CHAPTER 15

Ownership Considerations

¶ 15.01 OVERVIEW OF OWNERSHIP ENTITIES

The form of hotel ownership is a very important decision that must be made in the early stages of the hotel development process. Usually the decision is based on tax, legal, or business considerations. For example, an owner might choose to form a corporation instead of individual ownership in order to limit his personal liability.

In this chapter, the following forms of business entities are discussed:

1. Individual ownership
2. Concurrent ownership (by two or more individuals)

3. Partnership (general and limited)
4. Regular corporation (C corporation)
5. S corporation
6. Limited liability company (LLC)
7. Trusts
8. Real Estate Investment Trust (REIT)

[1] Tax Considerations

Each form of business entity has its own tax consequences; therefore, it is important to study each entity's tax impact on the hotel venture before deciding on a particular business entity. A brief description of the tax treatment for each type of ownership follows:

- *Individual ownership* lumps income, gain, and loss from hotel properties together with the owner's other items of income, gain, and loss.
- *Concurrent ownership* taxes each owner as an individual owner to the extent of his percentage interest in the property.
- *Partnerships,* whether general or limited, are not taxable entities, but are merely tax conduits; taxable income, gain and loss is passed through directly to the individual partners, who then treat these items as though they were individual owners of the property.
- *Regular (C) corporations* are taxable entities separate from their shareholders; they report income, gain, and loss separately. Consequently, corporate income and gain is subject to a double tax, once on the corporate level and again on the shareholder level when the income or gain is distributed as dividends.
- *S corporations, LLCs, and REITs* are separate legal entities that distribute income and losses in a way similar to partnership forms. There are, however, very specific statute requirements in the Internal Revenue Code that must be met to qualify for these entities.
- *Trusts* are taxable entities separate from their beneficiaries and thus similar to regular (C) corporations.

[2] Business and Legal Considerations

It is important for the hotel owner to look at the various business situations that he is likely to encounter and to determine thereby what form fits best. The wrong choice could mean missing a business opportunity that could cost the hotel owner severely. Some of the more important nontax considerations to review when choosing an entity are as follows:

- Cost of formation
- Number of people and type of management needed to run the hotel
- Degree of flexibility required to conduct the activities
- Extent of and probability of exposure to liability
- Ease of transferability of interest in the entity

- Estate planning
- Ease of transferability of the hotel property
- Expected duration of the venture

¶ 15.02 INDIVIDUAL OWNERSHIP (SOLE PROPRIETORSHIP)

The simplest business form is individual ownership (sole proprietorship). A sole proprietorship is any business that is owned by one person as an individual. As such, there is no legal distinction between the owner and his business. The owner establishes the sole proprietorship simply by opening up his hotel for business.

Under sole proprietorship, the owner keeps track of his business income and expenses and reports the results on his schedule C federal tax form along with other income and deductions that he has on his individual tax form. A major tax disadvantage of sole proprietorship is that the owner is responsible for paying both the employer and employee portion of the social security tax on earnings from the hotel. However, the owner is allowed to deduct half the payments on his federal tax return.

Sole proprietorships are usually found in small family-run businesses where the hotel property is the major asset of the owner. Most potential liability claims can be handled by the purchase of insurance. Also, if the owner should need to borrow money to build the property, the lending institution would more than likely require the owner to personally guarantee the loan even if the entity were in a corporate form of business. Thus, there is little incentive for a small operator to incur the expenses of doing business as a corporation.

¶ 15.03 CONCURRENT OWNERSHIP

Hotels can be held in one of three forms of concurrent (i.e. multiple) ownership:

- Tenancy in common
- Joint tenancy
- Tenancy by the entirety

Because concurrent ownership requires a high degree of cooperation between co-owners, it is normally used only when property is acquired by members of a family or by a small group of investors who have had a long association. The ownership is reported on each individual's tax return in accordance with the ownership interest and thus is similar for tax purposes to a sole proprietorship.

[1] Tenancy in Common

A tenancy in common is created when hotel property is transferred to two or more persons without express language creating one of the other two types of concurrent ownership (i.e., joint tenancy or tenancy by the entirety). For example, a tenancy in common is created by either of the following two conveyances: (1) To *A* and *B* or (2) To *A* and *B* as tenants in common.

The term "tenant" is used in its original sense as a co-owner of property, not in the sense of one who possesses real estate pursuant to a lease.

