ISSUES WITH JOINT OWNERSHIP

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The Knowledge Group

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I. <u>OVERVIEW</u>

When two or more persons decide to acquire property, a number of questions arise with respect to joint ownership. For example, with joint ownership, who manages and how will differences be resolved? What happens when one owner dies? How may the co-owners address liability issues? What tax issues need they address? And, how does joint ownership affect estate planning?

In fact, one of the difficulties with joint ownership of property involves "where to start" where frequently the issue involves how to take title. In that respect options may include taking title directly, such as a Tenant in Common (including community property) or in Joint Tenancy, where the interests are not seen as an active trade or business. Alternatively, there are instances where ownership may be taken through a Trust. Other options include the use of Partnerships, general and limited, or Limited Liability Companies (or similar entities) or a Corporation

While at <u>Exhibit 2</u>, a summary chart is provided, this outline the focus of this outline is to cover a selection of significant considerations with respect to joint ownership.

II. <u>CO-OWNERSHIP BY DIRECT TITLE</u>

A. <u>Cotenants (also known as Tenants in Common)</u>. As one of the simplest forms of ownership, ownership may be taken as tenants in common. With respect to real property, joint ownership may be stated by way of a grant deed (or other type of deed), in which the owners may title ownership as follows:

- John Doe and Sally Smith, as tenants in common.
- John Doe as to a 40% interest, and Sally Smith, as to a 60% interest, as tenants in common.

However, co-ownership may not be limited to a real property, and may include equipment, intellectual property or other assets, wherein title may be acknowledged in a bill of sale or other private or public documents. In fact, the designation of "tenant in common" need not necessarily be present, such as when a bank account is opened by two persons, without a stated designation of holding an account differently.

1. Effect of Tenant in Common Designation. Different states may provide for statutory acknowledgment of the tenant in common designation, and generally give similar general rights and meaning to the term. For example, under New York Estates, Powers and Trusts Law § 6-2.2, with respect to bequests and intestate passage, generally property passing to two or more persons is treated as taken as tenant in common, unless otherwise designated. However, there are exceptions for variations for spouses, providing for tenancy in entirety. On the other coast, in California, an interest in property created in favor of several persons that is not acquired in partnership or as community property, nor expressly declared to be in joint tenancy, is presumed to be held in tenancy in common. (Civil Code §686.) What is commonly recognized is that in any transfer, the title designation must expressly identify each person (or entity) holding title. In addition, as to those persons name, all of them, collectively, hold all rights in the real estate, including the right to own, use, enjoy, manage and borrow.The question, however, is what exactly does each person get? While with the grant of a tenant in common interest, most states should recognize that each person receives a separate but undivided interest in the property, including the right to possession of the whole; as to the other co-tenant, there are no survivorship rights, and the interest of each is descendible and may be conveyed by deed or will, the question arises as to the utility of the property to each of the co-tenants.

- Possession & Use. For example, generally each tenant in common has the right to the full possession and use of the property, whether as husband and wife, domestic partners or simply two roommates. However, neither can generally exclude the other.
- Rent. However, the question arises as to the right of possession and use, as to whether the use by one co-owner entitles the other to charge rent. Here the states are not in agreement. In many states, generally one co-tenant in exclusive possession of the property voluntarily, does not have to pay rent, unless the tenant in possession as undertaken an ouster. Pico v. Columbet, 12 Cal. 414 (1859). But, this rule is subject to interpretation. For example, where one tenant bears the burden of costs for another co-tenant, it does not relieve the other co-tenant from the duty to make contribution. Rainer v. Holmes, 272 Wis. 349, 75 N.W. 2d 290 (1955). And if one co-tenant leases the whole of the property to a third party, and retains all profits for his or herself it does not mean that there is no duty to

account to the co-tenant. Most states require cotenant to be subject to an accounting to the other cotenant, i.e., a sharing of net proceeds.[1] It would certainly be questionable for a 6% co-tenant to lease the entirety of a property and then expect to keep profits for his/herself. In Iowa and Ohio, the in-possession co-tenant is liable to his or her other co-tenants to account for the rents owed to the out-of-possession co-tenants. (H & H Farms, Inc. v. Huddle, No. 3:13 CV 371, 2013 U.S. Dist. LEXIS 72501 (N.D. Ohio May 22, 2013). Iowa Code § 557.16)

- Separate Reporting. Generally, each owner is personally responsible as to his or her separate reporting for tax purposes with respect to his or her interest in the real estate. However, the question arises as to exactly what to report. For example, in Powell v. Commissioner, T.C. Memo 1967-32, the Tax Court recognized that the one-sixth owner in real property, who paid 100% of the property taxes due, was entitled to deduct 100%. The Service did not prevail in its arguments, even though there may be a right of contribution, wherein the court noted that failure to pay would result in loss of the entire property.
- Conveyance of Property. In addition, generally each co-tenant has the right to convey his or her separate interest; however, the conveyance of the entire property to a third person requires that all owners agree.

On the other hand, this simplistic summary does not fit within reality. For example, one co-tenant can contract without the consent of other co-tenants to undertake an oil and gas well in most states. 1 E. Kuntz, The Law of Oil & Gas, chs. 5 and 6 (1987) On the other hand, in Tucker v. Estate of Abe Budman, unpublished, (Mich Ct. Ap. 2004), the Court illustrates the conflicting issues with respect to a farm lease undertaken without the consent of the other co-tenants. While permitted in Michigan, when interposed in a husband and wife situation, the failure to gain consent of the spouse may render the lease void.

[1] Ohio law states generally that "[o]ne tenant-in-common . . . may recover from another tenant-in-common . . . his share of rents and profits received by such tenant-in-common . . . from the estate, according to the justice and equity of the case." Ohio Revised Code 5307.21.

- Leases. The same considerations apply with respect to financing, where the property is used as security; in fact, the lender may insist that all co-tenants agree to the making of the loan in order to secure the whole property or to assure the loan will not breach a tenancy-in-common agreement.

2. Effect of Tenant in Common for Personal Residence. With respect to the use of a personal residence, while the general principals apply above, state laws may provide additional guidance in the context of landlord-tenant rights; but outside of that spectrum no special common law or statutory rules apply to a personal residence.

3. Use of Tenancy-in-Common Agreement. While not done as commonly as it should, a tenancy-in-common agreement may be entered among co-tenants. As outline above, there are a number of areas of controversy that can arise, and a tenancy-in-common agreement can help to reduce issues where there are set out rights and obligations with respect to co-tenants. Where a Memorandum of Tenant-in-Common Agreement is recorded, it may in fact be deemed to put third parties on notice, creating a position to set aside, in some circumstances, agreements executed by one co-tenant without the consent of the others.

Tenancy in common agreements will look much like partnership agreements, but may have certain variations to preserve recognition for tax purposes. For example, the agreement could provide that one tenant in common will be the day-to-day manager of the property, dealing with any tenants of the property as well as any lender, but may have actions that require the approval of all of the cotenants before proceeding.

Sample Tenancy-in-Common Agreement Language.

> *The purpose of this Agreement is to provide for the orderly succession of the ownership of the Property among the Owners in a manner which enables efficient management and use of the Property.*
>
> *1.1 Sharing of Costs, Profits and Losses.*
>
> *A. All profits, losses, gains and expenses associated with the Property shall be shared by the parties in accordance with their percentage interest in the Property.*
>
> *B. Except as otherwise provided in this Agreement, each Owner shall promptly pay his, her or its share of all expenses in accordance with his, her or its percentage interest.*

1.2. Loans and Advances. In the event that any Owner is unable or unwilling to make an Expense payment, the other Owners are authorized to pay such Expense or Expenses so as to avoid a default. Any amounts so advanced by one Owner on behalf of another Owner shall bear interest at a rate equal to ten percent (10%) from the date such amount is so advanced and shall be due immediately upon written demand

4. Effect of Tenant in Common for Investment/Business Real Estate. In considering use in a business setting, the following additional features should be considered.

a. Tax Features.

i. Return Reporting. As previously noted, each co-owner, is personally responsible for separately reporting for tax purposes. With respect to a joint undertaking, this means that each tenant-in-common must separately compute his or her allocable share of the profits and losses, wherein no summary information return is provided, but rather each owner is responsible to determine and report is or her "slice" of items of income and expense. For example, for rental real estate, each co-tenant must separately state every item of income and expense on the rental schedule provided on Form 1040, Schedule E, and must separately compute his or her depreciation in connection therewith.

