THE SCOOP ON ENTITIES

Normally, each fall I give a seminar on how to use entities for Pennsylvania real estate investors, so you can plan and implement an entity or series of entities in time for next year. But this year, the schedule does not fit another seminar, so I'll cover an update in an article.

First, what is an entity? It is a separate legal person designed to have an existence apart from you individually. An entity can enter into leases and other contracts, own real estate, sue and be sued in court, all without naming you individually. This is good for most businesses, but ESPECIALLY for real estate investing, where the public records like deeds and mortgages are abundant and easy to track.

There are simple benefits to having an entity, like reducing the appearance of your name in courts and other public records, leases and contracts. Entities can also protect you from certain claims and liabilities, reduce your risk of tax audits, save you tax dollars, and reduce your exposure to mechanics' liens.

Entities help me to keep personal accounts on my personal credit report and business accounts off my credit report. The more money you borrow for real estate investing, the more of an advantage this can be. Try to get a credit card when you have over a million dollars of real estate related loans and fifty utility accounts on your personal credit! But the entity's accounts don't appear on your credit report, because they aren't personal to you, although you may guarantee them all.

When you flip properties, using the right entities can keep claims from properties you rehabbed six to twelve years ago from coming back to affect your profits today. They can also protect your profits next year from claims arising from your current rehabs.

A series of entities used together can allow you to wear several hats, as owner, manager, contractor (and in my case lawyer) all while the entities interact to work with your properties in different ways, still keeping each role separate ad keeping your banks happy.

If you own rental properties, a series of entities can give you the convenience of common management, but can split your real estate equity in to separate pieces, so "all of your eggs are not in one basket" and you don't lose all of your equity as a result of an uninsured claim or problem at a single property.

Once you understand what entities can do, the next question is which are right for you? Corporations, Limited Liability Companies, Limited Partnerships and Trusts all have roles in real estate investing, but their roles are different.

A corporation or limited liability company works as an entity to flip a series of properties and then shut down and form another, managing both claims exposure and tax issues. We prefer LLC's for our clients over corporations, because both can be treated as S or C corporations for tax purposes, but the LLC has even more flexibility, being able to be taxed as a pure pass through or partnership as well, depending on who owns it. The LLC is also easier to maintain than a corporation, not requiring annual meetings and minutes to preserve its separate identity.

An LLC or corporation can also make a great property management entity for your long term holdings. Although you have to be a real estate broker or an owner of real estate to manage it, I use LLCs as the general partner in each of my Limited Partnerships holding title to real estate. That way, the deeds to different groups of rental units are in different LPs, so my equity "eggs" are in different baskets. But, AT THE SAME TIME, all of my leases, management activities and liability exposure from management are centralized in a single LLC.

One set of bank accounts, one phone number, and one name to do business under all help to make management easier.

The structure also has asset protection benefits, because the LLC is like a lightning rod for claims arising from management activities. It takes the heat, and diverts the attention from your LPs. But it also only owns just one percent of your equity, so the other 99% is protected from those claims. The LPs do no business, since they are just shells holding the deeds, so they don't even need their own bank accounts. And since any contracts for repairs or improvements are between the contractor and the LLC managing the property, there is no contract with the LP owner, so the contractor can't lien the property of the LP if the LLC doesn't pay.

You will hear that buying your properties in entities makes it harder to get them financed, but that is only partially true. Certain lenders like Wells Fargo and Countrywide have had policies for a few years that they won't loan to entities, but only if you hold title in your own name. I understand that Bank of America may be following along the same path. But if your credit is around 650 and the property on which you want to borrow cash flows and appraises, you can go directly to most local banks and get a mortgage loan in the name of your entity, which you guarantee personally. If you use a mortgage broker experienced in working with investors and entities, the broker won't even apply to Wells Fargo or Countrywide for your loan, because they also know these lenders' policies. You should never be in the position where you are approved for a loan, but at the last minute have to transfer title to your own name to close. That comes from a broker who didn't do his job finding the right lender.

If you use hard money or private loans to buy and renovate your properties, most hard money and private lenders will also loan to your entity with your personal signature on the loan. As long as they have a valid first mortgage from the entity owning the property, and you are the owner of the entity signing the note, everything should work out if you pay the loan, and it should be easier for you to give and the lender to accept your deed in lieu of foreclosure if you default. We close these loans all the time, and explain these issues to private lenders if they have any doubts.

Of course, even a thousand word article isn't enough to cover a three hour seminar on entities, but the information on how to use entities in PA hasn't changed from the last time I gave the entities seminar. That three hour seminar is recorded and still available if you need more information to plan your entity structure for real estate investing, and I'll always give ACRE members a free consultation!