

CHAPTER 1

Essential Forms of Ownership



When acquiring real estate, the form of ownership has significant consequences and is most likely one of the first decisions made by an acquirer of real estate. The selection of the form of ownership can have current and future consequential events that will be crucial when purchasing and selling real estate.

The selection of the form of ownership will determine the owner or owning entity's legal liability, and, in addition, tax consequences. In the event the incorrect form of entity is chosen, there could be dire circumstances creating personal liability, tax liability, or both. In this chapter, we will consider not only the various types of ownership, but also the advantages and disadvantages of each selected entity. If the selection is wrongfully chosen, there can be long-term lasting tax consequences as well as other concerns regarding legal, financial, and practical issues.

Historically, the selection of the form of ownership has changed, spanning the early days to the present. In this chapter, we learn that in the early years the use of the corporate form was extensively used and provided great limitations for the ownership of real estate (with the exception of Real Estate Investment Trusts (REITs)). Over the years, however, other forms of ownership evolved that proved suitable for the acquisition of real estate: limited partnerships (LPs), limited liability companies (LLCs), tenancies in common (TICs), joint ventures (JVs), certain trusts, and subchapter "S" corporations.

This chapter, and all following chapters, will address only investment or business property and will not consider personal residential property.

1.1 Forms of Ownership

Sole Individual Ownership:

- General partnerships
- Limited partnerships
- Limited liability company
- "C" corporations
- "S" corporations
- Joint ventures
- Tenancies in common
- Trusts
- Real estate investment trusts
- Delaware statutory trust

1.2 Sole Individual Ownership

Individual ownership is the simplest and least costly form of ownership. Albeit, individual ownership is a quick and easy way to commence ownership of real estate, the exposure to unlimited liability is a substantial financial risk. Although careful management and sufficient liability insurance coverage can mitigate the financial consequences, there are times when unexpected events can create financial implications that create claims on the owner's personal unprotected assets. Although insurance should adequately cover risks of liability, there are circumstances where insurance coverage may be inadequate. This form of ownership is not to be considered when acquiring real estate.

From a tax perspective, sole individual ownership is perhaps the simplest form of reporting income and expenses. There is no requirement for the sole individual owner to file separate business tax returns (i.e., partnership or corporation tax returns). All income and expenses are reported on the owner's individual tax return. If the source of income is from real estate, it will not be subject to self-employment tax, unless the owner is

deemed a dealer and not an investor (dealer v. investor is discussed in a later chapter). In the event the income is derived from a dealer activity, then the income is subject to self-employment tax and ordinary income tax rates.

Other factors to consider are outside of liability and tax issues, but consideration must be given to business and investment issues. A sole proprietor may limit the ability to attract capital when compared with other forms of ownership such as partnerships, limited liability companies, and syndication of real estate investments. In addition, acting as a sole proprietor may limit management and expertise that are afforded by other types of entities. For example, limited partnerships and limited liability companies may have more than one managing general partner, or managing member, who contribute diversified expertise, which a sole owner may lack.

1.3 Partnerships

As previously stated, when a sole owner lacks certain expertise, lending capacity, or the ability to raise equity to acquire or finance property, the partnership form of doing business can be most advantageous.

A partnership is an unincorporated association of two or more members or other types of entities (limited partnerships, corporations, trusts, limited liability companies) to acquire real estate and carry on a trade or business. The partnership is governed by an agreement among the partners, who contribute capital and services to the partnership. Partnership agreements may be changed from time to time as the partners may agree among themselves. The partnership agreement is a negotiated contract among the partners that provides for the following:

- The formation and name of the partnership
- Type of partnership
- Purposes, such as to own, manage, and operate real estate
- Capital contributions and capital accounts
- Admission of additional partners
- Allocations of profits and losses
- Special allocations
- Operating distributions
- Distributions upon sale, refinancing, or liquidation
- Management and powers of management
- Term of partnership
- Books and records.

The partnership form of doing business is recognized by state laws and is similar and in accordance with the Uniform Partnership Act.

