KREC Application (Form 103)
<u>Course Outline</u>

1. Time Allotment (50 minutes)
    a. Live lecture & Electronic media: 35 minutes
    b. Questions and answers: 15 minutes
2. Learning Objectives
    a. After participating in this session, attendees should be able to identify common types of real estate investment entity structures and understand the general similarities and differences between them.
    b. After participating in this session, attendees should be able to understand how common factors and considerations relevant to real estate investing affect the choice of entity structure.
    c. After participating in this session, attendees should be able to recognize when real estate investment activities might implicate state and federal securities laws.
3. Syllabus (50 minutes)
    a. Major Topic: Common types of real estate ownership entities and structures
        i. Time allotment: 10 minutes
        ii. Method of instruction: Live lecture; Electronic Media
    b. Major Topic: Factors and considerations when selecting entity and structure
        i. Time allotment: 10 minutes
        ii. Method of instruction: Live lecture; Electronic Media; Q&A
    c. Major Topic: Common types of real estate ownership entities and structures
        i. Time allotment: 10 minutes
        ii. Method of instruction: Live lecture; Electronic Media
    d. Major Topic: Unique types of real estate ownership entities and structures
        i. Time allotment: 10 minutes
        ii. Method of instruction: Live lecture; Electronic Media
    e. Major Topic: Real estate investing and choice of entity case examples
        i. Time allotment: 10 minutes
        ii. Method of instruction: Live lecture; Electronic Media; Q&A

KY CCIM CLE
Course Materials
<u>Real Estate Investment: Choice of Entity & Structure</u>
By: Jake Eldemire Smith, Esq. & Josh Stearns, Esq.

I. Common types of real estate ownership entities and structures
   A. Limited Liability Companies
      i. Description: legal entity that provides limited immunity from personal liability to its members, managers, employees, or agents from debts, obligations, or liabilities of the limited liability company. KRS 275.150.
      ii. The governing document of a Limited Liability Company is the "Operating Agreement." KRS Chapter 275 provides significant flexibility to an LLC by way of its operating agreement.
      iii. Pros:
         1. Limited liability for members, even if involved in management of LLC (as opposed to LP)
         2. Flexibility with respect to management and economics
            a. As opposed to state corporation statutes, state LLC statutes allow for extensive alteration of default statutory provisions via an operating agreement.
            b. Management: Members, Manager, Board of Managers etc.
               i. Still colloquially referred to as "GP"
            c. Economics: Operating Agreements can provide a variety of detailed distribution waterfalls as opposed to limited statutory options for corporations (preferred stock, common stock)
         3. Tax treatment: partnership default (for at least two members); c-corp election. No double taxation for distributions and can offset personal income.
         4. Ability to guard against cross-liability for multiple investments with single purpose entities.
         5. No restrictions on number or type of investors (individuals, trusts, other entities), as opposed to S-Corps which can't have entity ownership and limited in number of investors.
      iv. Cons:
         1. Operating Agreements generally limit members' ability to freely transfer ownership units, as opposed to shareholders of a corporation, making the investment more illiquid.
   B. Limited Partnerships
      i. Description: An LP is an association of two or more persons formed under the laws of any state and consisting of one or more general partners and one or more limited partners.
      ii. The governing document of a Limited Partnership is the "Partnership Agreement." Kentucky law places strict limits on the contents of partnership agreements, limited the flexibility of the LP itself.
      iii. Pros
         1. Limited liability for limited partners *(there are certain decision making aspects with respect to the management of the partnership, that if the limited partner participates in can expose them to personal liability)* Historically LP's could not participate in much at all, however, RULPA significantly limited the "control rule" allowing LP's to participate in decisions such as contributions, decisions re assets, taking or discharging of debt, votes on

general partner. The Partnership Agreement will provide this decision-making power to LPs through negative covenants.

        2. Tax treatment

    iv. Cons

        1. Strict compliance with complicated state LP statutes that if not followed correctly could convert to a general partnership and expose partners to personal liability – even with a comprehensive Partnership Agreement. In Kentucky, a number of "nonwaivable provisions" apply to every LP. KRS 362.2-110.
        2. General partner's personal liability for business debt is unlimited

C. General Partnerships

    i. Description: A general partnership (GP) is an association of two or more persons to carry on as co-owners of a business for profit.
    ii. Pros
        1. No filing requirements
    iii. Cons
        1. GP's exposed to unlimited joint and several personal liability
        2. GP's can bind the partnership without restriction, notice or consent from other GP's

D. LLC v. LP Debate

    i. Prior to LLC Statute enactment, most popular form of real estate investment entity was LP. LLC has shifted to most popular.
    ii. Both offer limited liability for owners (except the general partner)
    iii. Both are taxed the same
    iv. LP statutes harder to adhere to
    v. Certain decision making that LPs can't participate in
    vi. LLCs can structure management to mirror that of a limited partnership, i.e. manager of an LLC can have same powers as GP

E. Corporation

    i. Description: A separate and distinct entity from its owners.
    ii. "Corporate Bylaws" govern the corporation.
    iii. Pros:
        1. Shielded against personal liability – very rare to "pierce the corporate veil" and hold shareholders personally liable.
        2. Tax treatment:
            a. Lower corporate income tax rates
            b. Tax-free transfer of property to a corporation when it is transferred in exchange for a controlling stock interest in the corporation (26 U.S.C. § 351).
        3. Liquidity of investment: shares in a corporation are typically freely transferrable (unless subject to a stock transfer restriction agreement among shareholders).
    iv. Cons
        1. Tax treatment: double taxation on distributions to shareholders; no pass through of losses to offset personal income (unless you do S-Corp, which also has significant limitations on the type and number of shareholders)
        2. Management: shareholders usually don't have as much day-to-day control over the entity as members in an LLC, or even LPs do.
        3. Compliance with state corporation statutes is burdensome

