

THE NARROW CRITERIA OF WHO A DEALER REALLY IS

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Based on *extensive* research, my criteria of who a dealer really is very narrow. If your business is that of a full-time builder-developer you are a dealer (barring any liquidating factors). If you are full time at flipping properties, do a very large number of flips annually, this is your primary business with the true intent to sell, then most likely you are a dealer. Less than these scenarios, you could plan to avoid being a dealer.

USING A LIMITED PARTNERSHIP (LP) VS A CORPORATION

For dealer property, LP's are superior to S or C-corporations for

The following reasons:

1. Less employment taxes without having to pay salaries to limited partners. *Reason:* As active business income, dealer profits are subject to Social Security and other employment taxes, IRC 1402(a). But the share of income of limited partners (including dealer profits) is not subject to Social Security taxes, Prop. Reg. 1.1402(a)-2(g); IRS Pub. 533. S-corps can also save on Social Security taxes. However, as S-corporation employees, shareholders must receive a portion of income as a salary (which is subject to Social Security taxes). Thus, while an S-corp can save on Social Security taxes, it is subject to more payroll filings. With an LP, to take advantage of this benefit, salaries do not have to be paid to limited partners because partnerships are pure pass-through entities for the owners. The share of profits or compensation to the general partner (GP) for their active participation is subject to Social Security taxes, but compared to total partnership income, this should be a smaller amount subject to such taxes. Plus, you

could make the general partner an S-corp to reduce Social Security taxes for the GP owning a low percentage of the LP,

2. Less IRS scrutiny over reasonable salaries. In addition, unlike an LP, an S-corporation is subject to more IRS scrutiny and controversy over the issue of paying “reasonable compensation” to shareholders. The IRS wants to see more salary compensation in order to collect more in the way of Social Security taxes and other employment taxes. Accordingly, S-corps have become more frequent targets for audits. C-corps too are subject to issues of “reasonable compensation”. On the other hand, with an LP, because W-2 salaries do not have to be paid, there are no issues of reasonable compensation to partners. The issue does not exist just by the very format of the partnership 1065 versus the S-corp 1120S or C-corp 1120.

Note: The GP may be a C or S corporation with these corporate issues. But a corporate GP will only own a very small percentage of the LP entity, so there should be less of such issues. Plus you could apply audit-proofing planning strategies.

3. Even without W-2 salaries, an LP can still pay compensation eligible as earned income and the basis for making valuable retirement plan contributions – a guaranteed payment. Such earned income is created by the partnership paying the partner(s) something called a “guaranteed payment” which is a payment that is made without regard to partnership income. Such payment is ordinary earned income to the recipient-partner, IRC 707(c); IRC 61(a); but the payment is deductible by the partnership, IRC 162(a); IRC 707(c). The guaranteed payment is for specific services rendered by the partner to the partnership in their capacity of a partner. Examples of such services could be maintenance, contract work, accounting, bookkeeping, marketing, consulting, etc. The guaranteed payment arrangement should be incorporated in the

partnership agreement. The guaranteed payment is not paid as a salary via a W-2; it's like a 1099 payment, but with no 1099-filing requirement. Therefore, payroll reports do not have to be filed. But the guaranteed payment is the basis for valuable retirement plan contributions to IRA's as well as to SEP, Simple or Qualified plans.

4. LP's file IRS Form 1065, which is generally audited less than corporation returns just as a matter of general procedure.

5. State taxes. Some states tax S-corporations. Many states tax C-corporations, but some do not tax LPs, or tax them less.

6. LP's generally have less statutory restrictions than S-corps such as "S" elections. There are no accumulated penalty taxes as with C-corporations.

7. With a partnership (including an LP) there is the flexibility of allocating income or losses to the partners in a manner that best suits the partners' tax needs. For example, a partner in a high tax bracket may want allocated to them less of any net income. IRC 704(b). Even though it is a pass-through entity, S-corporation income or losses must be apportioned strictly in accordance with the exact number of shares owned, with no variations of special allocations to different shareholders.

8. Partnerships are much better for keepers than S or C corporations. If the LP decides not to sell the property, but instead decides to make it a keeper (or they must make it a keeper), they have the better keeper tax advantages of a "partnership" as opposed to the disadvantages of corporations.

For example, with a corporation, there would be a phantom tax liability on appreciated property that you transfer from the corporation to yourself. This would not happen in a partnership. Unlike corporations, appreciated real estate could be contributed to, or distributed from partnerships without paying income taxes. (This is *key!*) Moreover, corporations, with appreciated property, *cannot* do a tax-free conversion to an LLC. On the other hand, an LP, with appreciated property, *can* do a tax-free conversion to an LLC (and should do so in order to side step passive loss limitations if the rental keepers will be showing tax losses).