When two or more persons hold as tenants in common, each has an "undivided

interest" in the entire property to the extent of his or her ownership share. For example, conveyance to three persons, without designation of any percentage to each, would give each tenant in common a one-third interest in the entire property. Alternatively, the conveyance may allocate different shares to each co-tenant: for example, one of three co-tenants may own a 40 percent undivided share, with each of the others owning a 30 percent share.

All decisions with respect to the co-owned property must be unanimous; the property may not be sold, mortgaged, or leased without the consent of all the co-tenants. For this reason, tenancy in common usually is considered a viable form of ownership only for a small hotel project with very few investors. Co-tenants can agree that one or only a few of them shall have the authority to make all decisions with respect to the property; however, this creates a risk that the relationship may be deemed an association taxable as a corporation.

Each tenant's right to possession of the property is subject to the rights of the co-tenants. Each has the right to an accounting of rents and profits, and in the event any tenant spends money for the payment of taxes, insurance premiums, or necessary maintenance and repair, he is entitled to reimbursement by the other tenants for their share of the expense. If the co-tenants are unable to agree as to the management or disposition of the property, any one of them is entitled to begin a legal proceeding known as an action for partition. If the hotel property cannot be equitably divided, the court can order that it be sold, with the proceeds to be divided among the co-tenants according to their interest.

Each co-tenant may sell, mortgage, or give away his interest during life or transfer it at death. When the interest of a co-tenant is transferred to another, the new owner becomes a tenant in common with the remaining owners.

For tax purposes, each tenant in common reports his share of income, gain, or loss. If a co-tenant makes a gift of his share, the usual rules of gift taxation apply. In addition, a gift is deemed to have been made if one tenant in common pays more than his share of costs and is not reimbursed by the others. The interest of a deceased tenant in common is taxed as part of his estate, according to its value on the date of death or on the optional valuation date. The heirs acquire the interest of the deceased tenant in common at a stepped-up basis equal to the value used for estate tax purposes.

[2] Joint Tenancy

A joint tenancy is similar to a tenancy in common, with one very significant difference—the right of survivorship. If any joint tenant dies, his interest automatically passes in equal shares to the remaining joint tenants. If three joint tenants had owned the property and one died, each of the two survivors would take one half of the deceased joint tenant's interest. At the same time, in a joint tenancy as in a tenancy in common, all tenants are deemed to have an equal undivided share of the property; in other words, three joint tenants each own a one-third undivided interest.

A joint tenancy can be created only by express language in a conveyance, for example, "John Jones and Mary Jones as joint tenants with right of survivorship and not as tenants in common." A conveyance merely to "John Jones and Mary Jones" normally creates a tenancy in common, not a joint tenancy. Joint tenancies, because of their unusual survivorship feature, normally are used only among family members. One advantage is that this arrangement not only designates ownership of property, but also can serve as a substitute for a will. Thus, no public record will exist of the transfer of the property and no probate proceeding will be required; this is an attractive

feature to many wealthy people. In addition, except for unusual circumstances, creditors of the deceased joint tenant cannot reach property that has passed into the hands of the surviving joint tenant (or tenants).

However, a disadvantage of the joint tenancy in owning property is that it does not permit other types of disposition at death that may prove more beneficial to the overall estate.

Although a joint tenant cannot devise his interest by will, the interest can be sold or given away during his lifetime. If this is done, the new owner becomes a tenant in common, not a joint tenant, with the remaining owners. This reflects the conceptual basis of early English common law, which conceived of joint tenancy as a merger of four unities: interest, time, title, and possession. The time requirement means that all the joint tenancies must be established at the same moment. Consequently, if one joint tenant later transfers the interest to another, the unity of time is broken and the new owner becomes a tenant in common. Similarly, any joint tenant (like a tenant in common) may start an action of partition; if the property cannot be equitably divided, the property will be sold and the proceeds will be distributed to the parties.

A joint tenant reports his share of income, gain, and loss from the property. However, unlike the case with tenants in common, if one joint tenant pays expenses in excess of his proportionate share, the full amount of such expenses is deductible.

[3] Tenancy by the Entirety

A tenancy by the entirety is a joint tenancy between husband and wife. The tenancy carries with it the same right of survivorship as a joint tenancy so that, upon death of either spouse, the survivor takes the entire estate. Unlike a joint tenancy, however, neither spouse can convey any part of the property during their joint lives unless the other spouse joins in the conveyance. Thus, tenancy by the entirety (like the ancient right of dower) acts to protect the rights of the surviving spouse in property owned during the marriage. In most states recognizing the tenancy by the entirety, any conveyance to a husband and wife is presumed to be to them as tenants by the entirety, unless the title is specifically indicated to be otherwise.

