REAL ESTATE FINANCE

July 2004

Choice of Entity for California Real Estate Developers and Investors

William R. Ahern

William R. Ahern is an attorney at Allen Matkins Leck Gamble & Mallory LLP in Orange County, CA, where he practices in the firm's business and tax planning practice group, primarily focusing on the taxation of flow-through entities. Mr. Ahern may be reached at wahern@allenmatkins.com

The perfect real estate development opportunity has been located and the transaction is starting to take shape. The purchase and sale agreement has been executed, the investors located and a commitment for financing obtained. The next issue to be addressed is the type of entity to be formed to acquire the real property. If this is not your first deal, then you may be inclined to use the same structure as you have used in the past. However, because each entity that can be formed to acquire real estate has different advantages and disadvantages and each deal is different, an analysis should be undertaken to determine which structure is the most appropriate for your present transaction.

Most states offer C-corporations, S-corporations, general and limited partnerships, and limited liability companies as the primary vehicles through which title to real property can be acquired. In determining which business entity to use, the parties should consider, at a minimum, the manner in which the entity is taxed for federal and state income tax purposes, the ease and cost of forming the entity, the manner in which the management of the entity may be structured, the liability protection the entity affords to its owners and the fees and taxes that the applicable state imposes on the entity for the privilege of doing business in the state. In making this determination most real estate developers and/or investors will generally choose to form a general or limited partnership or limited liability company to acquire and develop the applicable project. This is because the net income of C-corporations is generally subject to two-tiers of tax[1] and S-corporations have restrictions on the number and types of shareholders such entities may have[2] as well as other tax attributes that are not conductive to real estate investment.

This article focuses on California law, and reviews the use of California general and limited partnerships and California limited liability companies as entities through which title to California real property can be acquired, the basic elements of each, and finally which entity should be considered in certain circumstances.

GENERAL PARTNERSHIPS

The first type of entity to discuss is a general partnership. A general partnership is an entity in which all of the constituent owners (*i.e.*, the general partners) have joint and several liability for the debts and obligations of the entity.[3] The general characteristics of a general partnership are as follows.

Governing Law, Definition, and Formation

The Uniform Partnership Act of 1994 (GP Act), which governs California general partnerships, defines a general partnership as an association of two or more persons to carry on as co-owners a business for profit.[4] No documents or instruments need to be filed with the state or county in order to form a California general partnership. Instead, the partners only need to possess the general intent to engage in the acts that constitute a partnership.[5] However, California now permits a Statement of Partnership Authority (Form GP-1) to be filed with the Office of the California Secretary of State to place third parties on notice as to the existence of the partnership.[6] The Statement of Partnership Authority may also be filed in the County Recorder's Office in each county in which the general partnership owns real property.[7] Although these filings are voluntary, they are prudent to prevent a third party from claiming its lack of knowledge of the existence of the partnership and the restrictions of authority, if any, placed on any of the partners thereof.

Partnership Agreement

The GP Act provides that any agreement between or among the partners concerning the partnership can be written, oral, or implied.[8] Of course, it is highly advisable that any such agreement be reduced to a writing in connection with the formation of the partnership to reduce the potential for later conflict.

Management

Unless the partnership agreement provides otherwise, each partner has equal rights in the management and conduct of the partnership's business and affairs[9] and each partner is an agent of the partnership for the purpose of its business.[10] In order to centralize management, the partners may elect to vest management and control in one or more of the partners. If the partners make such an election, then the partnership should file a Statement of Partnership Authority reciting such management restrictions to place third parties on notice of such election.[11] Otherwise, the restrictions on authority will generally not be effective against third parties without knowledge of such restrictions.[12] The management restrictions should also be set forth in the written partnership agreement.

Liability

Unless otherwise agreed to by the claimant or provided by law, all partners of a general partnership are jointly and severally liable for the obligations of the partnership.[13] Accordingly, the assets of each partner are at risk to satisfy claims brought against the partnership. Although such risks can be mitigated by obtaining insurance for the entity, there are certain types of claims that are uninsurable and others for which the cost of insurance can be prohibitively expensive.