→ Warning – Reporting as a Partnership. It is a common practice by accountants where there is rental real estate held as tenants-in-common to report the real estate as a partnership rather than a co-tenancy without considering if a partnership is in fact formed. While this is seen as making it administratively simpler, it has significant legal implications. Although some may be beneficial, the following should be considered:

- Loss of the right for each co-tenant to separately elect, depreciation, a Section 1031 exchange upon a sale, the qualified real property business indebtedness exclusion;
- Client confusion; are they a partnership or a co-tenancy for their FBNS, creditor contracts, approval of transactions?

For a fuller discussion of partnership treatment, see “Partnership Treatment” below.

ii. Tax Exchanges. An advantage of this form of ownership is with respect to Section 1031 tax deferred exchanges. In particular, each separate owner has the choice as to whether, upon a sale, to convert the sale into a Section 1031 tax-deferred exchange for the purpose of acquiring replacement property.

b. Legal Features. Because there is no separate entity concept, every legal concern that may arise concerning real estate held affects every tenant's share. For example, an action may be sought against any tenant-in-common for a recovery, wherein the other co-tenants have an obligation for contribution for any tenant who pays more than his share.

5. General Considerations. Holding title as a tenant-in-common results in several tax and legal concerns.

a. Creditor Risks. One problem that arises with a co-tenancy is that a co-tenant's creditors may affect indirectly other real estate owners. For example, a creditor to a co-tenant may foreclose on the interest secured thereby becoming a co-tenant or selling that interest to a third party. In addition, a co-tenant's interest may be subject to a bankruptcy or insolvency proceeding. A creditor may place pressure upon other co-owners and on real estate operations. See "General Considerations – Disputes; Partition" below. This may be mitigated only partially, by way of a written tenancy-in-common agreement which could require a first-right-of-purchase by the other tenants in common, upon the death, bankruptcy, insolvency or disability of a tenant-in-common.

In addition to separate co-tenant creditor issues, all co-tenants may have liability for general debts of the real estate. While a co-tenant has a right of contribution from other co-tenants, a general creditor may seek recovery from any co-tenant.

b. Approval by All Co-Tenants. Another problem is that any action affecting the entire real estate held requires unanimous approval. This may be mitigated somewhat by appointing a single co-tenant as attorney-in-fact to execute leases on behalf of all co-tenants or by hiring a property management company. With a co-tenancy, however, there are limitations on the delegation of control. This problem becomes more acute with respect to issues regarding sale of property and other concerns where the other owners do not cooperate.

c. Community Property. A husband and wife may take title to property as tenants-in-common, wherein for community property purposes, it is not necessarily required that their designation be stated to be as husband or wife, or as community property, except to clarify their intent. In listing property as tenants in common, both husband and wife must consent to any financing or sale of the whole property.

d. Succession. Generally, tenants in common come together because of an existing business or personal relationship. However, when one tenant in common dies or a tenant decides to sell his or her interest, that tenant may transfer as he or she chooses, including to a stranger. Thus, upon the tenant's death, his or her share will pass as designated by will, by trust (if the property is held/titled in that tenant's trust) or by intestate succession without the consent of the other co-tenants.

> → Planning. A written tenancy-in-common agreement can impose a reasonable first of purchase option. A first right of purchase creates an option and is not a non-permitted restraint on the right to sell.

e. No Probate Avoidance. For estate planning purposes, the listing of one's children as additional tenants-in-common, does not avoid probate and will not entitle the children to automatic succession.

f. Disputes; Partition. While each tenant has an unlimited right of use, all tenants generally must unanimously agree to any lease, financing or sale involving a third party. This creates a risk of disputes.

In addition, whether or not there is a dispute, each tenant has the right to seek a partition action. A partition action is a legal action to divide the property or, if the property is not easily divisible, to force a cash buy-out to remove a co-owner. For a partner wanting out, this may be seen as an advantage. It is equally beneficial for the co-owner who wants to stay in. For example, if one co-owner wants to stay-in, and can buy-out the other co-owner, a court will most likely not allow a partition by sale, but order a partition in kind. See Delfino v. Vealencis, 181 Conn. 533 (1980). While for practical purposes, there is a very limited market for the sale of fractional real estate interests, co-tenancies literally provide the opportunity to force a division of property or to require that the other owner buy-out an owner's interest. Sometimes state law is unclear as to whether partition rights may be waived.

g. Partnership Treatment. With real estate investments, the treatment for tax purposes may not coincide with the treatment for title purposes. Where a real estate investment is relatively passive, the real estate can be reported as described above a co-tenancy. On the other hand, if there are sufficient activities, the real estate may be considered to be held by a partnership consisting of the owners, where there is more than one, regardless of whether the real estate is titled in the names of the individual owners. In that event, reporting of income and deductions must be determined at a partnership level. (Subchapter K of the Code) Indeed, the opportunity to complete a Section 1031 exchange may be precluded or at least involve more complex strategies and possible tax risks.

i. Aggregation vs. Separate Entity. Unlike a partnership, with a co-tenancy, there is no real concept of a separate entity. For example, prior to UPA 1994, in a lawsuit, the naming of a partnership in a lawsuit was usually sufficient to hold all partners liable, whereas for co-tenants, each co-tenant must be personally named. There are also other differences.

h. Example. Individuals A and B co-own property that is leased out to others. If A and B are not considered to be in a partnership, A and B may each separately determine the allowable depreciation method on his or her interest in the property leased.

i. Tax Factors Used to Distinguish Partnerships from Co-Tenancy. In distinguishing a partnership from a mere co-ownership of property, two cases provide a number of the factors that determine a partnership in Comr. v. Tower (1946) 327 U.S. 280, and Comr. v. Culbertson (1949) 337 U.S. 733. The factors listed are:

i. Joint contribution of capital or services;

ii. The purpose of carrying on a trade or business;

iii. Joint ownership of the capital contributions and earning of the enterprise;

iv. Sharing profits and losses;

v. Mutual control of the business;

vi. The parties' agreement and their conduct relative thereto;

vii. Maintaining separate books of accounts for the business;

viii. Representing the business to others as a partnership; and

ix. Conducting business, holding title to property and filing tax returns in the partnership name.

On the other hand, these cases do not clarify how these factors are to be weighted or that these facts are exclusive. However, if most of these factors are present, a co-ownership of property or jointly conducted activity will probably be found for tax purposes to be a partnership.

Rev. Rul. 75-374, 1975-2 CB 261. For example, in Revenue Ruling 75-374 (1975-2 C.B. 261) a real estate investment trust and a life insurance company each held an undivided one-half interest in an apartment complex. A separate management corporation handled tenant services and charged for the services, making additional profit. The IRS ruled that because these tenants' services were provided by a separate entity that was not an agent of the two owners, a passive co-ownership arrangement existed, rather than a partnership.

Check-the-Box Regulations. Certain joint undertakings are entities under the Check-the-Box Regulations:

> "A joint venture or other contractual arrangement may create a ***separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom***. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, ***mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity*** for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes. (***Emphasis added***.) Treas. Reg. §301.7701-1(a)(2).

j. State Law Factors to Distinguish Co-Tenancy. In some cases, tax law looks to the presence of all two of three state law factors (active conduct, business profit motive) as the distinguishing features of a partnership rather than a co-tenancy:

i. Active Conduct of a Business. There must be an active business. If an activity involves passive investment by all investors, as co-tenants, partnership treatment may not apply and each co-owner could report his or her separate share of income.

ii. Profit Motive. There must generally be a profit motive. An enterprise merely engaged in sharing expenses may not be a partnership. For example, two accountants who merely share the costs of an office and receptionist are generally not partners and do not have a partnership. The absence of a joint profit motive is the critical factor. (Treas. Reg. Sections 1.761-1(a), 301.7701-3(a).)

iii. Co-Ownership. Mere co-ownership of property does not create a partnership. The regulations provide that co-owned property that is "maintained, kept in repair, and rented or leased" does not create a partnership. Co-owners who simply provide "customary" services such as heat, water, unattended parking, repairs, trash removal and the cleaning of public areas are not partners. (Treas. Reg. Sections 1.761-1(a), 301.7701-3(a).)

k. Election Out of Partnership Treatment. Given that there is some degree of uncertainty as to whether a partnership is found to exist, the Code allows under Section 761(a) an election out of partnership treatment for certain enterprises. The most common category that applies to real estate involves where (i) property is held for investment purposes only and not for the active conduct of a business and (ii) income of the members of the organization can be determined without computing partnership taxable income. (Section 761(a) of the Code).

Unfortunately, this election out of partnership treatment creates some unusual problems. First, it is applicable only to owners that are identifiable as an "organization" and therefore there is arguably a question as to whether cotenants should make this election in the first place, if the co-owners do not take on an active role as a group and never reported as a partnership.

