

Legal structure sets tone for real estate projects

Developers, contractors and owners spend countless hours planning and designing their buildings and developments. They hire the best designers and engineers they can find to assure the structural integrity of their buildings. They realize that each project is unique and requires individualized plans and designs. They recognize that a well-engineered structure and strong foundation are essential to creating a building that will stand the test of time.

Unfortunately, those same developers, contractors and owners often don't recognize that the "legal" structure selected for their buildings and developments can be equally important. Just as a properly designed building foundation is critical to accomplish the goal of holding up the walls of the building, the properly designed legal foundation is critical to accomplish the owner's goals relating to taxation, liability protection and exit strategies.

The legal structure is the entity created to own the assets and to achieve the proper separation of assets. There are many entities available for use in Oregon. They include corporations, small business corporations, general partnerships, limited partnerships and limited liability companies.

The properly designed legal foundation is critical to accomplish the owner's goals relating to taxation, liability protection and exit strategies.



Choosing your structure

The elements to consider when selecting your structure include whether the entity has one or two levels of taxation, whether the entity provides limited liability, whether use of the entity creates a self-employment tax problem and whether the distribution of appreciated assets from the entity to the owners is a deemed sale.

An overriding consideration and the primary reason that you separate assets into different entities is to create a liability shield for the owner's other assets. So long as the owners of an entity

LEGAL FOUNDATION

Coni Rathbone



observe the entity formalities, a creditor should not be able to reach the owner's assets to satisfy a liability of the entity.

Since it is advantageous to utilize an entity that provides

limited liability to all owners, we can dismiss the use of partnerships and limited partnerships.

And since owners want to be protected from paying two levels of taxation on the same dollar, we can also dismiss use of a regular business corporation. Of course, there are always exceptions to these general rules. However, typically, the best choices are S corporations or limited liability companies.

S corporation or LLC?

How do you decide between an S corporation and an LLC? The best way is to analyze the issues of self-employment tax and distribution of appreciated assets.

In an S corporation, there is no self-employment tax on distributions of profits to the owners. So, if you own a profitable operating business and you take a reasonable salary, then you can take the remaining profits of the S corporation as distributions and avoid paying self-employment tax on those distributions. With an LLC, you likely will be required to pay self-employment tax on distributions from the company. Therefore as a general rule if you are structuring for a profitable operating business you should use an S corporation.

Alternatively, if you are creating an entity that will own appreciating assets, like real estate, then a primary consideration is whether you can distribute the appreciated assets to the owners of the entity without creating a deemed sale. Deemed sale means that for tax purposes, the Internal Revenue Service will treat the conveyance as a sale of the property for fair market value, and tax the transferor as if a sale had taken place. Therefore there is a tax event without a cash event, thus creating undesirable phantom income.

In an S corporation, the transfer of the appre-

ciated asset to the shareholders is a deemed sale. In an LLC it is not. So, as a general rule, if you are holding real property inside an entity for the always important limitation of liability, then the proper entity is an LLC.

As an example: Joe Developer owns in his own name four apartment buildings; one each in Salem, Lake Oswego, Portland and Beaverton, all in Oregon. If there is a liability-creating event in excess of Joe's insurance limits in Salem, the creditor can take all four buildings and also Joe's house.

A better ownership structure is for Joe to create four separate LLCs, and convey each apartment building as a capital contribution to a separate LLC in exchange for the ownership interests in the LLC. That way, when the same liability-creating event occurs, the creditor can take only the Salem building and not the other buildings or Joe's house.

Another example: If Jane Manufacturer, as a sole proprietor, owns land and a building upon which she operates a profitable forklift manufacturing business, and if Jane suffers a large product liability judgment, the creditor can take Jane's manufacturing business, her land and Jane's house.

With proper structuring, by conveying the operating business assets to an S corporation and the land and building to an LLC, each owned by Jane, and then creating an arm's-length lease between the two entities, the same judgment creditor could take only Jane's manufacturing business, but not her land or her house.

As with each unique building design, each unique legal structure design is governed by the particular needs and goals of each project and owner. As you can see from the examples above, even the most basic structuring efforts can allow the owner's assets to stand the test of time.

CONI RATHBONE is a partner at the Portland office of Davis Wright Tremaine LLP, where she practices in the areas of real estate development and transactions, real estate securities and tenant-in-common programs. Reach her at 503-241-2300 or conirathbone@dwt.com.