Taxation

Federal and State Income Tax. Business entities can now elect how they will be taxed for federal income tax purposes by filing a statement of such election with the Internal Revenue Service.[14] California will generally respect such elections and treat such entities for California income tax purposes as they are treated for federal income tax purposes.

A general partnership will normally elect to be taxed as a partnership for federal and state income tax purposes. A partnership that makes such an election is generally not subject to federal or California income tax. Instead, the partnership acts as a conduit through which its various items of income and loss flow to the partners. The partners in turn must annually report their shares of those items on their own federal and state income tax returns.[15] Entities that elect to be taxed in this manner are often referred to as "flow-through entities." Subchapter K of the Internal Revenue Code provides rules governing the character, timing and the amount of income or loss allocated to each partner, the tax consequences of moving property into and out of partnerships and characterization of transactions between partners and the partnership.[16]

State of California Franchise Tax. One of the significant advantages of electing to conduct business in California as a general partnership as opposed to another type of business entity is that California does not impose a State Franchise Tax on general partnerships for the privilege of doing business in California. As used in this article, the term "State Franchise Tax" means the taxes and fees that California imposes on entities for the privilege of doing business in California. As discussed subsequently, California imposes such taxes on limited partnerships and limited liability companies for the privilege of doing business in California.

LIMITED PARTNERSHIPS

The second type of entity is a limited partnership. A limited partnership is an entity where only a limited number of partners have liability for the debts and obligations of the entity.[17] The partners that bear such liability are referred to as the general partners[18] and are usually the developers or promoters of the transaction. The liability of the other partners, which are referred to as the limited partners and are normally the investors in the transaction, is generally limited to their investment in the entity.[19] The basic elements of a limited partnership are as follows.

Governing Law, Definition, and Formation

The California Revised Limited Partnership Act (LP Act), which governs California limited partnerships, defines a limited partnership as a partnership with one or more general partners and one or more limited partners.[20] In order to form a California limited partnership, the general partner must execute, acknowledge and file a Certificate of Limited Partnership (Form LP-1) with the Office of the California Secretary of State.[21] In addition, either before or after filing the Certificate of Limited Partnership, the partners must enter into a partnership agreement.[22] Although it is highly advisable, the partnership agreement need not be reduced to writing.[23] It is especially important that the agreement be reduced to writing for the general partner since the LP Act specifically provides that if the agreement is not in writing and a dispute arises concerning the terms and conditions of the agreement, the burden of proof is placed on the general partner.[24]

Management

The management and control of the business and affairs of a limited partnership is generally vested in the general partner.[25] The limited partners generally take a passive role with respect to the business and affairs of the partnership. Notwithstanding the foregoing, the limited partners are usually entitled to vote on matters of a significant nature with respect to the partnership such as the sale or financing of all or any portion of the property and the dissolution of the partnership. The matters on which the limited partners are entitled to vote is subject to the negotiation.

Liability

Like a partner of a general partnership, a general partner of a limited partnership has unlimited liability for the debts and obligations of the entity.[26] A limited partner, on the other hand, is usually only liable for its investment in the partnership.[27] However, if a limited partner actively participates in the control of the business of the limited partnership, then the limited partner may be held liable as a general partner to persons who transact business with the limited partnership with actual knowledge of that partner's participation in control and with a reasonable belief, based upon the limited partner's conduct, that the partner is a general partner at the time of the transaction.[28] Although being vested with significant voting rights should not subject a limited partner to general partner liability, if the limited partner becomes actively engaged in the business and affairs of the partnership, then the limited partner may inadvertently subject itself to general partner liability.

Taxation

Federal and State Income Tax. Like a general partnership, a limited partnership that elects to be taxed as a partnership for federal and state income taxation purposes is a "flow-through entity" and the various items of income and loss of the partnership flow through to the partners, who must annually report their shares of those items on their own federal and state income tax returns.[29]

State of California Franchise Tax. The State of California imposes an annual franchise tax of $800 on each limited partnership organized in California, qualified to do business in California or conducting intrastate business in California for the privilege of doing business in California.[30]

LIMITED LIABILITY COMPANIES

The third and last type of entity is a limited liability company (LLC). An LLC is an entity in which all of the constituent owners (*i.e.*, the members) have limited liability for the debts and obligations of the entity. The basic elements of an LLC are as follows.

