The Benefits of Using LLCs and Other Entity Forms to Hold Real Estate Assets in Trust

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Some Preliminary Questions

- Who controls the property?
- What . . .
  - are the essential property characteristics?
  - are the short-term and long-term goals?
  - is the proposed ownership structure?
- Where is the property located?
- When does an entity need to be implemented?
- Why do I need professional advice?

Why Use a "Real Estate Holding Company"?

- Isolate assets (internal liability protection)
- Isolate liabilities (external liability protection)
- Facilitate more efficient transfers of title to property
- Restrict transfers of ownership of property
- Separate ownership from management
- Possible modification of fiduciary duties

Holding Company Vehicle

- Primary entity options:
  - No Entity
  - Corporation
  - Limited Partnership
  - Limited Liability Company
- Choice of entity factors:
  - Owner liability
  - Management structure
  - Taxation
  - Cost

Option #1 - No Entity

Advantages:

- Complete discretion in management matters
- No formation costs
- No additional entity-level taxation
- Rely on trust documents

Disadvantages:

- Unlimited liability (insurance can fill in some of the gaps)
- Not accommodating for additional owners, exit opportunities, etc.
- Commingling of assets and liabilities
- Rely on trust documents

Option #2 - Corporation

Advantages:

- Limited liability for shareholders
- Centralized management structure (SHs → Ds → Os)

Disadvantages

- Statutory formalities (bylaws, notices, meetings, voting, etc.)
- Double-taxation for federal income tax purposes (C-Corps)*
- Fiduciary duties for directors (well-established jurisprudence)

* S Corporation may eliminate double-tax issue, but shareholders are limited to individuals and certain types of trusts

Option #3 - Limited Partnership

Advantages:

- Limited liability for limited partners (so long as not participating in the control of the business and no third party reliance)
- Most management decisions vested in general partner (good/bad?)
- Pass-through entity for federal income tax
- Possible state-level tax benefits

Disadvantages

- Unlimited liability for general partner
- No control for limited partners
- Highest formation costs
- Multiple tax filings on federal and state level

Option #4 - Limited Liability Company

Advantages:

- Hybrid of Corp/LP structure
- Limited liability for members (even if participating in the business, except as otherwise provided in company agreement)
- Flexible management structure (managers v. members)
- Principally governed by contract with minimal statutory formalities
- Pass-through or disregarded entity for federal income tax purposes
- Charging order may be sole remedy for creditors

Disadvantages

- Limited history and jurisprudence
- Possible member liability for self-employment taxes
- Not subject to statutory indemnification provisions
- Possible disclosure of member identities

