was held at the time of sale.

The use of an LLC rather than an S corporation for development activities can result in ordinary income rates on sales of property, plus self-employment taxes for active managers of the project. Where a solo owner plans to develop real property, the S corporation is better than the LLC if the activity must be regarded as development rather than investment.




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*"The LLC is often the best entity if the real estate activity is property rental."*



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a resource for business owners

FROM THE LAW OFFICE OF MARY HANSON

## Publisher's Note

One of the challenging issues for a business owner with several businesses and investments is whether to have a number of entities. For many well established businesses, a number of entities are used – an LLC for rental real estate, an S corporation for an active operating business, and another corporation for a business owned with other co-owners. In addition, many owners of rental properties want each property held in a separate LLC, to separate the risks of one property from another, and to allow for the possibility of changes in ownership of different properties.

Nevertheless, I find it hard to suggest to a business owner or property owner that he or she needs to set up a number of different new entities.

Attorneys and accountants, accustomed to dealing with a lot of paperwork and managing a number of bank accounts, often underestimate the burden of operating as an entity. In contrast, a business owner or property owner may not be prepared to handle operating as an entity (let alone 2 or 3 entities!). The business owner may lack the clerical help or just the time to make sure the entity is operated properly.

If the business owner is not prepared to operate a business as an LLC or a corporation, or if the entity is not properly set up, the entity will not provide the desired protection from personal liability. There may be a "figurehead" or "smokescreen" corporation in name, but the entity may not withstand a challenge by a motivated claimant seeking to pierce the corporate veil and hold the owners personally liable.

Mary Hanson  
Attorney/Publisher

The LLC is often the best entity if the real estate activity is property rental. Since real estate rental is usually required to be treated as a passive activity, no active participant is subject to self-employment taxes. And because the activity is a passive activity for tax purposes, the sale of the real property results in capital gains taxes rather than ordinary income taxes.

The passive activity rules limit a taxpayer's use of passive losses to offset other income, such as salaries, wages, and other compensation. Plans for an investment in real estate that will generate losses rather than income or gains, must consider the

impact of the restrictions on this pass-through of losses. There is an exception for an individual who owns 10% or more of the rental property (or of the LLC or S corporation that owns the property) and whose adjusted gross income is less than \$150,000. That individual CAN use some of the losses from rental activity to offset his or her earned income for tax purposes.

If you are considering a real estate activity that could be characterized as development, it is important that you review this issue with an experienced tax professional before choosing the entity to use. **BA**

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