Governing Law and Definition

The Beverly-Killea Limited Liability Company Act (LLC Act), which governs California LLCs, defines an LLC as an entity having one or more members that is organized under the LLC Act and subject to Section 17101 of the LLC Act.[31] A feature unique to LLCs, is that unlike general and limited partnerships, which must have two or more owners, an LLC can be comprised of only one owner.[32]

Formation

An LLC is formed by filing Articles of Organization (Form LLC–1) with the Office of the California Secretary of State.[33] Either before or after the filing of the Articles, the members of the LLC must enter into an oral or written operating agreement.[34] Once again, it is highly advisable that the agreement be reduced to writing to avoid later conflict between the members.

Management

LLCs provide great flexibility with respect to management. For instance, management of an LLC can be vested in a manager, who need not be a member, or one or more of the members.[35] In addition, officers of the LLC may be appointed to carry out the day-to-day business and affairs of the entity.[36] Like managers, the officers may but need not be members of the LLC.[37]

Liability

The liability of the members of an LLC is generally limited to their investment in the entity.[38] Likewise, managers and officers of an LLC are not generally held to be personally liable for the debts or obligations of the entity solely by reason of being a manager or officer.[39] Unlike the GP Act and the LP Act, the LLC Act specially provides that a plaintiff may request a court to use the "alter ego doctrine" to pierce the LLC's corporate veil in which event the members will be personally liable for the debts and obligations of the entity.[40] A plaintiff may be successful in persuading the court to apply such a doctrine if there is such a unity of interest and ownership between the members and the LLC that the separate personalities of the LLC and the owners no longer exist, and if the acts are treated as those of the LLC alone, an inequitable result will follow.[41] Entering into a written limited liability company agreement, keeping the LLC adequately capitalized and entering into all contracts in the name of the LLC as opposed to the name of the person executing the contract on behalf of the LLC may help prevent the application of the "alter ego doctrine" and the piercing of the limited liability company's corporate veil.[42]

Tax

Federal and State Income Tax. Like general and limited partnerships, an LLC can, and generally will, elect to be taxed as a partnership for federal and state income tax purposes. If such an election is made, the LLC will be characterized as a "flow-through entity" and the various items of income and loss of the LLC will flow through to the members thereof, who must annually report their shares of those items on their own federal and state income tax returns.[43]

State Franchise Tax. Like limited partnerships, each LLC organized in California, qualified to do business in California or conducting intrastate business in California must pay an $800 minimum franchise tax for the privilege of doing business in California.[44] In addition, LLCs are also subject to a graduated fee (commonly referred to as the "gross receipts tax") based on the LLC's annual total income[45] as set forth in Exhibit 1.The application of the minimum franchise tax and the gross receipts tax is illustrated by the following example: If for the tax year 2004, an LLC that owns an apartment building had total income from rents equal to $1,500,000 and no other income, then the LLC would be required to pay gross receipts tax of $6,000 as well as the $800 annual minimum franchise tax.Thus, the entity's total tax liability to the State of California for the privilege of doing business in California for such year would be $6,800.

WHAT ENTITY TO CHOOSE

Liability Protection

Liability protection is usually of great importance to real estate developers and investors. Accordingly, a general partnership is generally not advisable to develop a real estate project unless adequate insurance can be obtained to protect the partners thereof against the liabilities associated with the operations of such entity or the transaction can be structured in a manner to mitigate such risks. Instead, a limited liability company or limited partnership should be considered. Which entity is ultimately selected will depend on a number of factors such as the anticipated annual gross receipts of such entity, the extent that the other owners of such entity desire to be involved in management and

EXHIBIT 1

Total Income (Gross Receipts)	Fee Amount
$0 - $250,000	-0-
$250,000 - $499,999	$900
$500,000 - $999,999	$2,500
$1,000,000 - $4,999,999	$6,000
$5,000,000 or more	$11,790

whether the owners thereof are going to be required to guaranty any acquisition or construction loans necessary to acquire and/or construct the applicable project. These factors are discussed subsequently.