Property held under tenancy by the entirety is not subject to levy by creditors of only one of the owners. In the event that the owners are divorced, the tenancy is destroyed and the divorced spouses become tenants in common. Where the spouses choose to file separate instead of joint returns, each tenant by the entirety reports his own share of the income, gain, or loss from the property on his separate return.

The major disadvantage of the joint tenancy or the tenancy by the entirety is their inflexibility with regard to planning to minimize federal estate taxes. Since there is now an exemption of $600,000 for a decedent, a co-owner whose estate is not likely to reach this figure (even after inclusion of the full value of the jointly owned property) need not be concerned. However, in many cases, the estate may exceed $600,000; consequently, a federal estate tax (which begins at 37 percent) may be payable. In discussing this problem, a distinction must be made between jointly-owned property between a married couple and between unmarried persons.

If a husband and wife are joint tenants of property or tenants by the entirety, one half of the property value is included in the estate of the first spouse to die, regardless of the amount each contributed to the purchase. The half so included will receive a "step up" in basis to current market value (thus eliminating any future tax on the appreciated value of that half prior to the date of death). At the same time, the transfer of the decedent's interest to the spouse is tax-free because of the unlimited marital deduction.

Example: *H* and *W* are joint tenants of property worth $1 million that cost $500,000. The property is their sole asset. On *H*'s death $500,000 (one-half the value) is included in his taxable estate. No federal estate tax is payable because of the $600,000 exemption (and also because of the unlimited marital deduction). *W* then becomes sole owner of the property. Her tax basis is $750,000, consisting of her one-half share of the original cost, or $250,000, plus *H*'s stepped-up basis of $500,000. If she sells the property for $1 million, she will pay tax on only $250,000 of gain.

The situation so far is favorable. However, *W* now is the sole owner of an asset with a value of $1 million. Upon her death, the general $600,000 exemption will be available, but the remaining $400,000 would be subject to federal estate tax. The tax on this amount is approximately $153,000 (assuming no taxable gifts during *W*'s life).

The federal estate tax would be eliminated completely in the foregoing example if the property were held by *H* and *W* as tenants in common. Upon *H*'s death, his $500,000 share would be exempt from tax, because it is less than the $600,000 exemption. If *H*'s share were left to his children (or in trust with income to *W* for her life), the property would not be included in *W*'s estate. Thus, on her death, her estate would amount to only $500,000, which would be fully exempt from tax, on the basis of the exemption. In both cases, the value of the real estate would be stepped up to the value at date of death.

If the joint tenants are not married to each other, one important distinction must be made from the previous situation. If one co-tenant dies, only the value of the property representing his contributed share of the original cost is included in his estate. So if a parent and child create a joint tenancy, with the parent contributing 100 percent of the cost, the entire value of the property will be included in the parent's estate. If the child is the first to die, no portion of the property will be included in the child's estate.

¶ 15.04 PARTNERSHIPS: IN GENERAL

Partnerships are one of the most common entities used to own hotels. Partnerships are popular for three reasons:

- *Tax factor.* A partnership is not a taxable entity, so no double tax is imposed at the partnership and the partner level; alternatively, tax losses can be passed through directly to the partners in many instances.
- *Legal factor.* The partnership agreement can be amended at any time and thus provides a great deal of flexibility with respect to allocation of profits and losses, division of management responsibility, and the settlement of disputes.
- *Business factor.* A partnership often involves lower organizational costs, state fees and taxes, and administrative costs than a corporation.

A partnership has some disadvantages, notably the absence of limited liability for general partners and the lack of free transferability of ownership interests, both of which are provided in a corporation. In recent years, the limited liability company (LLC) has been chosen by many hotel investors as a preferred alternative to both the partnership and the corporation.

A partnership is a form of business organization in which two or more persons are associated as co-owners in a continuing relationship for the purpose of carrying on a common enterprise or business for profit. A written agreement of partnership

(also called articles of partnership) defines the rights and obligations of each partner and sets forth how profits and losses are to be shared. The two types of partnerships are general partnerships and limited partnerships.

The term "partnership" is sometimes used interchangeably with the terms "joint venture" and "syndicate." Although a joint venture or syndicate may take the form of a partnership (either general or limited), the terms are not synonymous, because a joint venture or syndicate may also use some of the other legal forms of ownership, such a regular (C) corporation, S corporation, tenancy in common, or business trust.