Second, regulations further limit eligible owners, wherein they must: (i) own property as co-owners, i.e., as co-tenants; (ii) each reserve the right to take or dispose of his or her share of property; and (iii) not conduct business or authorize a representative to purchase, sell or exchange on his or her account. (Treas. Reg. 1.761-2(a)(2)).

l. Ruling Process for Co-tenancies. In addition, for a rare interested client, there is the opportunity to request a ruling as to whether a tenancy-in-common arrangement should be taxed as a co-tenancy and not as a partnership. While the recent revenue ruling is viewed by practitioners as some guidance for what a co-tenancy is permitted to do, it is not a safe harbor and may not be relied on as such. (Revenue Procedure 2002-22, 2002-1 C.B. 733) In Revenue Procedure 2002-22, the fundamental concept as identified is that:

> Each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. (Rev. Proc. 2002-22, *Id.*)

In this procedure, the Service will rule that both a sponsor package and other co-tenancy (not part of sponsor) is not a partnership if several requirements are met, including:

- There cannot be previous partnership reporting;
- All co-owners must be entitled to vote;
- Co-owners cannot be restricted as to the right to sell their interest, except as to a first right of refusal to the other co-owners at fair market value;

- Profits and losses must be proportionate in all respects;
- Debt share must be proportionate to sharing of profits and losses;
- Reasonable management agreements are allowed - management company may maintain an account and must pay out all profits within 90 days;
- A co-tenancy agreement is permitted.

6. Husband and Wife as Owners. For a husband and wife, the form of ownership presents a confusion of options. For tax reporting, where a husband and wife file a joint return, normally, rental property is reported simply on Schedule E, as if there was only one owner. However, there is also the option to treat the real estate as owned by a partnership and report income as partners.

7. Estate Planning. With respect to estate planning, a co-tenant may hold his or her interest directly or in trust, and may pass property by will, trust or even intestate succession. However, for tax purposes, the value of the interest is not necessarily a percentage of the whole. While there is no authority for discounting fractional interests in either the Internal Revenue Code (IRC) or in the regulations, except the statement in Treasury Regulation 20.2031-1(b) that "all relevant facts and elements of value as of the applicable valuation date shall be considered in every case" it has become standard practice to recognize that a fractional interest in property should receive some form of discount, reflecting the differing interests of the co-owners. Among the factors typically addressed by expert witnesses in determining value are: (1) the difficulties faced by owners of fractional interests in securing purchasers except at substantial discounts; (2) the limits placed on owners of fractional interests with respect to control, management, and operation of the property; (3) the inconvenience of dealing with multiple owners; (4) the possibility of complications caused by owners of very small fractions; and (5) the danger of partition suits.

Indeed, the premise for fractional interest discounts is that each tenant-in-common, regardless of the size of such tenant's interest, is entitled to possess and use the co-owned property and, without resort to partition, cannot "oust" the other co-owners. This forced sharing of access (rather than lack of access) has the potential to create significant confusion and upheaval. And, even a co-tenant with the smallest fractional interest has a right to operate the property subject to the identical right of each of the other co-owners, all co-owners must agree to all decisions related to the property if the operation is to be a success. A co-tenant thus has a veto, and disagreements can lead to gridlock. Judgment creditors of any co-tenant may secure a lien on such tenant's undivided interest and compel partition. In addition, the identity of a co-tenant can change with death or divorce. Finally, financial institutions will not provide a loan on undivided interest property where the property is the sole collateral unless all undivided interest holders sign the loan documents.

Unfortunately, the amount of the discount can be unpredictable. Estate of Cervin v. Commissioner, 68 T.C.M. (CCH) 1115, T.C. Memo 1994-550 (20% discount); LeFrak v. Commissioner, 66 T.C.M. (CCH) 1297, T.C. Memo 1993-526. (30% discount); Estate of James A. Elkins, Jr., et al. v. Commissioner, 140 T.C. No. 5 (2013). (10% discount)

B. Joint Tenancy. Under joint tenancy, two or more individuals both directly hold title to real estate together, and designate their ownership as being held in joint tenancy. Examples of how title is listed in the grant or other deed are as follows:

- John Smith, and Peter Doe as joint tenants.
- John Smith and Jane Smith (husband and wife) as Joint Tenants

1. Effect of Co-Owners with Survivor Rights. Joint tenancy is a modified form of co-ownership. Sometimes referred to as the “4 unities,” of interest, time, title and possession. All parties take title at the same time, hold the same interest, essentially the entirety of the property, interests are equal, and undivided, and upon a death the surviving co-owner(s) succeeds to the property without a probate proceeding. These unities cannot be severed except by a deed or declaration by a joint tenant, whether to convert to a tenancy-in-common or to convey title by one joint-tenant to a third person (causing the severance.)

With respect to succession of interests, when one joint tenant dies, the surviving joint tenant(s) automatically receives title without probate costs and delay. All that is usually required is a certified copy of the death certificate and an affidavit of survivorship. The last to survive takes absolute ownership.

Other than estate tax and legal considerations, discussed below, generally all of the features discussed above for tenants in common applies to a joint tenancy. This means that joint tenants generally must act together.

a. Spouses. While nationally, joint tenancy is probably the most popular way for husbands and wives to hold title, it is not necessarily the best option. Joint tenancy is the original "poor man's" trust insofar as it allows for succession without probate.

Where joint tenancy is used, the succession cannot be changed by a will or trust. They will not control where the property goes upon death to the surviving joint tenant(s). While this is the most common way married couples had taken title in the past, it may not be the best way.

> → Warning – Spousal Joint Tenancy Designations on Prior Separate Property. While joint tenancy may be seen as a simple solution for transfer of property between a husband and wife, where the property was originally separate property, community property law may override and bring the property back to separate property on a marital dissolution, presuming undue influence, unless there is an express, written transmutation agreement. Unfortunately, this area of the law generates considerable uncertainty wherein the courts have reached different conclusions on somewhat similar situations. For example, if there is a later divorce, the spouse receiving a joint tenancy interest may be required to prove the absence of undue influence if the joint tenancy deed changed the rights of the parties from their prior holding.

b. Unmarried/non-registered partners. Again, while not necessarily the best option, where two persons are living together as a couple, but have children from former marriages, the joint tenancy option is often chosen to try to assure passage of property to the other partner without a dispute by the children of either marriage, and without requiring probate or a joint trust.

c. Joint tenancy has also been popular to provide for succession in real estate from parents to children, wherein the children are designated as joint tenants. Conceptually, succession will occur upon the death of the parents wherein title will pass by law to the surviving children as joint tenants.

2. Tax Considerations. Joint tenancy has a number of tax considerations.

a. Spouses. Historically, joint tenants do not enjoy a 100 percent step-up in the value of real property upon the death of one owner, even if a spouse. Outside of California and states that have addressed the issue head-on, only one-half of the interest held in real estate held by a spouse in joint-tenancy will step-up. (But see California Family Code Sections 2580 and 2581.) As a consequence, joint tenancy holds a somewhat awkward position with respect to a husband and wife who intend property to be held as community property.

→ Note. As a route around this problem, historically, including Judge Cohn of the Tax Court, before she was appointed, would have in place a written agreement acknowledging the community property interest of property held in joint tenancy. There is some case authority for this position, but with the newer ways of holding title, joint tenancy probably should not be used between spouses to hold title.

b. Children. Where children hold an interest with a parent as joint tenants, the Service will determine whether the interest held by the children was solely for succession purposes. If the children made no contribution to the acquisition or ownership of real estate, the parent(s) holding title will be treated as the sole owner for all income and estate tax purposes.

The deceased's will has no effect on joint tenancy property. With joint tenancy, one joint tenant can convey his or her share without the other joint tenant's approval, thus ending the joint tenancy and creating a tenancy in common. As mentioned earlier, a joint tenant can bring a partition lawsuit to force a sale of the property if the other owners do not want to sell.

→ Warning – Creditors of Joint Tenants. Designation of title in joint tenancy means that real estate may become subject to the claims of the creditors to any person titled thereto. For example, if a child is added as a joint tenant to a personal residence, but that child then or later has issues with creditors, the parent's home may become exposed to the liability of the child's creditors.

3. Estate Planning. Obviously, as indicated above, joint tenancy inherently contains the element of estate planning by providing for succession of property to the survivors, without a will, trust or intestacy law. The downside is obviously where the co-owner did not intend the consequence of passage by law, which may be difficult to avoid.

Where the joint tenancy involves a true transfer of assets by death, the valuation of the property is not necessarily qualified for valuation discounts. Under Section 2040 of the Code, joint interests is stated to include the whole of the property, less that portion which is shown to have originally belonged to the surviving joint tenant and was never received for less than full and adequate consideration. However, where the interest is held by husband and wife, the value included is "one-half" of the value of the qualified joint interest. In these cases, the Tax Court favors a no discount position. Estate of Young v. Com'r, 110 TC 297 (1988).