9. LP's can take advantage of the employee fringe benefits of a C-corp by having the C-corp as a general partner.

10. For real estate, there are the many other advantages of partnership tax law over corporation tax law.

WHICH ENTITY TO USE FOR THE LP GENERAL PARTNER

LP's require at least one general partner (whose earned income is subject to employment taxes). Select which entity to be the LP's general partner (GP), which will have at least a 5% to 10% minority interest.

In General - With an LP the general partner is given control of the business and is personally liable for all partnership debt & obligations. A way to insulate the general partner (GP) from personal liability is for them to become a corporation or an LLC. An LP, with a corporate or LLC general partner, insulates the entire LP from personal liability. Thus, the LP needs to decide if they want the GP to be a C-corp, an S-corp or an LLC.

C-Corp as GP - If the entrepreneur has out-of-pocket health & medical expenses and wants to take advantage of C-corporation health-related fringe benefit deductions, then a C-corp, paying a reasonable salary, could be a good candidate for a GP. Plus any salary paid is earned income eligible for valuable retirement contributions, which shelter income. Plus a C-corporation could use a fiscal year as a way to defer corporate income. (For more about using a C-corp-partner, with fringe benefit deductions, see Chapter 5-B. However, the C-corp as a GP in an LP plays a much more active role than the C-corp as a minority member in an investor LLC.

2. S-Corp as GP - If the entrepreneur has little or no need for health-related fringe benefit deductions and they want to especially avoid paying more Social Security and other employment taxes, then here an S-corp could be a good candidate for a GP. (One of the rare times I recommend an S-corp for any type of real estate ownership). The net income of an S-corp is not subject to Social Security or employment taxes. However, a reasonable salary (which is subject to employment taxes) must be paid, but the entire net income does not have to be paid out in salary. That is, a reasonable amount can be paid as salary and the rest taken as S-corporation distributions, which is free of employment taxes. To satisfy the IRS (and tax courts), how much of a salary is not clear-cut. Opinions from tax experts vary from 20% to 50% of total S-corporation net income. But again any salary paid is earned income eligible for valuable retirement plan contributions, which can shelter income. (For more planning with S-corp reasonable salary and retirement plans.

3. LLC As GP – The GP could also be a limited liability company (LLC). If the LLC GP is a single member LLC it will file a Schedule C; or if it's a two (or more) member LLC, it will file a partnership 1065. You should avoid single-member LLC's and especially the highly audited Schedule C. (Form 1065 is audited less.) Plus, a single-member LLC generally does not get charging order protection.

A two or more member LLC-partnership as GP has the advantages of being a pure flow-through entity, including no required paying of salaries.

However the net taxable income of a GP LLC-partnership would be subject to Social Security taxes. So a C or S corporation, even with paying salaries, could provide additional tax saving benefits to the LP.

STRATEGIES WHEN USING A CORPORATION AS GP

1. Control with Lesser Amount of Higher Taxed Active Income -

You can much better *control* how much active income you need in a C-corp by having the C-corp as a GP with the C-corp GP being paid a lesser amount of profits, as opposed to using the C-corp as the primary dealer entity and all dealer active profits going directly into the C-corp subject to high federal taxes and usually state taxes.

2. Audit-Proofing Strategies for Corporations - Corporations are more audit-prone than partnerships. To reduce audit exposure...

(a) Document reasonable salaries – The GP Corporation should pay shareholders “reasonable” salaries (as previously discussed in part B-2 of this chapter). There should be a written employment agreement between the corporation and

the employee-shareholder, specifying duties and job responsibility. The corporate minutes should also document the same.

(b) File all extensions – The GP Corporation, the limited partnership, and the individual entity owners should all file their own extensions for their own tax returns.

Individual 1040's get an automatic 6-month extension from April 15 to October 15 filing IRS form 4868. If you owe, pay at least 90% with extension.

LLC's or partnerships get an automatic 6-month from March 15 to *September* 15 (not October 15) filing IRS form 7004.

Corporations (C or S) get an automatic 6-month extension from *March 15* to *September* 15 (not October 15) also on IRS form 7004 (but by March 15, not April 15).

Alert: File these corporate extensions before the above due dates, otherwise there could be costly penalties, even if the entity does not owe taxes.

HOW TO USE AN LP FOR DEALER-FLIPPERS

1. Must have a GP - In an LP, you must have a general partner (GP) with a recommended 5 to 10%* ownership interest. The remaining 95 to 90%* is owned by the limited partners. (Note: One can simultaneously be both a general and limited partner).