[1] Legal Characteristics of a Partnership

The legal characteristics of a partnership (both general and limited, except as otherwise indicated) are as follows:

Separate legal entity. For most purposes, a partnership is recognized as a legal entity separate from its individual partners. As such, the partnership may sue and be sued, and may hold and convey real property in the partnership name. In actions brought in federal courts, partnerships are recognized as separate legal entities, but diversity of citizenship (often a condition for bringing a federal lawsuit) is determined by looking at the individual partners.

Agency relationship between partners. Each individual partner in a general partnership (and each general partner in a limited partnership) has unlimited liability for any and all obligations of the partnership. This follows from the legal principle that every partner is the agent and principal of every other partner. Consequently, any debt incurred by any partner with apparent authority to do so in carrying on the business of the partnership is a debt of every other partner. A partner may have the right, under the partnership agreement, to have other partners contribute a portion of the liability or indemnify the partner held liable. A third party dealing with the partnership without actual notice of a lack of authority is not required to look into a partner's individual authority and thus may look to any of them to satisfy an obligation regardless of the terms of the partnership agreement.

Management of partnership. Unless they agree otherwise, all members of a general partnership (or all general partners in a limited partnership) have equal rights in the management of the partnership business.

Dissolution of partnership. The agency relations among the general partners is a personal relationship that cannot be changed without the consent of all the partners. Consequently, the partnership is automatically dissolved by the death or withdrawal of any general partner, notwithstanding any other provision in the partnership agreement. In effect, this means that any partner may dissolve the partnership at any time. No partner has the power to substitute another person as partner without the consent of the remaining partners. On the other hand, a partner who dissolves the partnership in violation of the agreement, or who refuses to consent to a substituted partner when such substitution is permitted by the partnership agreement, may be liable for breach of contract to the other partners. Nevertheless, the partnership is dissolved. In the situation in which all partners consent to the addition of a new partner, the partnership is not dissolved under the terms of most partnership laws.

Nature of interest. A general or limited partner's interest in the partnership is inheritable personal property consisting of the partner's pro rata rights in the specific partnership property, rights to a share of profits, and the right to participate in management (in the case of a general partner) and inspect the partnership books. The right to profits is expressly made assignable to third parties by UPA, regardless of any partnership agreement to the contrary. The result is that an assignee of profits has a legal right to claim the profits as against the partnership, although the partnership itself may have causes of ac-

tion against the assignor for a breach of contract. The assignee, however, does not become a partner unless the other partners agree. An assignee who is not admitted as a partner lacks the right to participate in management, inspect the books, dissolve the partnership by death of withdrawal, or demand an accounting prior to dissolution of the partnership. It is not clear whether an assignee not admitted as a partner is liable for losses (although it would seem that either the assignor or the assignee must be liable).

[2] Checklist for a Partnership Agreement

The following checklist includes factors that should be considered in drafting a partnership agreement:

- ☐ *Name of the Partnership.* While a partnership can choose any name under which to conduct its operations, its name should not be too similar to that of another business organization. How the participants' individual names are used as the partnership name—whether or not the partnership name will continue to be used after the death or retirement of a partner and whether or not it is permissible to do so under local law—must be considered.
- ☐ *Registration of name.* In some states, a partnership name must be registered with a public agency or officer—for example, a county clerk or secretary of state.
- ☐ *Nature of business.* The nature of the partnership business must be clearly spelled out.
- ☐ *Permits and licenses.* The partnership agreement should provide that it is not to become effective unless and until required licenses or permits are procured.
- ☐ *Partners' contributions.* These may be in the form of property, cash, or services, or any combination thereof. In addition to making a capital contribution to the partnership, a partner may make a loan or sell property to the partnership either for cash or on an installment basis. In each instance, the legal, tax, and accounting consequences to the partner and the partnership must be examined and dealt with.

  Where property is contributed, the partners' right to reconcile the tax bases and accounting values of the contributed property in order to prevent distortions should be taken into account.
- ☐ *Duration of partnership.* The parties may agree to a definite term, or the partnership may continue at will. As mentioned previously, a partner may terminate his relations with the partnership even if doing so breaches the partnership agreement.

  If the partnership agreement specifies a fixed term, the parties may continue the business beyond that term as a partnership at will, extend the term, or enter into a new partnership agreement.
- ☐ *Partnership profits and losses.* In cases in which the partners share both profits and losses, they are usually shared in the same proportion. However, the partners may agree that different kinds of partnership income shall be distributed among the partners in different proportions. Whatever the arrangement may be, it should be carefully set out in the partnership agreement.