C. **Community Property with Right of Survivorship**. If real estate is titled as community property with right of survivorship, then the deed designates both a community property interest and a right of survivorship. An example of how title is listed in the grant or other deed is as follows:

- John Smith and Jane Smith, as community property with right of survivorship.

1. Effect of Community Property with Right of Survivorship (CPWROS.) In some community property states, a husband and wife may, by deed, designate that real estate is community property, but may pass property outside of probate by automatic succession at death. To be treated as such, title must say "as community property with right of survivorship."

2. Considerations. Real estate designated as CPWROS is treated as having both spouses on title. Most of the general provisions applicable to co-tenants apply to spouses or domestic partners holding title as CPWROS.

There are some tax and legal differences, however. In addition to automatic succession without a probate proceeding, the foregoing designation in results in 100 percent of the interest passing to a surviving spouse being subject to step-up to fair market value as of the preceding spouse's date of death.

> → Note. CPWROS is an improvement from holding property in joint tenancy because it acknowledges the community property interest of property, affording a full step-up in value. However, there may still be reasons why using CPWROS may not always be the best option to hold title between spouses. A CPWROS designation does not address a simultaneous death or provide for later passage of title. CPWROS designations override a different disposition by will or trust.

III. TRUSTS

A. **Revocable Living Trusts**. Title to property may be conveyed into a revocable living trust, consisting of a written agreement that provides for management of assets held during one's lifetime and who is to receive those assets upon passage of the original trustors. The following is an example of the language used in the deed conveying property into the trust.

- John Smith and Jane Smith, Co-Trustees under the Smith Family Trust, dated August 2, 2016. (Trust Agreement Required).

B. **Effect of Conveying to Living Trust**. Where a single person or a couple conveys title into a revocable living trust, the designated trustee is the person who is granted all legal rights of management, but the beneficial interests in and to the property and beneficial rights to the designated real estate may remain with the original trustors. In making this conveyance, the "trustors" and "trustees" may be designated as the same person.

In most cases, the Trust is not intended to not change much initially. The trustors are designated as the sole beneficiaries. As trustee(s), each trustor has authority to act with respect to the assets, including make distributions to provide for their needs and wishes in most respects as if there were no Trust at all. While there is a need to separately transfer assets into the Trust, it does not generally affect income tax reporting. No separate taxpayer identification number is required for the Trust. All trust income and expenses will be reported on the trustor's personal income tax returns.

The principal reason for using the trust is for probate avoidance, if there is a need to do some basic estate planning. However, if a trustor becomes incompetent and unable to manage affairs, the alternate trustee (such as spouse or adult child) takes over management of the trust assets.

For many these days, the Trust is solely for probate avoidance, wherein most do not have a taxable estate. In addition, with spouses, it may also provide for a sequence of succession, wherein a surviving spouse may continue to manage property, and then, thereafter, the Trust provides for the designation of who is to receive property upon the surviving spouse's death.

It is probably the best method of holding title to homes and other major assets in a revocable "inter vivos" living trust not only to avoid probate costs and delays, but to address issues that other types of agreements are less able to provide.

C. Legal Considerations. There are a number of legal considerations with using Trusts. First, it does not replace the need for a personal will. Often these wills are minimal, and are known as pour-over wills, in that they serve the purpose to catch assets falling out of the Trust and to return them into (*pour* them back into) the Trust.

1. Character of Property Held in Trust. A major benefit of designating property into a trust is that it generally is not intended, independently, to infer any change in the character of real estate held as separate or community property. While title may be notated for clarification purposes, it is not conclusive. While property may be listed on an Exhibit to identify property held in trust, real estate should in fact be titled in the trust, to avoid any confusion and any later proceeding.

2. Estate Planning. Trusts may provide for estate planning and help to minimize estate taxes. Trusts provide a lot of flexibility, and therefore they can sometimes be very complicated.

a. Historically, many Trusts focused on using each spouse's Unified Credit Amount ($5,450,000), and had a credit (also known as "bypass" trust) to maximize each spouse's use of that estate tax exemption, by irrevocably designating rights to pass in certain aspects to one's children, rather than directly to the surviving spouse. The portability election has created an alternative, and more choices. For example, due to portability, a simpler trust may be used (passing all to a surviving spouse) or the marital deduction will be used instead. In fact, it may be a preference to make an irrevocable designation to a marital trust upon the first spouse to pass, to assure the deceased spouse's assets follow a bequest that cannot be changed by the surviving spouse.

b. Valuation Discounts. In addition, to the extent that trusts hold or create fractional interests, fractional interest valuation discounts may provide opportunities to reduce estate tax liability. However, to the extent that the marital deduction is used to keep property intact, not every circumstance will permit the use of fractional interests to reduce taxes upon the surviving spouse's death.

3. Amendments to Trust. Revocable trusts can be changed. Generally, for spouses sharing a single Trust, the agreement may state that while both are living, they should jointly amend the trust to make changes, but either one may revoke the Trust and provide for their own separate trust agreement with different provisions.

4. Costs of Trust. One principal disadvantage is the legal cost of a Trust. Drafting trusts can be more expensive. In addition, legal counsel have different views when drafting about the extent to which they will allow their clients special provisions. The cost of drafting a trust by legal counsel may run $1,500 or more.

5. Loans. However, on loans, many lenders may insist that the real estate be taken out of the trust to close on the loan. This is due to banking law, including court cases discussing the liability of trustee-borrowers. Once closed, the real estate may be put back into the trust.

6. Administration. Since the living trust is revocable, it can be amended as circumstance change.

7. Tax Consequences.

a. Overview. Generally a revocable trust has no income, estate or property tax consequences upon its execution and the transfer of real estate into the trust. The trustors, in being designated as trustees, retain all rights and continue to be treated as owner for all tax purposes, during his/her/their life. Indeed, the property owner need not tell the designated beneficiary (or any other family member for that matter) about the revocable trust prior to death. A revocable trust does not carry any unique analysis, but may be used as a planning tool to assist with planning for estate taxes and succession issues.

8.

IV. PARTNERSHIPS & CORPORATIONS

A. General Partnership.

1. Overview. Real estate may be transferred by deed into a general partnership. The following is an example of how real estate may be deeded into a partnership:

- Smith & Doe, a general partnership

2. Effect of Partnership Designation. The designation of a general partnership as title holder presumes a business entity in which two or more co-owners own the property either for investment purposes or for the conduct of a trade or business. Property may be formally contributed to the name of the partnership by one of the partners. In the absence of a written agreement, the terms of the partnership in are governed in most states under the Uniform Partnership Act (UPA Act).

As a separate entity, the partnership can hold and convey legal title to real property. It can sue and be sued. It is a separate entity for bankruptcy purposes. A partnership may also include a "joint venture." A partnership is very simple to form; two or more persons need merely agree to co-own real estate together.

Technically, no special action is needed except to designate the title of ownership. However, a fictitious business name should be used, subject to publication and recording requirements. It is also a good idea to have a partnership agreement.

3. Real Estate Not Titled in Partnership. For real estate held for investment purposes, it is often difficult to outwardly distinguish between co-tenancies and partnerships, because the real estate is not legally designated into a partnership. The UPA Act does not require that real estate be deeded into a partnership name in order for it to apply. This confusion

in fact impacts tax consequences of partnership ownership insofar as for investment property which does not involve active business conduct, the difference in reporting may simply require an election out of partnership reporting or the decision to not report as a partnership.

4. Features.

a. Income Tax. While a separate legal entity, a general partnership is not a separate taxable entity, but a conduit for its partners as owners. All profits, losses, deductions and credits are allocated among and reported by the partners. In computing his or her federal income tax liability, each partner is required to report on his or her federal income tax return his or her distributive share, as determined by the Partnership Agreement. Most tax elections, such as depreciation method, amortization of start-up costs, tax matters partner, etc. are determined at the partnership level and not by the individual partners.

For tax purposes, because the partnership acts as a pass-through entity, wherein reporting at the partnership level is passed through to the partners, there are complex partnership tax rules that may come into play. A partner's ability to deduct his or her tax losses from the partnership is subject to various restrictions, including: (i) such items can only be deducted by a partner if they are properly allocated to such partner under the partnership agreement; (ii) a partner may deduct his or her share of the partnership tax losses only to the extent of his or her tax basis in the partnership interest; (iii) deductions for partnership losses are limited to the amount each partner is "at risk" for partnership losses; and (iv) losses generated by a partnership may be limited by the passive activity rules.