Owner Liability

Least Desirable

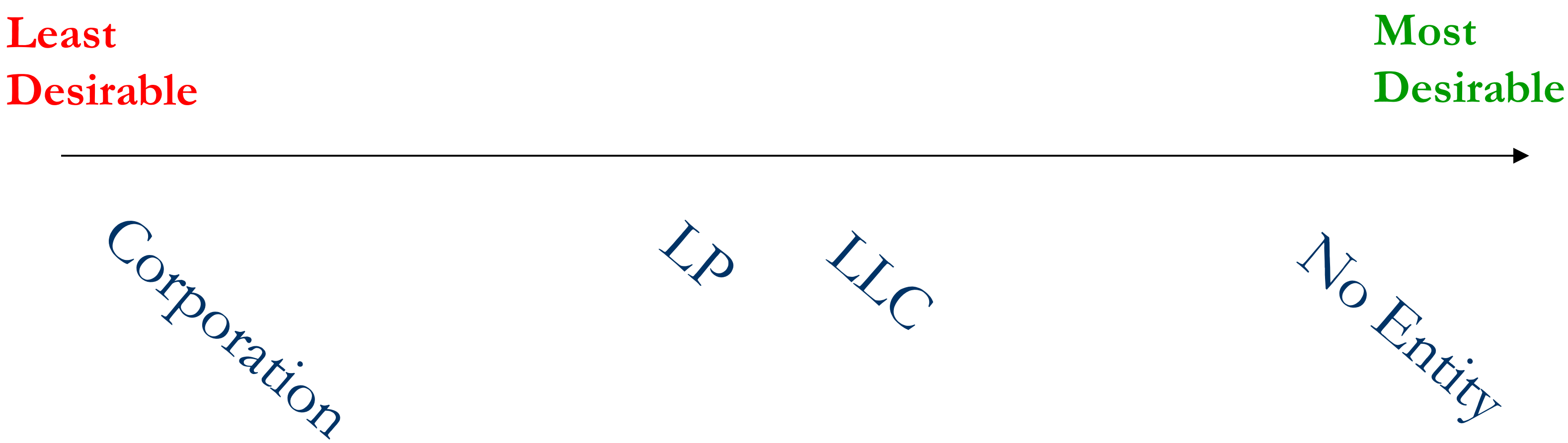
Most Desirable

No Entity

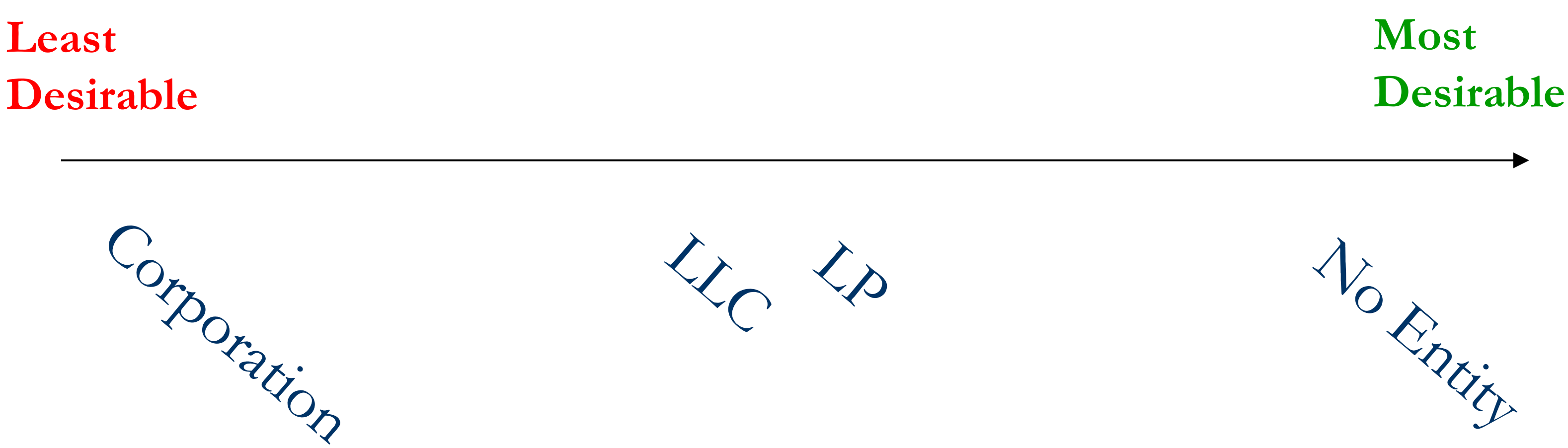
Corporation

LP / LLC

Management Structure



Taxation


Least
Desirable
Most
Desirable
Corporation
LLC
LP
No Entity

Cost

Least
Desirable

Most
Desirable

LP

LLC

Corporation

No Entity

. . . and the winner is . . .

? ? ?

New Entity Filings (Texas)

	2011	2012	2013	2014
Corp	24,123	23,404	22,563	23,750
LP	5,633	6,100	5,650	5,888
LLC	86,947	95,553	110,876	126,091

Source: Texas Secretary of State, Business & Public Filings Division

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Forming the Holding Company

- Select form of entity and jurisdiction of formation
- Confirm name availability
- File certificate of formation with Secretary of State
- Finalize remaining formation documents
- Obtain federal tax ID number
- Consider ancillary filings (assumed names, business licenses/permits, foreign qualifications, etc.)
- Consider IP issues (trademarks, domain names, etc.)
- Issue equity to initial owners (securities issues)

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Maintaining the Holding Company

- Establish and adhere to entity's legitimate business purpose
- Adequately capitalize entity (also consider insurance)
- Maintain independent nature of entity
- Follow prescribed procedural and documentary formalities
- Timely submit necessary regulatory filings
- Authority issues (members, managers, officers, employees)

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Avoid piercing the corporate veil concerns

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Should a Trustee Create a Holding Entity?

- Like everything in the law, the answer is "depends"
- Ownership by a trust of an interest in a closely-held entity presents significant issues for the Trustee
- The answer for most of the time is "Yes!"
- A Trustee's duties are found in the trust document, statutes, and common law

Source of Trustee's Duties: Trust Document

- The first place that a Trustee should look in answering any question is the trust document
- Statutes normally provide that a Trustee is to follow the terms of a trust and only except limited issues from this rule
- Trust documents normally do not limit a Trustee's power to hold privately held stock (or equity in holding company)

Source of Trustee's Duties: Statutes

- 44 states have adopted the Uniform Prudent Investor Act
- This provides that a Trustee owes a duty to comply with the "prudent investor rule"
- A Trustee must invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust

Source of Trustee's Duties: Statutes

- In making investment and management decisions, a Trustee should consider:
  - General economic conditions;
  - The possible effect of inflation or deflation;
  - Expected tax consequences;
  - The role the investment plays within the overall trust portfolio;
  - The expected total return from income and appreciation of capital;
  - Other resources of the beneficiary;
  - Needs for liquidity, income preservation, appreciation of capital; and
  - Trust asset's special relationship for special value, if any, to the trust or a beneficiary

Source of Trustee's Duties: Statutes

- Trustees have a duty to review the trust assets and implement decisions concerning the retention, disposition, and management of these assets within a reasonable time after receiving them in trust
- Trustees have ongoing duties (annual) to evaluate trust assets

Source of Trustee's Duties: Common Law

- Trustees have common law duties to:
  - Preserve and protect the assets of a trust; and
  - Administer the trust with the skill and prudence which an ordinary, capable and careful person would use in the conduct of his or her own affairs
- Trustee has a duty to immediately evaluate assets and make decisions that a prudent person would make
- Trustees with certain expertise may be held to higher standard
- So, normal business people who own real estate create entities to hold the asset ---> complies with a Trustee's duty