2. GP should be a Corporation for Purposes of Total Limited Liability - The Corporation will have its own limited liability.

3. GP and LP percentages of ownership – Note that the minimum allowed LP ownership is 1% for the general partner and 99% for the limited partners. However, some tax experts recommend at least 10 to 20% for the general partner. *Reason:* There is more substance in giving this more ownership to the general partner who will be controlling the business by making the partnership decisions. Also, a 20% general partner interest meets IRS safe harbor provisions.

4. The active operations of the dealer LP is run by the GP, not limited partners – Limited partners cannot participate in the every day business activities of the partnership, including buying and selling properties. So how does one person, selling dealer properties, use an LP? First off, one can be both a general and limited partner. The individual can be the limited partner and the general partner can be a LLC. You can own all or part of the LLC-general partner, which is a totally separate and distinct entity from you as an individual limited partner. It is the *GP C-Corp* (as *separate* entity) that will make all of the business decisions in finding, buying, developing and selling properties. You, as a separate *individual limited partner* will have no say in these everyday business activities.

5. GP compensation – The LLC-general partner will be compensated for their role as general partner when the general partner is an individual. This compensation will be subject to employment taxes. However, more of the profit is that of the limited partners which is not subject to employment taxes and sometimes not subject to state corporate taxes. Moreover, the general partner can shelter at least some of their income with the tax benefits of a C or S corporation.

PROPER LP FORMATION AND FORMALITIES

1. Formation - LP's should be formed with highly competent legal and tax counsel (not do-it-yourself kits). With the LP, the limited partnership agreement must make certain that the powers of the limited partners are no greater than those permitted by the applicable limited partnership statute. Again, the limited partners cannot control or manage the business of the partnership. LLC general partner does this. (However the limited partners do have right to inspect the books of the partnership and demand a formal account of partnership affairs.)

2. Formalities - The GP C-Corp must adhere to all of the formalities of an entity, including acting as a *separate legal entity* and not as your agent. The GP entity must sign and execute *all* contracts and other documents on behalf of the LP.

IF THE LP SHOWS TAX LOSSES, LIMITED PARTNERS ARE SUBJECT TO PASSIVE LOSS LIMITS ON INVESTOR-RENTAL LOSSES – DON'T USE

But quick sale (flip) properties will generally not have rental losses. Moreover, dealer activities in real estate are not subject to passive limits, Reg. 1.469-1T(c)(2)(v).

LLC'S WITH TWO CLASSES OF OWNERSHIP
(MANAGING AND LIMITED) COULD BE USED AS A
DEALER ENTITY INSTEAD OF AN LP

1. An LLC member can be considered a limited member-partner

(a) Like a limited partner – Any one or more active members in an LLC can also be considered a limited function member if they are not personally liable on any debts and they do not have authority to contract on behalf of the LLC under the applicable state statute, like a limited partner. (That is the member can simultaneously be both an active member and limited function member, similar to a partner in an LP where they can simultaneously be both a general partner and limited partner).

(b) No Social Security taxes – If an LLC member meets these tests they are considered a limited member and their share of income (including dealer profits) is not subject to self-employment (Social Security) taxes, Prop. Reg. 1.1402(a)-2(g).

(c) Little or no say in management – This would mean that LLC members, treated as limited partners, would have little or no say in management. Some LLC's do have managing members, while other members are limited. Therefore, an LLC with managing and limited members (who could be the same person) could be very much being like an LP.

2. Consider using an LLC instead of an LP – Traditionally LP's have been more proven asset protection vehicles and a way to reduce Social Security taxes. However, times are changing and LLC's are taking over. LLC's in the US more and more are

accumulating a positive track record of legal protection, becoming a premiere entity. Plus under current IRS regulations, they could be used to reduce Security taxes in a very similar manner of an LP but with less complexity. Accordingly, unless there are substantial state taxes with LLC's and not LP's, the trend will be to use a separate LLC for dealer property.

IMPORTANT REMINDER: INVESTOR VS. DEALER IS NOT A BLACK & WHITE ISSUE

The above discussion was based on using the best entity for "dealer" property. However, it should be noted that whether a property is an "investor" property versus a "dealer" property is not clear-cut; and with planning, dealer status could often be totally avoided. Strategies to avoid or minimize dealer.

LPS' AVOIDING STATE TAXES

Where there will be substantial state taxes with LLC's but not LP's, then consider an LP. However, presently there are very few states where this is the case.

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