LEGAL UPDATES

Smart Real Estate Strategies for Closely Held Business Owners

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Real estate ownership is complicated and without careful planning can leave owners saddled with unanticipated taxes, liability exposure, and eye-watering mortgage payments. There are many traps for the unwary that can arise at pivotal moments—be it in the midst of an acquisition or sale or the implementation of a succession plan—making them all the more costly and stressful.

Effective planning is key for protecting your property and ensuring the best outcomes for your business, your family, and your bottom line. Below are several planning steps that should be put in place now to proactively protect and maximize the benefits of your real estate investments.

Assemble the Right Team

It is critical to have the right team of advisors. As real estate comes with tax, legal, liability, and estate planning issues, your team should (at minimum) include attorneys, tax advisors, and insurance professionals. Ideally, assembling a team of advisors and professionals that work at the same firm or work well together is prudent to ensure a holistic and consistent approach to owning, operating, and managing property that will pay dividends in the short term and for generations.

Choose professionals with experience working in the jurisdiction where the property is located. State and local laws governing change of ownership rules, estate and gift taxes, real estate transfer taxes, and property reassessment conditions can vary significantly, which can impact your ownership structure strategy. For example, a lawyer in Connecticut might not be the best advisor for a strip mall property in Texas.

Think Through Your Real Estate Goals

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With your team in place, it is never too soon to start the planning process and the gathering and sharing of information. Good advisors will work with you to first establish your goals, then work backwards to develop the strategies that will see them realized. Your advisors should help develop a roadmap that incorporates:

- Your plans for the property, whether that includes holding, transferring, selling, or reinvesting;
- Your current and future plans for using the property, whether it's the retail storefront for your business or a vacation home for your family;
- The terms of any loan and any covenants around transferring the property;
- The unique needs of your company, such as the industry you operate in or any employee stock ownership plans;
- Strategies to reduce your exposure to estate and gift tax, which could involve transferring all or a portion of the property or business to one or more trusts for the benefit of your children or other descendants;
- Strategies to transition the property or the business upon retirement or at death in a tax-efficient manner and that is consistent with your goals and objectives; and
- Strategies to mitigate risk associated with ownership of real estate, including ways to limit liability and customize insurance coverage.

At first blush, ownership of real estate might appear straightforward; however, seemingly simple decisions can have significant consequences and result in considerable unanticipated expense. For example, transferring ownership to a family member could trigger gift tax, which might have been avoided with careful planning. Not having enough insurance coverage or not purchasing certain property endorsements could result in loss. Working with your team early and often creates efficiencies, which will help minimize liabilities and maximize your investment.

Choose the Right Ownership Structure

How you choose to own real estate —whether personally in your name, with multiple owners, as part of your business, or through an entity or trust—will have a significant downstream impact on your taxes, liabilities, and any plans to transfer the property or implement a tax-deferred 1031 exchange.

If the real estate is related to your business operations, you should work with your advisors to determine whether or not it should be owned by the operating company. There can be significant advantages to keeping the ownership of the real estate separate from the operating company, including but not limited to flexibility in retaining the property when selling the company (e.g., by potentially leasing the property to the new owners) to protecting your property value from creditors in the event of bankruptcy or a lawsuit against the operating company. Separate ownership can also help facilitate alternatives for transfer tax planning.

Utilizing either a single-member limited liability company (LLC) or a multi-member LLC that is taxed as a partnership is often a smart strategy for real estate ownership, as these structures can provide limited liability protection while preserving flexibility to avoid income tax on a future distribution of property from the LLC to the LLC member(s); however, it is important to understand whether and to what extent this could impact the possibilities of consummating a 1031 exchange. On the other hand, holding real estate in a corporation (including an LLC taxed as a corporation) is usually inadvisable because a corporation (generally) cannot distribute property to a shareholder on a tax-free basis, which makes future planning more difficult.

Avoid Tax Pitfalls When Transferring Property

It is critical that you consult with your team of advisors well in advance of transferring any ownership in real estate or in an entity that owns real estate, regardless of whether the recipient is a family member or a third party and regardless of whether the transfer is structured as a gift or a sale. If the transaction involves a transfer to or from a legal entity, you should consult with your accountant or tax attorney on any potential income tax issues. In addition, depending on applicable federal, state, and local laws, transferring real estate to another person or moving it into a separate entity could trigger a change of ownership threshold that, without adequate planning, could lead to a property tax reassessment, or a breach of loan covenants or insurance terms.

In addition, transferring encumbered real estate could trigger a "due-on-sale" clause in the loan agreement, which could require you to immediately repay the balance of the loan in full. A transfer could also disrupt existing insurance policies or invalidate insurance coverage for the property. In recent years, it has become increasingly difficult to secure insurance coverage in certain high-risk areas, such as parts of California and Florida. Therefore, having an insurance advisor navigate gaps in coverage or anticipate potential gaps in coverage is important. At the very least, having an advisor notify the lender and insurance provider in advance of a transfer can help facilitate an agreement to assign a loan, continue coverage, or help mitigate or avoid the risk of defaulting on a loan or losing coverage altogether.

Sophisticated tax planning techniques that utilize real estate and irrevocable trusts can be a powerful planning tool to reduce estate and gift tax exposure. Valuation discounts could be applicable, which allow for the real estate to be transferred to or for the benefit of family members at a discounted value for estate and gift tax purposes. Those types of techniques and strategies, however, require a considerable amount of planning and must be implemented with the assistance of an attorney experienced in trust and tax matters.

1031 exchanges, where capital gains taxes from the sale of one property are deferred by reinvesting the proceeds into like-kind property, also require careful planning to ensure title consistency between the properties and compliance with tax law requirements in order to preserve the deferral benefits.

Update Your Real Estate Information Often

Effective planning is not a one-and-done exercise. You should review your real estate leases, ownership records, entity organizational documents, insurance coverage, and any loan agreements regularly to ensure they continue to meet your needs and goals.

Business owners busy running their companies might not realize that: (i) a lease or option is expired, (ii) rent under a lease is no longer at market value, (iii) insurance coverage is not adequate due to value appreciation, or (iv) there is a tax liability lurking upon gift, sale, or death. All of these issues have the potential to create headaches and expense upon the sale of the company, the sale of the property, or the transfer of the company or property to family members at death.

That's why your advisor team is essential. They can help conduct regular audits to ensure your assets align with your business needs; your estate plan is up-to-date; that you're taking advantage of all the federal, state, and local tax allowances and exemptions; and that you are minimizing risk in owning real estate and maximizing your investment.