Many of these rules are common sense and address recognition of each partner's interest with respect to allocations, to respect the economic effect as to business and accounting reporting, and to deal with practical issues. However, the level of rules are complex with respect to many areas and are not limited solely to aggressive partnership planning.

While for most basic partnerships, the complex tax rules do not apply, a brief listing (and by no means explanation) of some of these provision are as follows:

(1) Code Section 704(b). Capital accounts and allocations for each partner must provide for substantial economic effect of transactions.

(2) Code Section 704(c). Partners who contribute appreciated property must receive special allocations to minimize the difference between basis and fair market value.

(3) Code Section 734 and 743. Certain "hot assets" must be dealt with proportionately. A sale or redemption of a partner's interest may be deemed a sale of hot assets. Hot assets include appreciated property.

b. Legal Features. While not necessarily required, many states may allow a Statement of Partnership Authority may be filed with the State's Office to document the existence of the partnership. Partnerships do obtain federal employer identification numbers which are important for identification for tax reporting and for opening accounts and dealings with others.

In addition, the partners may agree orally or in writing to the manner in which they will conduct their business affairs. The terms of the written partnership agreement may be varied to accommodate the particular needs and wishes of the partners.

Furthermore, the UPA provides guidelines as to the relationship between partners among themselves and to the partnership. Under the UPA, these rights and duties include:

(1) The right to be repaid capital contributions.

(2) The right to inspect records and obligation to disclose all things affecting the partnership.

(3) The right to be bought out upon dissociation at fair market value if the partnership continues (exception for term and project partnerships).

5. Admission/Dissolution. Unless otherwise agreed upon, generally no person can become a member of a partnership without unanimous consent of the partners. A partnership may continue for a period of years or until a project is done. A partnership may be dissolved by agreement, by the death of a partner, by the withdrawal or admission of any partner. A partnership may be terminated by court order.

6. Securities Issues. A partnership interest constitutes a security interest. It is subject to the same restrictions on issuance as are stock shares.

7. Management. As with co-tenancies, each partner may have full rights to the management and conduct of the partnership business. To avoid anarchy, authority may be set out in a partnership agreement which may provide for a lead or managing partner and for certain decisions and actions to be made upon vote of a majority or some greater number. However, an act by one partner, with or without approval, is binding on the partnership. All partners are liable for the debts of the partnership.

8. Liability. If real property is unprofitable or other liabilities are incurred, all the partners are personally liable. However, under the UPA, there is a limited degree of asset protections for LLPS. In addition, to be personally liable, in some states, the state law may require that a judgment be obtained against a partner Personal liability extends to both anticipated and unexpected obligations. For any wrongful act or omission by any partner in the regular course of the partnership's operations, all of the partners may be held equally liable. As a result, each partner puts himself entirely at risk for the success of the real property.

9. Disadvantages. While a benefit of a partnership is that it may usually be terminated without an adverse tax consequence, benefits have to be weighed against disadvantages. A chief disadvantage is the liability exposure to all partners. Another disadvantage is that partnerships may have the same partition/sale issues, though these can be controlled usually by agreements.

B. Limited Partnership.

1. Overview. A limited partnership is a partnership that has at least one general partner and one limited partner. Real estate may be transferred by deed into a limited partnership. The following is an example of how real estate may be deeded into a partnership:

- Smith & Doe, L.P., a limited partnership.

2. Effect of a Limited Partnership. The creation of a limited partnership creates limited liability protection by persons designated as a limited partner. The limited partner is not liable for any obligation of a limited partnership and, unless otherwise agreed, is at risk only to the extent of his or her contributed capital.

Generally, where a limited partner does not participate in the control of the business, only the general partners are liable for partnership debts. Consequently, a limited partner is primarily a passive investor. Unless the limited partnership agreement provides otherwise, the limited partner does have a number of rights that are intended to give the limited partner some degree of protection. These include the right to transact business as an independent contractor with the partnership, approve amendments to the agreement, to lend and borrow money and vote on mergers, extraordinary debt, business changes, admission and removal of a general partner. While some voting rights and a limited partner's right of access to the books and records cannot be varied, other rights can be denied the limited partners under the limited partnership agreement.

3. Features.

a. Income Tax. Like a general partnership, a limited partnership is not taxable as a separate entity, rather all profits and losses "pass through" and are allocated among and reported by the partners. Tax elections such as depreciation method, amortization of start-up costs, tax matters, etc. are determined at the partnership level.

For limited partnerships, however, there are more tax provisions that come into play. In particular, because limited partners usually have no duty to personally repay partnership debts, a number of special rules apply to assure that allocations of limited partner losses have economic effect, including limitations on the amount of losses that are allocated to a limited partner.

b. Legal

i. Management. With limited exceptions, management of a limited partnership is exclusively the right of the general partners. As with a general partnership, each general partner is his own boss and has full rights to the management and conduct of the partnership business. To avoid anarchy, normally business decisions on ordinary matters are done by majority vote; however, an act by one general partner, with or without approval, is binding on the partnership. The limited partners are primarily passive investors.

ii. Liability. If the business is unprofitable or other liabilities are incurred, the general partners are personally liable. Personal liability extends to both anticipated and unexpected obligations. For any wrongful act or omission by any general partner in the regular course of the partnership's business, the partnership is equally liable. As a result, each general partner puts himself entirely at risk for the success of the business.

By contrast to the general partner, limited partners are not personally liable for the obligations of the partnership. Moreover, they are not normally required to contribute capital in addition to their initial capital contribution unless otherwise agreed to in the partnership agreement.

iii. Formation. A limited partnership is not formed until there is filed a Certificate of Limited Partnership with the Secretary of State. There should also be a limited partnership agreement which states the rights of both the general partner(s) and the limited partner(s). In addition, as with any business, other permits and licenses may be required to conduct business, maintain employees, etc.

4. Disadvantages. Like other partnerships, the benefit of a limited partnership is that it may usually be terminated without an adverse tax consequence.

Historically, limited partnerships were preferred for real estate partnerships because it offered liability protection to all investors other than the general partner.

C. Limited Liability Company.

1. Overview. A limited liability company (LLC) is a state chartered entity which has one or more members, wherein all members have limited liability but are granted a number of partnership type features. Real estate may be transferred by deed into a limited liability company which has been formed. The following is an example of how real estate may be deeded into a partnership:

- Smith & Doe, LLC.

2. Effect of a LLC. The creation of a limited liability company (LLC) creates a business entity which provides limited liability protection to all members. The LLC, as a separate business entity has the right to contract, do business, own property, sue and be sued. Unlike a limited partnership, if the LLC is designated as member managed, then all members may participate and control the business of the Company. However if the Articles of Organization designate one or more managers, then only the managers may operate the LLC's business – however, a member may be a manager. If vested in the managers, unless also designated as a manager, a member may not act on behalf of the corporation. Officers may be appointed to run day-to-day business operations.

a. Liability. A primary feature of an LLC is that no member is liable for any obligation of a LLC, unless otherwise agreed. A LLC member is at risk only to the extent of his or her contributed capital, and capacity as a manager will not generally make that member liable for partnership debts.

b. Formation. States allow the formation of limited liability companies by one or more persons by the filing of Articles of Organization. In addition, an Operating Agreement outlining the rights of the Manager(s) and the LLC members is recommended.

c. Company Powers; Fiduciary Responsibilities. LLCs contain a separation of powers that may be somewhat similar to that of a corporation. However, in some respects it has its own unique features. With the most recent update, encompassing the Revised

Uniform Limited Liability Act (Revised LLC Act), LLCs have adopted a number of complicated fiduciary duties and limitations also found within the UPA Act. While the Revised LLC Act is intended to give maximum effect to the principles of freedom of contract and to the enforceability of operating agreements, it is not without certain restrictions as to matters that cannot be changed or for which flexibility is limited.

3. Features.

a. Income Tax. LLCs are generally treated, unless otherwise elected, as either disregarded (for single member LLCs) or as a partnership for tax purposes. Where disregarded, all income is reported by a single owner as if the LLC did not exist for general tax reporting. This feature is only available where there is one owner.

Where there are two or more owners, except possibly for a husband and wife, the treatment is that of a partnership for tax purposes.