State Franchise Tax

If it is anticipated that the property to be acquired will generate a significant amount of gross receipts, then the use of a general or limited partnership should be considered. This is due to the fact that such entities are not subject to the gross receipts tax that is imposed on LLCs for the privilege of doing business in California. The differences between such entities are illustrated by the following example:

> Assume that an entity needs to be formed to acquire an apartment building that is expected to have income of $3,000,000 a year in rents. If a general partnership is chosen, no State Franchise Tax will be imposed on the entity since California does not impose a State Franchise Tax on general partnerships for the privilege of doing business in California. If a limited partnership is chosen, then the entity would only be subject to an $800 State Franchise Tax. If an LLC is chosen, then the entity would be subject to the annual $800 minimum franchise tax and a gross receipts tax of $6,000 for a total State Franchise Tax liability of $6,800. Over the life of the entity, this would amount to a substantial sum.

Based on the foregoing example, a general or limited partnership would result in the least amount of State Franchise Tax being imposed. The disadvantage with choosing either of these entities is that at least one of the partners, usually the developer or promoter, will need to be liable for the debts and obligations of the entity. However, by incorporating an LLC in the structure, the developer or promoter may achieve limited liability and yet reduce the tax burden. This may occur, for example, by forming an LLC, which provides the owners with liability protection, to serve as a one percent general partner of a limited partnership that is formed to acquire the property. Such a structure would generally provide limited liability to all parties and allow 99 percent of the rents collected from the property to avoid the gross receipts tax. The developer could also hold a direct interest as a limited partner to obtain a greater ownership interest in the property. However, the developer would need to be careful to avoid participating in management (in its limited partner capacity) and keep its interests "separate" to protect its limited partner status and avoid general partner liability.

Investor Management

It is not uncommon for the investors that provide the equity necessary to acquire and/or develop a real estate project to mandate significant management rights with respect to the business and affairs of the entity to protect their investment. As discussed above, limited partners that require to be actively engaged in the business and affairs of the partnership may inadvertently subject themselves to general partner liability. Members of a limited liability company are not subject to the loss of liability protection for participating in the business and affairs of the LLC. Accordingly, if an investor desires to have a significant role in the management of the entity but does not want to risk subjecting itself to personal liability for the debts and obligations of the entity, then an LLC should be considered.[46]

Alternatively, if the applicable real estate project is expected to generate significant income over an extended period of time and the parties determine that the State Franchise Tax would be prohibitively expensive if an LLC was chosen, then a structure similar to the one discussed under the "State Franchise Tax" heading should be considered. More specifically, the developer (or promoter) and the investor that desires to participate in the management of the entity could each form a limited liability company (or another type of limited liability entity such as a corporation) to serve as general partners of a limited partnership. The limited liability companies would be each admitted as a one percent general partner of the limited partnership. The developer and investor would acquire the remaining 98 percent ownership interest in such entity as limited partners. The partnership would be co-managed by the general partners. Since the developer (or promoter) and the investor would each control one of the general partners, such a structure might allow the investor to actively participate in the business and affairs of the partnership without subjecting itself to unlimited liability[47] and allow 98 percent of the entity's income to avoid the gross receipt tax that is imposed on LLCs. However, since this structure involves at least three entities, the costs associated with the formation and operation of such entities should be compared with the cost of the formation and operation of a single limited liability company before such structure is implemented.

True Guarantors versus Purported Guarantors

Most real estate projects require a construction and/or an acquisition loan to construct and/or acquire the applicable project. In cases where either of these types of loans is required, lenders usually require the developer to provide a completion and/or repayment guaranty. If such guarantees are required and the loan goes into default, then the lender may elect to exercise its right to foreclose on the property and cause the property to be sold in a foreclosure sale. In the event that the proceeds from the sale are insufficient to satisfy the loan in full, then the lender may seek a deficiency judgment against the guarantor for the balance.

If it is anticipated that a completion and/or repayment guaranty will be required and there is a concern that such guaranties may be triggered, then the developer (and/or promoter) may consider forming an entity where the guarantor has personal liability for the debts and obligations of the entity (*i.e.*, a general or limited partnership) and to serve as the general partner thereof. By using this structure, the developer may be able to rely on California case law and/or statutes to limit its exposure under any such guaranty.