F. Trust

i. Description: A fiduciary arrangement between a grantor, trustee, and trust beneficiary whereby the trustee manages an asset contributed by grantor for the benefit of the beneficiary
ii. Estate Planning Device
iii. Pros
    1. Grantor can limit the amount of control the beneficiary has over the real estate or set bench marks for obtaining control
    2. Tax planning
    3. Irrevocable trust are generally shielded from creditors
    4. Anonymity
iv. Cons
    1. Lack of flexibility – particularly with an irrevocable trust
    2. If a revocable trust, not completely shielded from creditors
v. Get an estate planning lawyer involved.

II. Factors and considerations when selecting entity and structure
  A. Number of Anticipated Investors
    i. Small group of investors – shared management and active (member-managed LLC)
        1. This could be a situation where a limited partner is a sophisticated operator who wants to put up significant capital, wants management duties, and perhaps wants to avoid the investment to be identified as a security under SEC regulations.
    ii. Medium group of investors or small group of investors that the GP does not know well or otherwise does not want to have active involvement – Manager Managed LLC
    iii. Large group of investors – passive investment, less control over management – LP or manager managed LLC
  B. Investment Strategy
    i. Buy and hold; turn key
        1. Long-term time horizon where there may be descent among owners of the holding company – LLC.
            a. Same goes for a company where real estate is not the primary business but the company owns the building it operates out of – OpCo will be taxed as a corporation, but real estate should be held in LLC.
    ii. "Flip" or "Value Add"
        1. Obviously not as common in commercial real estate
        2. Tax considerations if the intent is to add value and then sell before one year. One of the few situations you might consider a corporation.
    iii. Private Equity/Institutional Investor
        1. Typically a charter with a time horizon and clear exit strategy.
        2. PE may be more comfortable with a limited partnership and may want to hold GP's feet to fire (LPs are more common in other states like Delaware and even Indiana)
        3. A lot of private equity money in turn key acquisitions, value add projects, and development projects (see below)
    iv. Development
        1. LLC can provide same benefits as an LP – "manager" still referred to colloquially as "GP"
        2. Like a Partnership Agreement, an Operating Agreement provides flexibility to determine who pays costs of diligence, who signs personal guaranty (and

takes personal guaranty fee), preferred returns, "promote", equity distribution upon equity event, etc.

v. Estate/Family Planning

1. May consider a trust
2. Still can use a LLC, but some grantors may say LLCs grant too much flexibility to members

C. Degree of Investors' Involvement

i. Number of Investors – the more the investors, the less involvement the majority of them should have

ii. Active involvement – Shareholders, Limited Partners and owners of REIT can't participate in daily management of property

D. Acceptable Degree of Risk

i. Limited personal liability – no real difference between LLC and LP. Shareholders are more unlikely to be held personally liable. LP's are riskier than LLC because of adherence to state statute.

ii. Investors may want to hold a GP's feet to the fire through unlimited liability and may just be more familiar with the LP structure

iii. GP's are the worst option for this factor

E. Tax Treatment

i. Pass-through treatment – LLC (two members), LP, GP and S-Corp

1. Pros:
   a. Offset personal income tax liability with losses
   b. No double taxation
2. Cons:
   a. Profits usually taxed at higher personal income tax rates
   b. S-Corp has significant limitations on ownership and is an administrative burden

ii. Non-Pass Through – C-Corp Election by LLC, Corporation

1. Pros
   a. Income taxed at lower corporate income tax rates
2. Cons
   a. Double taxation on distributions
   b. Can't offset personal income tax

F. Equity & Debt Financing

i. Most lenders prefer LLC structure.

ii. LLC structure is far better choice for equity financing. Significant limitations with respect to the capitalization structure, preferred rights etc. with corporations.

iii. Equity financing will likely trigger state and federal securities laws and require significant negotiation with investors as to preferred rights for distributions and management. LLC's provide flexibility in this respect.

III. Unique types of real estate ownership entities and structures

A. Bitcoin & NFTs

i. https://news.coincu.com/87737-a-house-was-purchased-with-bitcoin/

ii. https://www.tampabay.com/news/real-estate/2022/02/11/nft-house-sells-for-654k-in-historic-auction-tampa-condo-up-next/#:~:text=Real%20Estate-,NFT%20house%20sells%20for%20%24654k%20in%20historic%20auction%20%E2%80%94%20Tampa,more%20than%20a%20year%20ago.&text=A%20house%20in%20Gulfport%20auctioned,%24654%2C310%2C%20or%20about%20210%20ethereum.

iii. Crypto Mortgages: https://fortune.com/2022/03/03/crypto-mortgage-housing-market/

B. REITs

i. Description: A REIT is an entity created under the IRC that allows holders of beneficial interests in a trust to own real estate.

ii. Pros:

1. limited liability for investors
2. centralized management
3. ready market for transferring shares since many REITs are publicly traded.
4. Tax treatment: While taxed at regular corporate income tax rates, a REIT can deduct dividends paid to shareholders if it meets certain qualifications. This has the effect of avoiding double taxation because income from the REIT is taxed only at the shareholder level. Deductible losses, however, cannot be passed through to shareholders.

IV. Examples

V. Polling questions