While somewhat infrequent, an LLC might elect to be taxed as a corporation. Except in corporate groups, this feature is generally not favorable. However, some accountants have adopted this election, then an S Corporation election, based on the principal that this may possibly offer some protection from an endeavor to pierce the asset protection for failure to keep minutes.

i. Single Member LLCs. From a formation standpoint, a significant LLC development is single member LLCs. A LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes), unless it files Form 8832 and affirmatively elects to be treated as a corporation.

ii. Husband and Wife. Since the introduction of single member LLCs, there has been confusion as to whether a husband and wife who owned the entire interest of a LLC as community property qualify as a single member. In order to provide some guidance in this area, the IRS adopted Revenue Procedure 2002-69. This procedure applies to an entity if: (1) the entity is wholly owned by a husband and wife as community property under the laws of a state, foreign country, or possession of the United States; (2) no person other than one or both spouses would be considered an owner for federal tax purposes; and (3) the entity is not treated as a corporation under IRS Regulation Section 301.7702-2. In these situations, the IRS will respect the husband and wife's treatment of the entity as either a disregarded entity or partnership for federal tax purposes. However, the IRS will treat any change in the reporting position by the husband and wife as a conversion of the entity.

iii. Legal Features. The LLC is a blend of partnership and corporate law. Like a corporation, no member is ordinarily personally liable for the obligations of the Company. Moreover, its default rules provide for mandatory indemnification of any member in a member-managed LLC and any manager of a manager-managed LLC who complies with the duties set forth in the Act, unless reduced in the Operating Agreement. However, like a partnership, there is substantial flexibility in the right to allocate profits and losses among the members.

iv. Asset Protection. California is somewhat unique in that it has codified the standard in the LLC statutes. That statute imposes personal liability on a member of a LLC to the same extent as a shareholder of a corporation, except that where meetings of members or managers are not required, the failure to observe formalities regarding the calling or conduct of those meetings is not a factor to be considered in establishing that liability. In this regard, a LLC may be a better choice of entity it does not have to worry about keeping corporate minutes to avoid piercing the veil.

v. Reverse Piercing on LLCs Not Allowed. Additionally, LLCs offer charging order protection from "reverse piercing," which is an effort on the part of a personal creditor of a LLC member to reach the LLC's assets to satisfy the member's debt to the judgment creditor.

4. Disadvantages. LLCs have become very popular for real estate since they offered the benefits of partnerships, i.e. they may usually be terminated without adverse tax consequences and of corporations, i.e. they offered a degree of liability protection to all investors. This makes LLCs a predominant choice. However, the increase in statutory fees means that in some cases the cost of the LLC in California may outweigh its use. The result has been at times the use of limited partnerships or a blend, where the LLC serves as the general partner. However, while saving in LLC fees, this adds additional administrative complexity and costs of two returns, two sets of books, and the complexity of providing the governance documents and explaining the structure to third parties such as lenders, title companies, etc.

D. Corporation.

1. Overview. Real estate may be transferred into a corporation. A corporation is a separate chartered entity existing under the authority of state law. It has its own separate identity, separate and apart from the incorporator and shareholders.

2. Features.

a. Income Tax Features. Except for S corporations, a corporation is a separate taxable entity and pays corporate income tax on net income. For tax purposes, corporations pay different rates based on their tax bracket. The result is that there is the opportunity to "shelter" corporate income at reduced federal tax rates of 15 percent on the first $50,000 of taxable income and 28 percent on the next $25,000. Corporations (other than S corporations) can offer a few extra tax-free benefits such as group term health insurance and key-man medical insurance.

While shareholders of a corporation (not an S corporation) do not personally pay tax on the corporate income, the options to distribute funds to shareholders tax free are few. In fact, dividend distribution to individuals out of corporate earnings are taxed twice. Corporate earnings are taxed to the corporation. As dividends, they are again taxed to the individual recipient, resulting in the second tax.

b. Legal Features. A corporation is a separate legal entity. It may sue and be sued, sign contracts and transact business in the same capacity as an individual. Corporations must maintain their separate identity to limit risk of personal liability to its shareholders.

i. Management. Management is the obligation of the board of directors who are elected by the shareholders. The board of directors sets policy, elects officers to run the day-to-day operations of the business and authorizes extraordinary matters such as loans, mergers, and the sale of the business. Shareholders have limited rights to vote on certain matters such as the sale of the business, a merger, a reorganization or dissolution. The same persons may be stockholder, directors and officers. Where there is a single shareholder, the shareholder may be the sole director and officer.

ii. Liability. The most notable feature of a corporation is that shareholders are generally not liable for the debts of the corporation. But there are notable exceptions.

iii. Formation. A corporation is formed by the acknowledgment of the filing of Articles of Incorporation and the issuance of shares of stock. A corporation should also issue bylaws governing the conduct of the administration of the business.

3. S Corporation. A corporation having not more than 75 individuals may elect for tax purposes to be an S corporation wherein income and losses will be taxed to the shareholders rather than to the corporation.

4. Disadvantage. The primary concern with Corporations has been the risk of lock-up of gain in a corporation, causing double taxation. For example, merely terminating a corporation is a taxable event. As a result, the use of real estate in a corporation requires cautious planning and is usually **not favored**, particularly with respect to the potential for lock-up of value. This lock-up becomes more prevalent where there are estate taxes on stock held in a decedent's estate wherein the real estate does not enjoy the benefit of a step-up in tax basis.

V. CHOOSING AMONG OWNERSHIP AND ENTITY FORMS.

Unfortunately, there is no "one size fits all" choice as to entity with respect to real estate investments. Most real estate investments, however, are usually not done through corporations, or even an S corporation, out of concern for double taxation or stricter limitations on at-risk rules for S corporations.

A. Nonbusiness. For nonbusiness activities, such as ownership of a personal residence, the best option may be to consider use of a revocable living trust to hold property. The holding of title in a Trust by one co-owner, does not preclude another co-owner from holding title in a different manner, if there are two or more co-owners.

If a less complicated option is chosen, it may depend upon the particular circumstances, wherein the consequences of each option should be considered.

B. Business/Larger Investments. Where real estate is part of a business operation or a larger investment, in many circumstances a legal entity should be considered. For example, smaller real estate investments, an LLC may work best as the $800 LLC tax would seem to be a fair exchange for a limited degree of asset protection. However, where LLC total income will exceed $250,000, the additional LLC fees might not always justify the protection given. On the other hand, legal entities have several downsides. These include more difficulty in using the parent-child transfer exclusion for property tax purposes, and difficulty or possible loss of use of a Section 1031 exchange exclusion on investments where not all owners want to participate in the exchange.

Some very large real estate groups have returned to using a combination of entities to try to get the best of all worlds, i.e., limiting liability as to all owners while avoiding the additional LLC fees. For example, some investments are held in a limited partnership with an LLC as the general partner.

VI. BASIC TAX CONCERNS

A. Basis and Loss Limitations. A major tax consideration to real estate investments is tax basis, which sets the limits as to losses for real estate as concern both operational and failures.

1. Losses Limited to Basis in Equity. The allowability of losses for income tax purposes is limited to the owner's basis in the entity.

2. LLC. Under Section 704(d), a partner may deduct partnership operational losses allocated to him to the extent of his adjusted basis in his partnership interest. The partner's basis includes tax capital contributions and the partner's share of debt under IRC § 752.

3. Limited Partnership. Same as LLC.

4. S Corporation. A Shareholder of an S corporation may deduct losses of the corporation to the extent of the shareholder's basis in stock plus any amounts loaned to the corporation by the shareholder. IRC § 1366(d)(1).

a. S corporation shareholders do not get a share of the entity's debt for purposes of determining their basis in their stock, such as a partner can for the partnership's debt.

b. In order to take losses on debt by an S corporation, and thereby increase a shareholder's basis in indebtedness, there must be a shareholder loan and the loan must represent the S corporation's bona fide indebtedness. Prop. Reg. § 1.1366-2(a)(2)(iii), Example 1. S corporation shareholders generally are not permitted to increase their basis by guaranteeing a loan made by a third party to the corporation until they actually have to make payments on the guaranty. *Id.*; *Maloof v. Commissioner*, T.C. Memo 2005-75.

5. Optimum Choice. With respect to a real estate investment, a greater amount of losses will be allowable with a partnership-type entity (such as an LLC) than a S Corporation.)

6. Areas of Caution. In determining tax basis, complex rules apply with respect to allocating LLC entity debt among the partners. While a recourse debt (which is not guaranteed by anyone) to a LLC is "recourse" for state law purposes, it is nonrecourse debt for tax purposes and normally will be allocated in proportion to the members' percentage interests. The members can take deductions equal to the sum of tax capital and allocable debt.

> Example: ABC, LLC is a limited liability company with A, B, and C as equal members each with tax basis capital accounts of $25,000. ABC, LLC borrows $150,000, secured by a recourse mortgage on real property. A, B and C do not guaranty payment of the loan. The mortgage liability is treated as a nonrecourse liability of ABC, LLC and $50,000 is allocated to A, B and C each. Therefore, A, B and C can each take deductions/losses up to $75,000 each (subject to the Anti-Abuse Rules).