This area of the law is very complex and the facts surrounding each transaction must be carefully analyzed to determine whether the applicable guarantor may be entitled to any of such protections. However, in transactions where it is anticipated that one or more of the owners of the entity will be required to provide a completion and/or a repayment guaranty, the owners should analyze whether the risk of suffering a liability under the guaranty is greater and more costly than the other potential liabilities that may be associated with the project many of which can be insured against (*i.e.*, tort claims for injuries suffered on the property, construction defect, etc.). If it is determined that risks of incurring a loss under the guaranty are greater and more costly than such other risks, then the use of a general or limited partnership should be considered and the persons providing such guaranties admitted as the general partners thereof.

CONCLUSION

Because each deal is different and each entity that can be formed to acquire the applicable real estate project has different advantages and disadvantages, an analysis should be undertaken to determine which structure is most appropriate for the deal at hand.

NOTES

1. The net income of a c-corporation is generally subject to two levels of tax since such income is taxed at the corporate level when earned and again when distributed to the shareholders thereof in the form of dividends.
2. In order to qualify as an s-corporation, a corporation may not have (i) more than 75 shareholders, (ii) have anyone other than an individual, estate, tax-exempt organization or certain trusts as shareholders, (iii) have a non-resident alien as a shareholder or (iv) have more than one class of stock. IRC § 1361.
3. California Corp C § 16306(a).
4. California Corp C §§ 16101(7), 16202(a).
5. California Corp C § 16202(a).
6. California Corp C § 16303.
7. *Id.*
8. California Corp C § 16101(8).
9. California Corp C § 16401(f).
10. California Corp C § 16301.
11. California Corp C § 16303(a)(2).
12. California Corp C § 16301(1).
13. California Corp C § 16306(a).
14. See Tres. Reg. § 301.7701.
15. Laura E. Cunningham and Noel B. Cunningham, The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships (2ed 2000) at 1.
16. *Id.*
17. California Corp C § 15611(r).
18. California Corp C § 15643(b).
19. California Corp C § 15632.
20. California Corp C § 15611(r).
21. California Corp C § 15621(a).
22. *Id.*
23. California Corp C § 15611(y).
24. *Id.*
25. California Corp C § 15643(a).
26. California Corp C § 15643(b).
27. California Corp C § 15632(a).
28. *Id.* California Corp C § 15632(b) sets forth activities in which a limited partner may engage that will not undermine such partner's status as a limited partner. These activities include, without limitation, (i) being an employee, agent or independent contractor for the partnership or the general partner of the partnership, (ii) being an officer, director or shareholder of a corporate general partner of the partnership, or a member, manager, or officer of a limited liability company that is a general partner of the partnership, (iii) consulting with or advising the general partner with respect to the business of the limited partnership and (iv) exercising any right or power permitted to limited partners.
29. Cunningham, *supra* n.15 at 1.
30. Rev & TC §§ 17935, 23135(d)(1).
31. California Corp C § 17001(t).
32. California Corp C § 17001(f).
33. California Corp C § 17050(a).
34. *Id.*
35. California Corp C § 17150.
36. California Corp C § 17154(a).
37. California Corp C § 17154.
38. California Corp C § 17101(a).
39. California Corp C § 17158.
40. California Corp C § 17101(b).
41. 15 Cal. Jur. 3d (Rev.), Corporation § 33.
42. *Id.*
43. Cunningham *supra* n.15 at 1.
44. Rev & TC §§ 17941(a), 23153(d)(1). The California Revenue and Taxation Code defines "total income" as gross income plus cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer, but excludes allocations or attributions of income, gain, or distributions to one limited liability company in its capacity as a member of, or holder of an economic interest in, another limited liability company if the allocations or attributions are directly or indirectly attributable to income that is included in determining the annual fee payable by the other limited liability company.
45. Rev & TC 17942.
46. California Corp C § 17101.
47. California Corp C § 15632(b) provides that a limited partner does not participate in the control of a business within the meaning of California Corp C § 15632(a) by being a member of a limited liability company that is a general partner of a limited partnership.