It is essential to understand that partnerships must have two or more partners. The death or withdrawal of a partner could cause a statutory termination of the partnership, unless the leaving partner is replaced or the deceased partner's estate becomes a partner. Furthermore, tax law promulgates that if fifty percent or more of the total interests in the partnership capital and profits are sold or transferred within a twelve-month period, or all the operations are discontinued and no part of any business, financial operation, or venture is continued by any of its partners, the partnership will terminate.

1.4 Types of Partnerships

A. General Partnerships

An association of partners that forms a general partnership may encounter legal liability. A general partnership is nothing more than a combination of sole individual proprietors and, as such, exposes each partner to personal legal liability. To further exacerbate the problems of liability because of an agency relationship, the partners can be jointly and severally liable to claims of creditors and others for business acts performed by partners. Furthermore, each partner is responsible for the acts of the other partners.

General partners may share management activities, and all partners have an equal right to conduct business. Most general partnership agreements will provide for a simple majority vote to manage the activities of the partnership.

Purchasing real estate in a general partnership form is most unfavorable due to the legal liability exposure. General partnerships, however, will not establish any tax hardships and for the most part are tax friendly.

All operational income and expenses, including gains or losses from the sale of real estate, are reported on each partner's personal income tax return. The partnership at year-end will file an information tax return (Form 1065, non-taxable entity) with the IRS. An integral part of Form 1065 is the Schedule K-1 that is provided to each partner. Schedule K-1 reflects each partner's pro rata share of income, losses, capital transactions, and recourse and/or nonrecourse liabilities.

With the information provided by the Schedule K-1, each partner will incorporate the information in his or her personal income tax return.

B. Limited Partnerships (LPs)

A limited partnership is a form of partnership similar to a general partnership, except that in addition to one or more general partners, there are one or more limited partners. It is a partnership in which only one partner is required to be a general partner, though there may be multiple general partners.

The general partners have management control and share in profits and losses on an operational level and in a capital event (sale or refinance of the property). The general partner has actual authority as agent of the partnership to bind all other partners in contracts with third parties that are in the ordinary course of the partnership's business. The managerial duties and profits that may inure to the general partner are described in the partnership agreement. The general partner assumes the obligations of the partnership. Therefore, if the general partner is performing as an individual, the individual general partner will be subject to personal legal liability. Often the general partner will protect his or her self from potential liability by forming a limited liability company, corporation, or other form of entity that affords protection from personal liability.

A limited partnership not only has a general partner and/or general partners, but every LP has limited partners. Limited partners are investors. Like shareholders in a corporation, limited partners have limited liability; they are only liable on debts and financial obligations incurred by the partnership to the extent of their investment, and, as long as they do not participate in management duties, they will not breach their limited partner status.

As previously stated for general partnerships, LPs will also report operational income and expenses, including gains or losses from the sale of real estate, with the financial information reported on each partner's personal income tax return. The partnership at year end will file an information tax return (Form 1065, non-taxable entity) with the IRS. An integral part of Form 1065 is a Schedule K-1, provided to each partner, which reflects each partner's pro rata share of income, losses, capital transactions, and share of recourse and/or nonrecourse liabilities. With the information provided by the Schedule K-1, partners can incorporate the information in their personal income tax returns.

LPs not only provide protection to their investors, but are also tax friendly compared with other forms of entities.

C. Limited Liability Companies (LLCs)

A Limited Liability Company (LLC) is a business structure allowed by state statute. LLCs are popular because, similar to corporations, owners have limited personal liability for debts and the actions of the LLC. Other features of LLCs that are similar to partnerships include providing management flexibility and providing the benefit of pass-through taxation.

Although the characteristics of partnerships and LLCs are similar, an understanding of certain terminology is important. For example, LLC investors are identified as members, and limited partnerships' investors are known as limited partners. LLCs have operating agreements, and limited partnerships have partnership agreements. A managing member manages LLCs, and a managing general partner manages limited partnerships.

An advantage of LLCs is their use of a "single-member LLC," known as a disregarded entity. By using the single-member form, the problems of sole individual ownership will be mitigated and will resolve the exposure of legal liability that is prevalent when real estate is owned solely in an individual's name.

