A Road Map to Real Estate Ownership

To help illustrate the many different types of real estate and the variety of forms of ownership that go along with them, we will use our hypothetical family of John and Mary Public. John and Mary are both age 65 and have three children, namely a son named Bob who is 25 years of age, a daughter named Barbara who is 30 years of age and another son named Bill who is 35 years of age, all of whom are married with children. In addition, John and Mary own their own home, a vacation home, which is rented more often than it is used as a vacation home, three two-family rental properties and a commercial property.

John and Mary's entire estate is worth approximately $3,000,000 and all of their property is currently owned jointly. A friend of theirs, who is also in the rental business, was recently sued, which forced them to begin rethinking how they own their real estate both from a creditor and estate tax planning standpoint.

The balance of this article will explore the different forms of real estate ownership that are available to John and Mary for each type of property along with the probate, creditor and tax implications associated with each type of ownership. Let's begin with their home, which is currently owned as joint tenants by the entirety. It is important to note that this form of ownership can only be used between spouses and only with regard to their primary residence. From a creditor standpoint, this form of ownership is beneficial in that the creditor cannot force half of the property to be sold in order to satisfy the outstanding obligation against either spouse individually. Say, for example, that John was sued personally with regard to his business, which had nothing to do with Mary, the creditor would not be able to force Mary to sell the home in order to access John's half of the equity.

With regard to probate, this form of ownership would avoid those costs on the death of the first spouse as jointly owned property passes by operation of law and not through the probate process. However, in the event John dies first and Mary does no additional planning, then the home would be owned in her name 100% on her death and would therefore be subject to the probate process. Finally, with regard to estate tax planning, this form of ownership would waste the first spouse's exemption amount as the entire property would pass under the unlimited marital deduction to the surviving spouse and be subject to estate taxes upon the death of the surviving spouse.

Therefore, the suggested form of ownership for John and Mary's home would be to have it transferred to John and Mary as trustees of a nominee realty trust with their respective family revocable trusts serving as 50% beneficial owners. These revocable trusts would allow them to remain in complete control of their home during their lives, avoid the costs associated with the probate process and ultimately help them utilize both their federal and state estate tax exemption equivalent amounts, thereby reducing and

possibly eliminating their estate tax exposure. A complete discussion of revocable trusts and estate taxes are beyond the scope of this article, but the author suggests that you contact your estate tax planning attorney in order to discuss your specific situation.

John and Mary then considered giving their home to their children during their lives. Gifting the home, or any highly appreciated piece of property, to the children is not generally considered a recommended option in terms of real estate ownership, as it is fraught with problems. First, John and Mary would have lost complete control over any such real estate and with regard to their home, if they did not retain a life estate, they would have lost even the right to live there for the balance of their lives. Furthermore, they would have lost the ability to sell any such property or use the proceeds, while strapping their children with negative capital gains tax consequences. Finally, this form of ownership would expose the asset to their children's creditors.

In this regard, the gift of any does not result in any highly appreciated property, immediate capital gains tax consequences to the recipient but the recipient would receive a carryover basis from the giver. In other words, if John and Mary's entire cost basis for their home, including all capital improvements made over their lifetime is $100,000, then the children would receive that same cost basis thereby trapping any capital gain that is currently built into their residence.

For example, assuming John and Mary gave their home to the children and upon their demise, the home was worth approximately $500,000, and the children decide to sell it, they would have to recognize a $400,000 capital gain on their individual income tax returns. Assuming a 15% tax rate at the federal level and a 5% tax rate at the state level, that would result in a tax liability of approximately $80,000. In addition, John and Mary would have to consider the gift tax implications of giving their home away during life. In this regard, they are limited to gifting $11,000 per year pear person without incurring a gift tax consequence. However, instead of paying any gift tax, they would be entitled to utilize a portion of their $1,000,000 exemption amounts, which would simply result in their ability to shelter less assets from estate taxes upon their demise.

Instead, John and Mary should own their home in their respective revocable trusts as mentioned above. These revocable trusts would allow them to sell their home at anytime, and avoid any related negative capital gains tax consequences. In this regard, if they have owned and used their property as their primary residence for two of the last five years and then sold it, they would be entitled to avail themselves of a $500,000 capital gains tax exclusion, thereby virtually eliminating any capital gains tax consequences associated with the sale. Finally, owning their home in revocable grantor trusts will not jeopardize this capital gains tax exclusion.

Furthermore, by having the revocable trusts pass their home to their children following their demise, the children would receive what is known as a step-up in basis for capital gains tax purposes. This means that the children's cost basis in the home would be stepped-up to the fair market value of the home as of the date of John and Mary's demise, thereby eliminating any capital gains tax consequences in the event the home was to be

sold shortly after their demise. In other words, if the home had a fair market value of $500,000 on the date of John and Mary's demise and the children sold it shortly thereafter, their basis would be $500,000 thereby eliminating any capital gain and saving the children approximately $80,000 in capital gains taxes.