B. Section 1031 Exchanges.

1. Partnership/LP/LLCs. While LLCs may have benefits in many areas, for tax purposes, it has been preferable to not be treated as a partnership in contemplating a Section 1031 exchange. In particular, co-tenants in real estate can personally decide whether or not to participate in a Section 1031 exchange with respect to real estate. By contrast, the partnership itself must generally make that determination and individual partners are prohibited from using their individual partner interests as exchange property for a Section 1031 exchange.

2. C Corp/S Corp. The same issue arises with respect to S Corporations and C Corporations that a Section 1031 exchange can only be by the entity and not by shareholder interest.

C. Employment Taxes.

1. Partnerships. While generally, partners must pay self-employment taxes on their share of the ordinary income of the partnership, as well as any guarantied payment received. IRC §1402(a), this does not apply to rents from real estate.

In addition a "limited partner" is not required to pay self-employment tax on their share of the ordinary income of the partnership except for guarantied payments received for services. IRC §1402(a)(13). The exemption depends on the partner's level of participation in partnership business. *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011); *See also Howell v. Commissioner*, T.C. Memo 2012-303.

2. S Corp. While employment taxes often have been the deciding factor in favoring an "S" corporation over a LLC, this is not necessarily true with real estate, where the real estate is not considered part of an active trade or business. Generally rental income from real estate is excluded from earnings from self-employment (Code Section 1402(a)(1)), and accordingly with respect to most forms of doing business, tax will not be triggered. With an "S" corporation, however, there is required to be paid a reasonable salary. While only the salary paid to the employee-owner is subject to employment taxes but not the undistributed taxable income. (Rev. Rul. 59-221), the problem of requiring a salary may result in employment taxes that would not have otherwise had to be incurred.

The IRS has held that when shareholders perform services for an "S" corporation but don't draw a salary, any "dividends" paid to the shareholders in lieu of reasonable compensation for these services are treated as wages subject to withholding. (Rev. Rul. 74-44).

3. C Corp. Employment taxes apply to reasonable salaries required of a C Corporation. Real estate may be held in a C Corporation to facilitate loan financing or for other reasons. However, given that the payments of rents is not service income and is expressly excluded, there is no employment tax benefit to placing real estate in a C Corporation.

4. Planning. Where real estate is involved, the decision as to choice of entity includes consideration of whether or not there is an issue with self-employment taxes applying. The exemption for rentals favors keeping real estate in a separate legal entity that is leased to the trade or business operation in order to avoid self-employment tax concerns. That separate entity should be an LLC, or other partnership and not an S Corporation or C Corporation to avoid employment tax issues on the real estate.

D. Estate Planning with Real Estate. An interesting aspect with estate planning with real estate is that there are opportunities to do extensive estate (and income) tax planning with real estate that is more flexible than other investments.

1. Overview. With real estate, the overwhelming planning has tended to be with pass-through entities, including limited partnerships and LLCs. However, the beginning point is the consideration of why these entities, rather than any-other type?

2. Why Use of Entities. With respect to estate planning, the use of a general partnership, an LP or an LLC is not new and has been used by families as they have a fair degree of flexibility without creating a separate taxable entity or risk of double taxation on distributions with respect to real estate investments.

a. Section 2704(b). In reviewing the benefits of discounts for FLPs and LLCs it is important to understand IRC Section 2704(b). This section was added to limit the use of control/transfer restrictions for the purpose of obtaining discounts from the use of entities transferred for gift/estate tax purposes. Section 2704(b) states that any "applicable restriction" must be disregarded in valuing the transferred property if the transfer is made to a member of the transferor's family. The term "applicable restriction" refers to an agreement restriction that goes beyond those provided by law.

Fortunately, court decisions have found that the restrictions on the limited partner interests were acceptable, being no greater than those permitted by state law and therefore should be respected for purposes of determining valuation discounts in planning for larger estates. (*Harper Est. v. Com'r*, T.C. Memo 2000-202; *Knight v. Com'r* (2000) 115 T.C. 506 (2000); and *Jones Est. v. Com'r* (2001) 116 T.C. 121 (2001).

b. LLC v Family Limited Partnership. In addition, computing discounts, it appears that LLCs and limited partnerships have somewhat similar restrictions by state law which should indicate similar discounts would be allowed for valuing transfers of interests. Several other states continue to grant greater rights to LLC members to withdraw and as a result those states' laws limit the allowable discounts.

In choosing between LLPs and limited partnerships, families need to consider those differences that do exist. For example:

i. Right to Participate. With a limited partnership, a limited partner, by statute, cannot participate in the management or operation of the partnership. With an LLC, an LLC member is not precluded from having a right to be designated a manager. This potentially may give greater rights to members to usurp the manager.

ii. Self-employment Tax. There continues to be issues as to the tax treatment of a member with respect to self-employment taxes. This issue is somewhat clearer with limited partnerships. However, this is usually not an issue with real estate that produces rental income.

c. Estate Planning Goals. Both LPs and LLCs are taxed as partnerships generally. From a planning perspective, LPs and LLCs can accomplish the same goals.

d. Estate Freeze. As an example of estate planning, LLCs may be used to accomplish an estate freeze wherein the goals are to:

i. Retain net property income for the Senior Generation;

ii. Retain the value of the property owned by the Senior Generation for the Senior Generation;

iii. Remove any appreciation over the current value of the properties from the Senior Generation and shift it to the Junior Generation (estate freezing);

iv. Limit the liability of the family members for acts occurring on the properties.

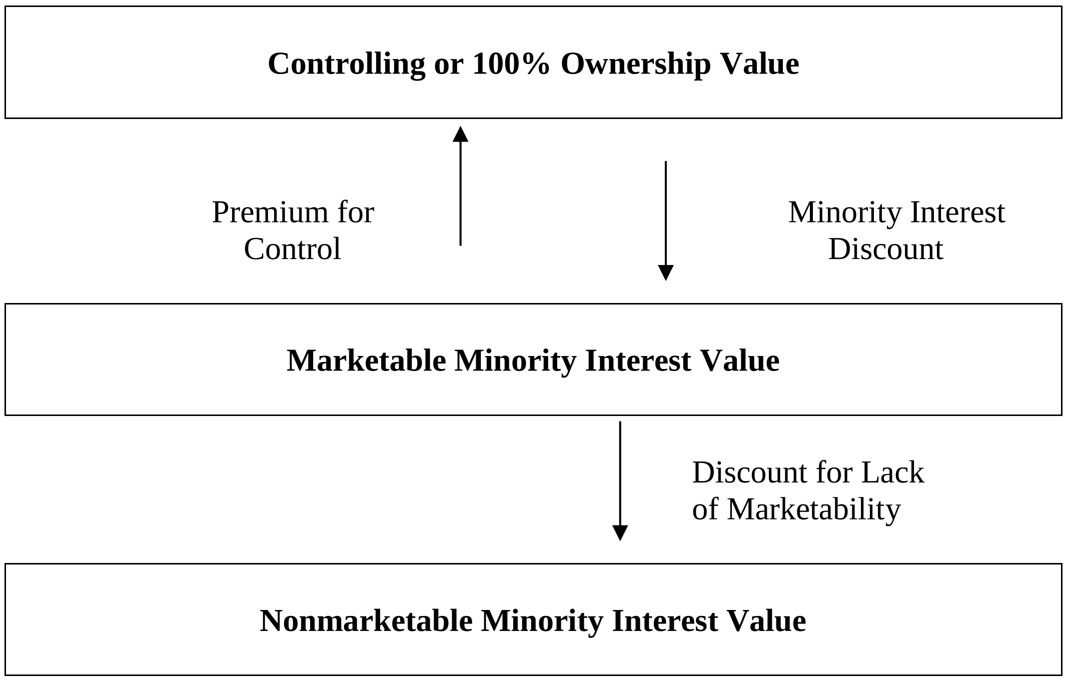
The goals are accomplished by creating a family LLC that has membership interests which are Class A interests, which vote and retain current income and asset value, and Class B interests which do not vote and hold property appreciation rights, both of which are initially owned by the Senior Generation. For example, assume that the Class A interests will provide that the Senior Generation receives 90% of the net cash flow from the property's operations as well as 100% of the net proceeds from the sale or refinancing of LLC property up to the fair market at date of formation. The effect of this structure is then to combine ownership rights and allow the Senior Generation to maintain its current economic position by retaining income and asset value.

By contrast, the Class B interests will provide that the owners receive 10% of the net cash flow from the LLCs operations and 100% of the net proceeds from the sale or refinancing of the properties over and above the current fair market value. This removes the future appreciation from the estates of the Senior Generation. The gifts are of an expectancy and, therefore, have a depressed value.

e. Determination of Discounts in Value. In Rev. Rul. 81-253, 1981-1 C.B. 187, the Service held that, ordinarily, no minority shareholder discount is allowed with respect to transfers of shares of stock between family members if, based upon a composite of the family members' interests at the time of the transfer, control (either majority voting control or de facto control through family relationships) of the corporation exists in the family unit. However, after numerous losses in the courts, the shares of other family members will not be aggregated with the transferred shares to determine whether the transferred shares should be valued as part of a controlling interest.