For federal income tax purposes, LLCs are treated as pass-through entities. If there is only one member in the company and the LLC is a disregarded entity for tax purposes, the individual will be required to report the LLC's income and loss on his or her income tax return.

For LLCs with multiple members each will receive a Schedule K-1 for reporting their pro rata share of the LLCs income or loss, which will be reported on each member's tax return.

The following are the advantages and disadvantages of LLCs:

Advantages

- Check-the-box taxation—an LLC can elect to be treated as a sole proprietor.
- Limited liability, meaning that the owners of the LLC are called members, and shielded from liability for the acts and debts of the LLC.
- Less administrative paperwork and recordkeeping is required than a corporation.
- "Double taxation" is not a factor because of the pass-through status.
- Profits are taxed personally at the member level, not at the LLC level.

Disadvantages

- Although there is no statutory requirement for an operating agreement in most states, members who operate without one may encounter problems.
- It may be more difficult to raise financial capital, as investors may be more comfortable investing in better-understood entities.
- Many states have a franchise tax, margin tax, or capital value tax.

1.5 Corporations

A corporation is a legal entity created under the laws of each state and is designed to establish the entity as a separate legal entity having its own privileges and liabilities distinct from those of its shareholders. There are different forms of corporations that conduct business. An essential feature of a corporation is limited liability to its shareholders: If a corporation fails, the shareholders would only lose their investment and not be held liable for the debts and obligations of the corporation.

Corporations are an invisible being engaged in the active conduct of owning, operating, and managing real estate. Corporations have perpetual life and rights of assignment of stock ownership. A board of directors delegates such authority to corporate officers who perform the day-to-day operations of a corporation. The board, however, frequently makes major decisions.

For purposes of owning real estate in a corporate form, developers and investors must carefully examine the advantages and disadvantages of owning the property in the corporate form. Although corporations provide protection from liability, one must look to the potential tax implications in the event a wrong choice is made on the type of corporation. Corporations are taxpayers with their own tax structure, one separate from the shareholders' tax obligations. In the following paragraphs, we learn there are basically two types of corporations. (The letter designation is taken from a subchapter of the Internal Revenue Code that sets the tax rules for each of the corporations.)

- C Corporations
- S Corporations.

A. "C" Corporations

C corporations are extensively used in business by many different types of businesses and will shield their investors from liability, which is the main advantage. But the use of C corporations for real estate can be most detrimental from a tax perspective. Because a C corporation is a taxable entity, real estate transactions creating income within the corporation will be taxed, and any distributions such as dividends to its shareholders will be further taxed. As a result, C corporations incur "double taxation," as illustrated in Table 1.1:

For example, Blackacre Realty, a C corporation, sells land and building for \$500,000, and after all expenses and paying off the mortgage, the net proceeds from selling the property are \$400,000. The \$400,000 is distributed to shareholders as a dividend. The dividend distribution is taxable to the receiving shareholders, and, in addition, the corporation will pay a tax on the taxable gain.

Table 1.1 Blackacre Realty C Corporation Sell with Double Taxation

Gross Selling Price	\$500,000
Less Selling Expenses	(25,000)
Net Selling Price	\$475,000
Less Adjusted Basis	(150,000)
Gain on Sale	\$325,000

In the Blackacre example, the shareholders will pay a tax on the received dividends of \$400,000, and (as of 2017) a 37 percent tax—the highest individual tax rate (each shareholder may qualify for a 15 percent tax rate). Additionally, the corporation will pay a tax on the \$325,000 gain at a tax rate of 21 percent. This example demonstrates the occurrence of “double taxation.”

In the event the corporation does not sell the property but decides to distribute the property to the shareholders or another entity, a tax will be incurred based on the fair market value of the property, which is deemed the selling price. This transaction will cause a tax at the corporate level. Property within a C corporation that has increased in value over a period of time may present a substantial tax problem. As previously stated, the distribution of the property will be a taxable event. Therefore, property within a C corporation tends to be “locked in” the corporation. It is very tax detrimental to use C corporations for real estate ownership, especially when there are other alternatives of ownership to consider.

