

Real Estate Co-Ownership Brief

A Series of Briefs on Legal Issues Regarding Co-Ownership of Real Property



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Is joint ownership the best way to hold an interest in real estate?

By Kathryn Andrews

Joint ownership of real property is becoming more and more common. Co-ownership may result from multiple investors pooling funds to acquire real estate or over time as ownership interests are transferred to others as gifts, upon death, upon marriage, or otherwise.

The property can be held directly by the co-owners as tenants-in-common. Other briefs in this series address some of the issues presented by such direct ownership. Alternately, the property can be held in a legal entity, with the co-owners holding interests in that entity instead of direct property ownership. The following is a synopsis of the pros and cons of the most common legal entities used to hold real estate:

1. General Partnerships. A general partnership may be formed automatically by operation of law when two or more persons carry on a for-profit business as co-owners. No formal government filings are required to form a partnership. A general partnership is not an optimal instrument for holding real property, since each partner bears unlimited personal liability. In fact, the only advantages of holding real estate in a general partnership are (i) the ability to pass income and expenses through to the partners, and (ii) the step-up in tax basis following the death of a partner.

2. Limited Partnerships. A limited partnership is an improvement over a general partnership, since the limited partners enjoy limited liability. Under normal circumstances, the liability of limited partners is limited to the value of their equity interest. Nevertheless, every limited partnership must have at least one general partner and that general partner bears unlimited personal liability for partnership obligations. It is possible for an entity, such as a corporation, to act as the general partner. This can limit personal liability, but that may result in an unnecessarily complex and costly ownership structure. All partnerships, regardless of whether they are general partnerships or limited partnerships, share the benefit of passing the income and expenses through to the partners.

3. Corporations. A properly formed, capitalized, and maintained corporation provides limited liability that protects the personal assets of its owners. The corporate formalities can be cumbersome, however. From a tax perspective, there are two separate types of corporations, called “C corporations” and “S corporations.” This naming convention is based on the portion of the Internal Revenue Code that governs the tax treatment of the corporation and its owners, called shareholders.

- a. **C Corporations.** C corporations are subject to corporate income tax. If a C corporation wants to distribute its earnings to its shareholders, those earnings are generally distributed as dividends, which are taxed to the shareholders when received. Thus, the income generated by the property is subject to being taxed twice; once at the corporate level and again at the shareholder level. Also, if C corporation dissolves and distributes appreciated real property to its shareholders, the corporation is required to recognize gain and pay tax on the distribution. Shareholders again pay tax on receipt of that distribution. This double taxation makes C corporations unattractive vehicles for holding real property.
- b. **S Corporations.** An S corporation is created when the shareholders of a C corporation elect to be taxed as an S corporation. The effect of a properly and timely filed subchapter S election is that income and expenses from operations pass through to the shareholders in proportion to their applicable percentage of ownership interest. S corporations have numerous limitations such as restrictions on who can be a shareholder, the number of permissible shareholders, and classes of ownership interests. The partial flow-through tax treatment makes S corporations more suitable for real estate ownership than C corporations. Like a C corporation, though, a distribution of appreciated property from the corporation to its shareholders triggers entity level gain. This can result in a tax cost on any distribution of property from the S corporation, even if there is no actual sale.

4. Limited Liability Companies. Limited Liability Companies (“LLCs”) provide limited liability that protects the personal assets of its owners while automatically allowing for pass through taxation of income and expenses. In this way, an LLC has the liability protection benefits of a corporation and the tax benefits of a partnership without the downside of either. LLCs are also easy to form and operate, and allow for tremendous management and ownership flexibility.

It is important to consult your legal and tax professionals regarding the optimal entity for co-ownership of real property. There are several alternatives, all with their associated advantages and disadvantages.

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