



Real property: opportunities and challenges

CONSIDERATIONS TO MEET YOUR BUSINESS OBJECTIVES

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Real estate is a unique business asset that presents both planning opportunities and challenges in making sure the asset is appropriately integrated into the legal structure of a business. There is a broad range of objectives and considerations a business should take into account that often relate to the particular interests and characteristics of the business or business owners themselves. This article lists a few critical considerations a business should ask if it owns or is acquiring real estate assets.

WHY DOES MY BUSINESS HOLD REAL ESTATE?

The question that will most influence how a business approaches its real estate holdings is, "What is the objective of the business in owning the real estate?" Understanding the goals and objectives of a business in owning real estate will greatly enhance the ability of its tax or legal advisors to develop a structure that furthers its objectives. For example, the objective may be a focus on profit from an investment in real property, or simply for the property to serve as an address for the business operations.

A business might categorize its objectives regarding real estate as follows: (a) active production of income; (b) passive investment; (c) incidental or collateral use; and (d) mixed use (personal and business). The first three are the most common business objectives. However, mixed use is becoming more common with respect to small startup businesses, consulting businesses, and in connection with mixed-use development properties (i.e., live and work spaces). In a relative sense, it is as important for small businesses as it is for large multinational corporations to make sure its business assets, including real estate, are properly structured.

The answer to "Why does my business hold real estate?" will affect the answer to the next critical question, "How will the business hold title to the real estate?"

WHAT IS BEST LEGAL STRUCTURE FOR MY BUSINESS TO USE FOR INVESTMENT IN REAL ESTATE?

Once the objectives of the business are identified, the choices of entity type to hold title to the real estate include: (a) direct ownership (no separation of title from business or individual proprietor); (b) fractional ownership (tenants in common with other property owners); (c) partnerships; (d) limited liability company; and (e) corporation. Choosing a structure can be fraught with potential pitfalls that can frustrate the objectives of the business with respect to the real estate. Improper choices can even stymie the actual functioning of the underlying business or place a burden on its eventual sale.

Careful and informed consideration should attend this significant step of developing a structure to hold real estate in a business. When deciding which type of entity to employ in holding real estate, a business should be prepared to discuss, at a minimum, the following key factors with its advisor: (a) costs of formation and maintenance; (b) operational and structural flexibility and/or complexity; (c) estate planning; (d) financing; (e) insulation from liability; and (f) taxes.

• RISK MANAGEMENT/LIABILITY EXPOSURE

For most businesses that own real estate, risk management (in particular, limiting exposure to real estate liabilities) is perhaps the most significant motivation for separating the ownership of the real estate into its own entity. In this regard, nearly all

state law registered entities (i.e., corporations, limited partnerships, LLCs) offer similar liability protection, so long as proper corporate formalities are observed, the discussion of which is beyond the scope of this article. But these entities are significantly different in other important areas, not the least of which is tax treatment.

• TAX TREATMENT AND PLANNING

Another significant concern is the tax impact of owning real estate. This emphasis is appropriate given the ramifications that tax laws may have on later actions of the business, especially the eventual sale of the real estate. The most basic, but fundamental, tax distinction in the entity selection process is the difference between corporations (in particular a "C-Corporation") and a tax partnership (including limited partnerships and multi-member LLCs).

For both types of entities, transferring the real estate into the entity is rather uneventful; no gain (or loss) is recognized by the contributing taxpayer on the contribution of the property to the entity, with some limitations. Once in the entity, taxes may not initially appear to be a factor because in the C-Corporation the entity recognizes all profits and losses from the real estate, whereas, in a partnership, all items of profit and loss are "passed through" to the partners (the tax rates for both individuals and corporations are currently capped at 35 percent). On its face this seems rather benign because both the corporation and the individual are being taxed at roughly the same rate; however, a closer examination exposes the dreaded double tax associated with C-Corporation. In order to get the money derived from the real estate (from rental, sale or otherwise) out of the C-Corporation, an individual shareholder will be subject to an additional dividend tax (currently 15 percent). Hence the