John and Mary must now consider the various forms of ownership for their rental and commercial properties. As mentioned above, they are unable to own these properties as joint tenants by the entirety as they are their primary residence. John and Mary, like many people, currently own these properties as joint tenants with the right of survivorship. From a probate standpoint, this means that, upon the death of the first spouse to die, the property will automatically pass by operation of law to the surviving spouse and outside of the probate process. Although avoiding probate is a benefit, unless the surviving spouse does some additional planning, upon the surviving spouse's death all the real estate will be owned in her own name and therefore subject to the probate process.

Furthermore, joint tenancy offers no estate tax planning benefits, as all of the real estate would pass under the unlimited marital deduction to the surviving spouse, thereby unnecessarily inflating the value of the surviving spouse’s estate and correspondingly increasing the estate tax exposure. Always remember, estate taxes are to be paid on the surviving spouse’s death and the less planning that is done during life, results in more taxes being due on the surviving spouse’s death. Finally, from a creditor standpoint, in the event a tenant gets hurt on one of their rental properties, the lawsuit would be against both John and Mary individually thereby exposing all of their remaining rental and commercial properties, along with their personal residence and other assets to this particular creditor. Therefore, this form of ownership does not provide any creditor protection.

There is, however, no negative income tax consequences to this form of ownership for, if John and Mary were to sell any property, they would be subject to the normal capital gains tax rates, including a 25% federal capital gains tax for recapture of the depreciation expense that was taken while the property was being rented. Therefore, John and Mary conclude that they should not own their commercial and/or rental real estate as joint tenants with the right of survivorship.

John and Mary then considered arranging the ownership of their rental and/or commercial real estate as tenants in common. This simply means that both John and Mary would have a one-half undivided interest in each such property. In this regard, upon the death of John, he would have the ability to direct how he leaves his one-half interest in the property, instead of it passing by operation of law to his surviving spouse, Mary. However, if John were to own his one-half interest in his own name, then, upon his demise, it would also pass through the probate process rather than avoiding probate as with the joint tenancy arrangements discussed above.

If, however, John and Mary's revocable trusts owned these properties 50% each as tenants in common, then, upon the death of the first to die of either John or Mary, their

half of the property would avoid the probate process as it would be owned by a trust instead of them personally. Furthermore, the revocable trusts would be designed in such a way as to not only insure the proper disposition and control of the assets following their demise, but also to insure that they each more fully utilize their current $1,500,000 federal and $950,000 Massachusetts exemption equivalent amounts, thereby reducing and possibly eliminating their estate tax exposure.

From a creditor protection standpoint, whether John and Mary own these properties as tenants in common in their own name or whether their respective revocable trusts each own a 50% interest as a tenant in common, either arrangement would provide no creditor protection during their lives. For example, in the event an individual gets hurt in a rental property and sues, the law suit would be against both John and Mary either individually or as trustees of their respective revocable trusts thereby exposing the balance of their real estate as well as their home and other personal assets, to this particular creditor. It is important to note that, although these revocable trusts provide significant benefits in terms of their ability to reduce the costs associated with the probate process as well as lower, and in some cases eliminate, estate taxes, they nevertheless provide no protection from general creditors.

Another common mistake that occurs when dealing with real estate ownership is owning it either with a child or a friend as tenants in common. Say, for example, John and Mary simply wanted to add all of their children's names to one of their rental properties as a tenant in common. Now, John and Mary will have significantly reduced their control over that piece of property for, if they ever wanted to sell it, they would now need their children's permission. In the event the children did agree to sell the real estate, John and Mary must remember that a portion of the proceeds would go to the children and not them. This may be a problem, especially if John and Mary needed that money to enhance their retirement, or buy a replacement property.

From a creditor standpoint, John and Mary have exposed this particular rental property to their children's creditors. In other words, in the event any one of their children were to have a car accident, financial difficulty or a divorce while John and Mary are living, then that particular piece of property would be exposed to those creditors. John and Mary also consider the flip side of this equation, which is that, if a tenant gets hurt on the rental property and files a law suit, that such suit would still be against John and Mary individually, but would now include all of the children who's names appear on that particular deed as well as exposing all of their homes and other personal assets to that creditor.

John and Mary also considered the income tax consequences of such an arrangement. In other words, once they add the children's names to a rental property, they must also sacrifice a portion of the rent as such rent must be allocated among the owners equally. Finally, once John and Mary add either their children's names or a friend's name to a piece of property, whether it be as joint tenants or as tenants in common, there always remains the possibility that any individual owner can petition the

court to partition the property and force a sale of the property. Finally, such an arrangement may result in a large gift tax obligation to John and Mary.

After exploring the various forms of real estate ownership, John and Mary have decided that they would like to maintain complete control over their real estate, avoid the costs associated with the probate process, reduce and possibly eliminate their estate tax liability, protect their assets from creditors, avoid any negative income tax and/or gift tax consequences with their choice of ownership while, at the same time, insuring the proper disposition and control of their assets following their demise.