B. “S” Corporations

An alternative to using C corporations, if the corporate form is desired, is the S corporation. S corporations have many features similar to partnerships, though liability from third parties is provided and taxation is for the most part friendly, although an S corporation carries its own tax nuances that complicate use of this form of ownership.

All the shareholders of the corporation must elect S corporation status. If status is elected, each shareholder reports their respective pro share of the corporate income, losses, and gains from sales of real estate on their personal tax returns. The pass-through of the tax events is similar to the pass-through of partnerships, which report such taxable events to their partners by providing each partner with a Schedule K-1.

Qualifications for “S” Corporation Status

To qualify for “S” status, an election must be made and the following requirements met:

- Must be an eligible entity
- Must only have one class of stock
- Must not have more than one hundred shareholders
- Shareholders must be US citizens or residents and must be real persons; therefore, corporate shareholders and partnerships are excluded. But certain trusts, estates, and tax-exempt corporations are permitted to be shareholders

The S corporation election must be made by the fifteenth day of the third month of the tax year for which the election is intended to be effective, or anytime during the year immediately preceding the tax year.

If a corporation has elected to be treated as an S corporation and ceases to meet the requirements (for example, if, as a result of stock transfers, the number of shareholders exceeds one hundred, or an ineligible shareholder such as a nonresident alien acquires a share), the corporation would lose its subchapter S status and revert back to a C corporation.

Furthermore, if more than 25 percent of an S corporation’s gross receipts consist of passive income for three consecutive years when the S corporation has accumulated earnings and profits, the S corporation would automatically lose its subchapter status and revert back to being a C corporation.

In summary, the use of the S corporation status carries a great amount of tax nuances and specific rules that if violated could have severe tax implications. There are more suitable forms of ownership for real estate.

Five-Year built-In-Gain Recognition Period

If an S corporation that was previously taxed as a C corporation has a built-in gain on property that was transferred, and such gain was attributed to the period which it was a C corporation, it is subject to a corporate level tax on the built-in gain (“BIG” tax) when it recognizes the built-in gain within the statutory time period subsequent to the conversion to S corporation status. The BIG tax will only apply if the S corporation sells the transferred property with the built-in gain within the five-year recognition period. The code permits an S corporation to carry forward certain tax attributes from a C corporation to an S corporation for the purpose of reducing or eliminating its liability for the built-in-gains tax. Accordingly, it may carry forward a NOL or capital loss from a C corporation as a deduction against the net built-in-gains tax for the tax year to an S corporation for the purpose of reducing or eliminating its liability for the built-in-gains tax. Accordingly, it may carry forward a NOL or capital loss from a C corporation as a deduction against the net built-in-gains tax for the year.

Example

XYZ Realty Inc., a C corporation with a tax year of December 31 2016, elects S corporation status on January 2, 2017. At the time of the conversion and transfer of the realty, a valuation was made, resulting in the adjusted basis and fair market value of the property as follows:

	Adjusted Basis	Fair Market Value
Land:	\$200,000	\$400,000
Building:	<u>\$1,000,000</u>	<u>\$2,000,000</u>
	<u>\$1,200,000</u>	<u>\$2,400,000</u>

On XYZ Realty Inc.'s first corporation tax return (Form 1120-S), the company reports a built-in gain of \$1,200,000 (\$2,400,000-\$1,200,000). In 2019, XYZ Realty Inc sells the land and building for \$3,000,000. Since the realty was subject to \$1,200,000 of built-in gain at the time of the conversion and was sold within the five-year recognition period, the S corporation is subject to the entity level tax on the \$1,200,000. The balance of the gain will be passed through to the shareholders.

1.6 Joint Venture (JV)

A joint venture is similar to a partnership. A JV is formed for a specific time and has an entity purpose. For example, a JV may be formed to specifically construct a particular property. Generally, a JV has a beginning and an ending. The three major differences of a JV, compared with a partnership, are that 1) a partnership generally involves an ongoing, long-term relationship; 2) a JV comprises a single business activity; and 3) all the partners must agree to dissolve the partnership, whereas a JV has a finite time for project completion before it comes to an end.