This recognition of a form of discount raises similar issues of valuations generally between limited partnerships and LLCs pertaining to analysis of value.

Analysis of Value.



- Control assumes power to effect changes in strategy, structure, policy and is inherently marketable.
- Minority assumes liquidity without control.
- Nonmarketable minority assumes some degree of restrictions on transferability--express or implied (economic).

Factors Affecting Value.

	ISSUE	DISCOUNT
Performance of entity	Good	Low
Assets at highest and best use	Yes	Low
Number of shareholders	Many	Low
Concentration of control shareholders	Yes	High
Implied built-in gain/loss	High Gain	High
Number of potential purchasers	High	Low
Financeability of assets	High	Low
Volume of comparable transactions	High	Low
Divergences regarding operations, destiny, etc.	High	High
Size of business	Big	Low
Size of block	Small	High
Glamour of entity	Yes	Low
Volatility of assets	High	High

The options are almost without limit and include the following:

3. Gifts of Fractional Interests. For estate and gift tax purposes the transfer of noncontrolling interests in real estate may qualify for discounts that result in reduced estate/gift tax consequences from the conveyance.

For example, even with a 50 percent interest in real property, some discount is allowed. In *Propstra v. U.S.* (9th Cir 1982), 82-2 USTC ¶13,475, the Ninth Circuit allowed a 15 percent discount on the value of a decedent's undivided one-half interest in real estate held as community property. More recent cases have found a higher discount. *Brocato v. Com'r*, T.C. Memo 1999-424 (20% discount on 50% interest); *Estate of Williams v. Com'r*, T.C. Memo 1998-59 (20% discount for marketability and 30% discount for lack of control on 50% interest in timberland)

4. Family Limited Partnership. The purpose of a family limited partnership is to allow for the transfer of property to the next generation while having the option to preserve some level of control over the management of the real estate itself. There are certain advantages to family limited partnerships:

- Family limited partnerships are relatively easier to administer;
- Family limited partnerships may eliminate the need for ancillary probate as to where the property is located, if outside of the decedent's resident state.
- Family limited partnerships avoid the problem of double tax as an investment vehicle since partnerships act as a conduit.
- As indicated above, while not without controversy, there are opportunities for discounts when valuing a fractional partnership interest.
- A family limited partnership provides a degree of asset protection against failed marriages and creditors of the children.
- A family limited partnership may be used as a business succession and compensation tool.

Under the Code, a family limited partnership must utilize capital as a material income producing factor. Where there is a service partnership, the IRS will not recognize the conveyance of interests to other family members who do not participate in the partnership's business.

When real estate is owned by an entity, there is more successful recognition of a discount upon conveyances. What happens here in valuation is that the assets are valued, then that value is discounted to reflect restrictions and limitations on ownership through a partnership or other type of entity, i.e. limited liability company.

Interestingly, the amount of the discount bears no consistent rule as to what the IRS will accept. Indeed, discounts by appraisers are frequently litigated. While the IRS recognizes some amount of discount, it has been left to the courts to approve the discount on a case by case basis.

The use of family limited partnerships presents a number of opportunities. It also presents a number of requirements. For example, interests should never be given directly to minor children, but should be held in trust. Family limited partnerships must not be merely for tax avoidance. In other words, the other limited partners must have some, albeit limited, rights. Limited partners must also have reasonable expectation of distributions.

5. S Corporations. Surprisingly, S Corporations are not being treated more favorable than partnerships in determining discounts. In Estate of Gross v. Com'r, (6th Cir 2001) 88 AFTR ¶2001, the court allowed no discount for an S Corporation in light of the taxes born upon the shareholders.

While this treats S Corporations similar to partnerships for valuation purposes the problem is that it results in different values for virtually identical corporations based on whether an S Corporation election is made. The drawback of S Corporations for holding real estate include:

- A five-year waiting period to avoid a built-in gains tax;
- More restrictive tax basis rules, including for inside basis no right to step-up tax basis of S Corporation assets upon the death of a shareholder;
- Limitations on qualified shareholders and the “one-class of stock rule” limit availability and planning options.

EXHIBIT 1
TYPES OF BUSINESS ENTITIES

Proprietorship

The business of a single individual who holds direct ownership and control over the assets of the business. The business may be designated by the proprietor's name, or a fictitious name, i.e., "ABC Company."

Partnership

Two or more persons who engage in a business for profit. The general partners of the corporation own and control the assets of the business through or on behalf of the partnership entity. The business is designated by the partners' names, i.e., "Wiley and Smith" or a fictitious name.

Limited Partnership

A partnership consisting of at least one general partner and one limited partner. In exchange for giving up most management and control rights, the limited partner's personal liability is limited only to his contributed capital and to debts voluntarily assumed. The business name contains the name "Limited Partnership" or "L.P."

Corporation

A separate state chartered entity formed for the purpose of engaging in business within the state and all other states in which it qualifies to do business. Ownership of the business through shares and control of the business through the Board of Directors and Officers is separated. The business name contains the words "Corporation," "Incorporated" or a variation thereof.

Limited Liability Company

A separate state chartered entity representing a blend between partnerships and limited liability companies. No member is personally liable for Company obligations (with limited exceptions).

EXHIBIT 2

The following table lists the major "substantive" and "tax" characteristics applicable to each entity:

COMPARISONS		
ITEM	**PARTNERSHIP (LLC)**	**CORPORATION**
LIABILITY OF OWNERS	GENERAL PARTNERS HAVE UNLIMITED PERSONAL LIABILITY FOR PARTNERSHIP DEBTS AND OBLIGATIONS. LIMITED PARTNERS' (LLC MEMBERS') LIABILITY FOR PARTNERSHIP DEBTS AND OBLIGATIONS IS LIMITED TO THEIR INVESTMENT.	SHAREHOLDERS' LIABILITY FOR CORPORATE DEBTS AND OBLIGATIONS IS LIMITED TO THEIR INVESTMENT.
Transferability of ownership	Partners cannot transfer their ownership interests without the consent of other partners	Shares are freely transferable.
Management	Every <u>general partner</u> has a right to participate equally in management. <u>Limited partners</u> have no right to participate in management.	<u>Shareholders</u> elect the directors, who appoint the officers/managers of the corporation. Shareholders have no right to participate in management.
Taxation (operating profits) (See table comparing Federal v. State)	Partnerships are not taxed as separate entities. Partnership income and losses flow directly to the partners' tax returns.	<u>C corporations</u> are taxed as separate legal entities. Shareholders are taxed on dividends paid by the corporation. <u>S corporations</u> are not taxed as separate legal entities. S corporation income and losses flow directly to the shareholders' tax returns.
Losses deductible by owners	Investments plus prorated share of partnership liabilities.	<u>C corporations</u> – no. <u>S corporations</u> – limited to amount invested and loaned to corporation.

EXHIBIT 2

SUBJECT TO PASSIVE ACTIVITY LOSS RULES (IRC § 469	YES	C CORPORATIONS – GENERALLY NO. S CORPORATIONS – LIMITED TO AMOUNT INVESTED AND LOANED TO CORPORATION.
Special allocations	Possible, if substantial economic effect.	No.
Fiscal Year (IRC §§ 444, 7579 and 2804)	May end up to three months earlier than years of principal partners.	C corporations – any fiscal year. S corporations – may end up to three months earlier than year of principal stockholders.
Tax-free fringe benefits	Limited	C corporations – all permitted by law. S corporations – limited
Tax-free merger (IRC § 368)	No.	C corporations – yes. S corporations – yes.
Accumulated earnings tax (IRC § 531)	No.	C corporations – yes. S corporations – no.
Personal holding company tax (IRC § 541)	No.	C corporations – yes. S corporations – no.
Partnership	100% taxed to owner	(a) 100% taxed to owner (b) $800 annual fee for limited partnerships
LLC	100% taxed to owner	(a) 100% taxed to owner (b) $800 annual fee LLCs (c) Gross receipt tax on LLCs.
S Corporation	(a) Usually 100% taxed to owner (b) Possible built-in gain tax (c) Possible passive activity loss tax	(a) Usually 100% taxed to owner. (b) Possible built-in gains tax. (c) Possible passive activity loss tax. (d) $800 minimum tax (e) 1.5% net income tax.
C Corporation	(a) 100% taxed to corporation	(a) 100% taxed to corporation.