One recommended approach to accomplish such a tall order would be the implementation of a Delaware Series Limited Liability Company. In this regard, John and Mary would establish a series limited liability company into which they would contribute their rental and commercial properties. Each property would be owned by a separate cell inside the single series limited liability company. It is important to note that their home cannot be transferred to this series limited liability company, as it does not have any business purpose associated with it. In exchange, they would each take back a 50% ownership interest in the company. However, to avoid probate and help with their estate tax concerns, they would each transfer their membership interests in the company to their respective revocable trusts.

The series limited liability company provides that no corporate action may be taken without the majority of owners being in agreement. From an estate tax planning standpoint, since neither John nor Mary individually will have a controlling interest, estate planning attorneys are able to apply discounts in the overall range of 35% to 40% for lack of the marketability and lack of control associated with this type of ownership when valuing such assets for estate or gift tax purposes.

In the event John and Mary decide to gift a portion of their interest in the series limited liability company their children during their lives, these same discounts would be applied as of the date of the gift. In other words, since the children would be receiving only nonvoting interests in the series limited liability company, that would enable John and Mary to gift approximately 40% more than would be allowable under the current $11,000 present interest exclusions mentioned above, as well as retain control over the company. The application of these discounts enables John and Mary to transfer even a larger portion of their assets either during life through gifting or at death. Finally, it is important to note that John and Mary do not have to make any gifts and these discounts would still be applied as of the date of their death.

The immediate effect of this form of ownership will serve to reduce the value of that portion of John and Mary's real estate investments transferred to the series limited liability company and therefore reduce the overall value of their gross estate and correspondingly lower their estate tax exposure by the discounted amount. Finally, in the event they decide to gift a portion of their interest in the series limited liability company during their lives to their children, this technique would serve to freeze their gross estate

as to the value of any assets so transferred as all such assets and their future appreciation will be outside of their gross estate.

Insofar as federal annual income taxes consequences are concerned, John and Mary would continue to pay all of the income taxes associated with the series limited liability company at their lower individual rates, just like they use to prior to establishing this company. In this regard, series limited liability companies are flow through entities and pay no tax but, in turn, will flow the series limited liability company's income proportionately to its respective owners. The portion of the income that would flow to each of them as 50% owners will be picked up on their individual income tax return. In the event John and Mary were to transfer a portion of their ownership interest in the series limited liability company to their children, then that portion of the company's income would also flow through to their children who would need to include it on their individual income tax returns. Therefore, there are no adverse income capital gains or gift tax consequences associated with this form of ownership.

From a creditor protection standpoint, for example, if the tenant in Rental Property #1 got hurt and filed a law suit, assuming Rental Property #1 is owned by Series #1, then the law suit would be filed specifically against the series limited liability company Series #1, rather than against John and Mary individually, thereby protecting their home and other personal assets from such a law suit. Furthermore, the creditor would be prohibited from pursuing the other rental or commercial real estate owned in the separate cells inside the single series limited liability company thereby further reducing John and Mary's creditor exposure. Finally, prior to transferring any encumbered property to these series limited liability companies, it is important to obtain bank approval.

From an administrative standpoint, the series limited liability company requires that only one income tax return be prepared each year and only one filing fee be paid per year per state in which you operate in. However, it is important to maintain each series as a separate entity by perhaps keeping separate books and records as well as separate bank accounts for each series. In addition, the estate planning attorney should prepare a separate series contract for each such series as well as separate stock certificates for each series.

John and Mary may have also considered owning their rental and/or commercial real estate in a regular limited liability company as opposed to the series limited liability company mentioned above. The biggest difference between a series limited liability company and a regular limited liability company is that the series limited liability company provides individualized protection for each such property owned inside the company. The regular limited liability company maybe more appropriate for people who own a single rental property, but most certainly no more than two.

In other words, if, instead, John and Mary established a regular limited liability company as the owner of their rental and/or commercial real estate and that same tenant in Rental Property #1 got hurt and filed a law suit, the suit would be against the entire

company and all of the other rental and/or commercial properties would also be exposed to that creditor. However, it is important to note that the regular limited liability company would provide protection against John and Mary's home and other personal investments and bank accounts as the law suit would be against the company and not them personally. The series limited liability company would offer enhanced creditor protection as shown above.

John and Mary have concluded that by owning their real estate through a combination of revocable trusts and a series limited liability company that they will avoid a lot of the pit-falls associated with the more common forms of real estate ownership mentioned above. The revocable trusts will enable John and Mary to retain complete control over their assets during their lives, reduce the costs associated with the probate process, insure the proper disposition and control of their assets following their demise while, at the same time, enabling each of them to more fully utilize both their federal and state estate tax exemptions, thereby reducing, and possibly eliminating, their estate tax exposure. In addition, the series limited liability company enables John and Mary to retain control over their assets during their lives, accelerate their lifetime giving, provide an enhanced level of creditor protection as well as avail themselves to the estate and gift valuation discounts mentioned above, which will serve to further reduce their estate tax exposure. Through some basic estate planning techniques, John and Mary can truly have their cake and eat it too.