The term JV refers to the purpose of the entity and not the type of entity. Therefore, a JV can be a corporation, an LP, LLC, or any other legal structure.

The following are the advantages and disadvantages of a JV:

Advantages

- Raises needed capital
- Permits specific financing
- Expands lending capacity
- Spreads risks through product diversification
- Spreads risk through geographic diversification

- Combines different management styles
- Increases selection and capacity of projects
- Increases foreign opportunities

Disadvantages

- Loss of control
- Lack of compatibility of joint venturers

For tax purposes, JVs, in most cases, are treated as partnerships.

1.7 Tenancy In Common (TIC)

The Legal dictionary describes TIC as

a specific type of concurrent or simultaneous ownership of real property by two or more parties. Usually, the term “tenant” is understood to describe a person or entity who rents or leases property in the context of concurrent estates. A tenant, however, can also be a co-owner of real property.

All tenants in common hold an undivided ownership interest in real property. This permits each party the right to alienate or transfer ownership of his or her ownership interest.

A recent use of TICs is prevalent for Section 1031 Deferred Tax Exchanges. The TIC presents a form of real estate asset ownership in which two or more people have an undivided fractional interest in the asset. Ownership shares are not required to be equal. Upon closing and taking title to the property, each co-owner receives a deed, or other proof of ownership, for his or her undivided percentage of ownership in the entire property.

Each co-owner is provided with his or her pro rata share of income and expenses, based on their respective undivided interest in the property by the manager of the TIC, and such information is reported on his or her tax return.

1.8 Trusts

A trust is an entity created and governed under the state law in which it's formed. A trust involves creation of a fiduciary relationship between a grantor, trustee, and

a beneficiary for a stated purpose. A trust may be created by any of the following methods:

- A declaration by the owner of property that the owner holds the property as trustee
- A transfer of property by the owner during the owner's lifetime to another person as trustee
- A transfer of property by the owner, by will or other instrument taking effect upon death of the owner, in trust to another person as trustee
- An exercise of a power of appointment to another person as trustee or an enforceable promise to create a trust.

The trustee obtains legal title to the trust assets and is required to administer the trust on behalf of the beneficiaries according to the express items and provisions of the trust agreement. A fiduciary is an individual or organization charged with the duty to act for the benefit of another. Additionally, a beneficiary is one entitled to receive benefits from the trust.

Under the grantor trust rules, the grantor, rather than the trust or beneficiary, is taxed on any income generated by the trust.

Trusts are frequently used to gift property to minor children for purposes of estate planning.

1.9 Delaware Statutory Trust

A Delaware Statutory Trust ("DST") is a legally recognized trust. DSTs are formed as private governing agreements under which:

1. property is held, managed, administered, invested, and/or operated; or
2. business or professional activities are carried on by one or more trustees for the benefit of the trustor entitled to a beneficial interest in the trust property.

DST investments are offered as replacement property for investors seeking to defer their capital gains taxes through the use of a Section 1031 tax-deferred exchange. The DST property ownership allows the smaller investor to own a fractional interest in large, institutional quality and professionally managed commercial property along with other investors, not as limited partners but as individual owners within a Trust. Each owner receives his or her pro-rata share of the cash flow, tax benefits, and property appreciation, if any.

Property type assets may include multi-family, student housing, assisted living, self-storage facilities, medical office, and triple net retail properties.

The tax regulations as described by the US Treasury and IRS states,

“A taxpayer may exchange real property for an interest in the DST without recognition of gain or loss” under Section 1031, if the following seven restrictions are adhered to:

- Once the offering is closed, there can be no further contributions to the DST by either current or new beneficiaries.
- The trustee cannot renegotiate the terms of the existing loans and cannot borrow any new funds from any party, unless a loan default exists as a result of a tenant bankruptcy or insolvency.
- The trustee cannot reinvest the proceeds from the sale of its real estate.
- The trustee is limited to making capital expenditures with respect to the property for normal repair and maintenance, minor nonstructural capital improvements, and those required by law.
- Any reserves or cash held between distribution dates can only be invested in short-term obligations.
- All cash, other than necessary reserves, must be distributed on a current basis.
- The trustee cannot enter into new leases or renegotiate the current leases unless there is a need due to a tenant bankruptcy or insolvency.