Why a Trustee Should Create a Holding Entity

- LIABILITY EXPOSURE!
- Environmental claims are a perfect example:
  - CERCLA imposes joint and several liability for hazmat clean up of contamination caused by multiple parties, including current owner
  - Recoverable items include cleanup and necessary response costs, natural resource damages, and costs of health assessments/studies
- Other potential liabilities include:
  - Tort claims for accidents on property (public access property has higher risk);
  - Nuisance claims due to activities on the property; and
  - Deficiency suits for loans where property was collateral

Why a Trustee Should Create a Holding Entity

- A judgment against an owner of real estate is not confined to the value of the property
- If a trust owns property and has a judgment against it, the judgment creditor can reach other assets to satisfy judgment
- If the formalities of a holding company are maintained, its primary purpose is to limit risk exposure for other trust assets
- Should create a separate holding entity for each asset to maximize liability protection

Other Issues To Consider: Trustee Duties

- New Duties?
- A Trustee should exercise control for the benefit of the beneficiaries – supervise corporate management to ensure that the best interest of the beneficiaries is being realized
- Duty to scrutinize distributions/dividends to make sure that beneficiaries are being treated evenly and fairly
- Duty to bring shareholder derivative and other similar claims if necessary

Other Issues To Consider: Principal v. Income

- Trustee has a duty to be fair and impartial to all beneficiaries
- Example: a trust that owns energy assets has to allocate some portion of royalty payments to principal (maybe 80% under uniform act)
- A trust receiving a distribution from an entity (that holds royalty interests) may all be income (depending on trust document and statutory guidelines)
- This can affect beneficiaries rights to distribution

Other Issues To Consider: Duty to Diversify

- A Trustee has a general duty to diversify (though that can be overridden in trust document)
- If the trust is the controller of the holding company, this is not an issue as the Trustee has the ability to sell real estate and invest in other assets
- But, if the Trustee does not have control, there is a potential to lose ability to diversify trust assets due to decreased market for ownership interest in closely held holding company

Other Issues To Consider: Fractional Ownership

- Fractional ownership of asset complicates the issue
- By creating a holding company, must be careful to retain control of the asset
- Potential to lose right to partition assets with use of holding company

Other Issues To Consider: Fractional Ownership

- Placing fractionalized ownership into a holding company may protect assets if other owners have a bankruptcy or lender claim
- Other owners will not own the real estate; they only own equity interests of holding company
- So, bankruptcy trustee or lender may have no right to partition real estate, whereas they would with a TIC situation

Other Issues To Consider: Fractional Ownership

- By placing fractionalized ownership in holding company, it may devalue the market value of the asset
- This may be a good thing if the Trustee distributes equity interests of holding company to beneficiaries ---> lowers tax obligations

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Other Issues To Consider: Trust Termination

- Minimize effects on beneficiaries upon termination of trust
- Use of LLC may decrease taxable events and taxable values
- If trust is a revocable trust, creating a holding entity may create another wall that a settlor's creditors will have to break through to reach assets

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Other Issues To Consider: Change in Ownership

- If co-owner dies, a probate in the county in which the property is located is necessary – not so with equity interests of holding company
- Continuity of management exists with holding company – not so with TIC ownership
- With holding company, rights of members to assign interests may be restricted by agreement and may establish right of first refusal for sale of equity interests of holding company

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Other Issues To Consider: Dual Trustee Roles

- Trustee serving as board member, officer, etc. in holding company can create issues
- Trustee has a duty to not profit from a transaction, so the Trustee should probably not receive additional compensation in that additional role
- Serving in dual role can also create conflicting duties
- A director/officer has the duties of:
  - Care (business judgment rule);
  - Loyalty (act in good faith and not allow other interests to prevail over interests of entity); and
  - Obedience (avoid ultra vires acts beyond scope of the powers)

Other Issues To Consider: Dual Trustee Roles

- Can limit some of these duties via proper documentation
- In Texas, actions as Trustee are legally separate from actions as officer/director
- But, in other jurisdictions, actions are separate only where Trustee does not hold a controlling interest in holding company
- Should not really be an issue if trust owns all of the entity – really just an issue to watch when there is fractionalized ownership

Other Issues To Consider: Tax Issues

- A flow through entity is not taxed at the entity level, the taxes are paid by the owners (here, the trust)
- But, just because an owner may have “taxable income,” it does not mean that it will get a distribution
- So, need to ensure that entity distributes at least enough money to cover tax obligations

Consent/Release

- Whether a Trustee is concerned about creating a holding company or not doing so, the Trustee can always seek a consent and release agreement from all beneficiaries after providing full disclosure

Hire A Lawyer!

- To take advantage of this idea, you should hire a law firm with experience in estate planning, taxation, and business formation
- The attorneys would assist you by selecting the best entity option for the jurisdiction in question and creating the entity
- Ask others in your organization that have experience managing ownership interests in closely held businesses

Questions ???

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