Features of a DST are very attractive. These features include:

1. Liability protection for the trustee
2. Asset protection for the beneficial owner
3. It is a separate legal entity
4. There is delegation of management
5. Low minimum investment requirements
6. Cash investors may complete a 1031 exchange
7. There is a onetime registration
8. No franchise taxes
9. No limit of investors
10. Availability of indemnification

1.10 Real Estate Investment Trust (REIT)

A real estate investment trust (REIT) is a real estate company that offers common stock to the public and freely trades on the stock exchange. Ownership of REIT stock represents ownership in an operating company. REITs are unique primarily because 1) it manages groups of income-producing properties, and 2) it must distribute most of its profits as dividends to its shareholders. Real estate REITs generally own shopping malls, office buildings, industrial properties, hotels, and apartments.

A. Qualifications for REIT Status

There are various rules that must be followed to maintain REIT status:

- Must distribute 90 percent of its ordinary income as a dividend.
- Must distribute 90 percent of capital gains from the sale of property.
- Must not reinvest earnings.
- At least 75 percent of the REIT's gross income must be from real estate-related income.
- Must have at least one hundred shareholders
- Five or fewer individuals cannot own more than 50 percent of the value of the REIT stock.
- Must not directly manage its properties, but must employ independent management contractors.

Because REITs are required to distribute 90 percent or more of their operating profit as dividends, the use of the C corporation form will not have the onerous tax implications of "double taxation."

1.11 Organization Costs

There are expenses in the formation of entities. Such expenses are organizational and start-up costs. Examples of certain organizational and start-up costs are as follows:

- Legal and accounting fees to form the entity
- Brokers' fees

- Printing costs
- State registration fees

The taxpayer must make an election to amortize the start-up and organization costs over 180 months, beginning with the month in which the entity commenced business.

An election to amortize organization expenses is to be made no later than the due date for the tax year in which the business began.

Organization costs are treated differently for accounting and tax purposes. For accounting purposes, the organizational expenses are paid when they are incurred and will have a direct impact on cash flow; however, the organizational costs for tax purposes are amortized (deducted) over the 180-month period.

1.12 Tiered Partnerships For Asset Protection

As previously stated, when acquiring real estate, the form of ownership is paramount for asset protection. By using a tiered partnership structure, asset protection can be accomplished. In general, it is not advisable to take title to multiple real properties within a single entity.

If real property is titled into one entity, and in the event that a property is distressed or has substantial claims of creditors, all the other assets within the entity can be subject to claims of creditors. In order to provide asset protection, each individual property should be owned by a separate LLC or LP.

As the Figure 1.1 illustrates, a holding company is formed along with separate LLCs. All investor equity is contributed to the holding company. This entity is known as the investment company LLC "holding company." It is the holding company that has the necessary capital and will provide the required equity to the other formed LLCs so that they may acquire real property and take title into their respective entities.

The individual LLCs will make cash distributions (from operations or a capital event) to the investment co. LLC, and, in turn, the investment company LLC may make distributions to the investors. No LLC has title to more than one property. In the event, LLC#1, office building, has problems with trade creditors or lenders and is facing the possibility of foreclosure, there is asset protection for LLC#2 and LLC#3. Notwithstanding that, asset protection is provided by this structure: If mortgages encumber the properties and there is one lender on each property, the mortgages may be cross-collateralized.

An additional advantage of using tiered partnerships is that this structure will be required to file one tax return. The individual LLCs (#1, #2, #3) are considered "disregarded entities" because they are 100% owned by the investment company LLC and, as such, will be consolidated into the investment company LLC. Therefore, investment

company LLC is the only entity filing a tax return, which will include all the operations of the other LLCs.

Figure 1.1 Tiered Partnerships for Asset Protection