  A partnership is not an entity separate from its members for income tax purposes. Each partner is taxed on his share of the partnership income and profits and is entitled to deduct his share of the partnership losses. The part-

nership files only an information return, not the income tax return that an individual or corporation would file.

- ☐ *Compensation of partner for services to partnership.* In the absence of an express provision in the partnership agreement to the contrary, a partner is usually not entitled to compensation for his services to the partnership. If a partner is entitled to and does receive compensation for his services from the partnership, this is a deductible business expenditure of the partnership.
- ☐ *Withdrawal of capital.* When it is anticipated that the partnership will accumulate a substantial amount of money, the partners should be permitted to withdraw a sufficient sum to meet their income tax obligations. The partnership agreement should clearly spell out the parties' understanding with respect to the partners' rights in this regard.
- ☐ *Management of partnership affairs.* All partners have an equal voice with respect to the management and conduct of the business affairs of a general partnership, unless they agree otherwise. The partnership agreement should clearly state each partner's rights and duties as well as the extent to which the partners are authorized to bind the partnership by their contracts.
- ☐ *Accounting.* The partnership agreement should require all partners to account to the partnership with respect to all matters affecting the partnership.
- ☐ *Partnership property.* Property acquired with partnership funds is partnership property, unless an intention to the contrary is clearly established.
- ☐ *Partners' death or withdrawal.* The partnership agreement may provide for the continuation of the business after the death or withdrawal of a general partner. Partners should be careful when crafting the partnership agreement to provide for the valuation of any partners' partnership interest following death or to withdrawal.
- ☐ *Indemnification of partner.* The partnership may be required to indemnify each partner for payments made and personal liabilities reasonably incurred in the ordinary and necessary course of the partnership business.

[3] General Partnership

The simplest ownership form to use for two people who operate a business is the general partnership. This form of business can be as informal or formal as the partners wish it to be. General partnerships that have been formed with a simple handshake have lasted for many years. Although the requirements for forming the general partnership today have been made more formal by states adopting the Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA), hotel developers should be careful when choosing partners. In fact, partnerships among individuals have led to many court battles over such issues as control, valuation, and succession. Therefore, it is extremely important to state as clearly as possible in the partnership agreement all the relevant duties and obligations of the individual partners and the means of dissolving the partnership upon dissolution.

The UPA and RUPA both require that a general partnership file and record in a public office a certificate identifying the names and addresses of each partner. The certificate must be amended in the event of a change in the partners.

However, it is possible for a partnership to exist without the knowledge or the intent of the partners; on the other hand, investors may believe they are in partnership when in fact they are not. Under UPA, the following three rules aid in determining whether a partnership exists:

1. Persons who are not partners with respect to each other are not partners as to third persons except where, by their conduct, they have led others to believe that they are partners and to rely on that belief to their disadvantage so as to create a partnership by estoppel.
2. The mere existence of joint or part ownership of property does not establish that a partnership exists, regardless of whether or not the co-owners share the profits made by the use of the property.
3. The sharing of gross returns from property does not, in and of itself, establish the existence of a partnership, regardless of whether or not the persons sharing the returns have a joint or common right or interest in the property from which the returns are derived.

Proof that an individual shares in the profits of a business is prima facie evidence that he is a partner in the business, unless he receives the profits as payment of a debt (installment or otherwise), wages, rent, an annuity paid on behalf of a deceased partner, interest on a loan (even though the amount of the payment varies with the profits of the business), or consideration for the sale of the good will of a business or other property by installments or otherwise. There are four basic disadvantages in choosing the general partnership form of ownership:

- *Personal liability for partnership debts.* Each partner is personally liable for the partnership debts—that is, all of the partner's assets may be reached by a creditor of the partnership in the event that the partnership assets are not sufficient. For this reason, the general partnership is normally used only by a small group of investors who know each other.
- *Authority of individual partners to bind the partnership.* Those who deal with a general partnership have the right to assume that each partner has broad authority to bind the partnership, provided the transaction fits within the scope of the partnership's business and apparently relates to that business. Because each partner is jointly and severally liable for the partnership's obligations, a partner may find himself in the unenviable position of having to dig into his own pocket to pay an obligation that was incurred by another partner apparently on behalf of the partnership.
- *Limited transferability.* UPA permits a partner to assign his share of the profits from a partnership, but the assignee does not have the right to participate in the management or administration of the partnership business.
- *Less privacy and anonymity.* Generally, a partnership offers less privacy, anonymity, and confidentiality than does a trust or corporation. The requirement of filing a certificate (and sometime publishing it) forces the disclosure of the identity of the owners. In a partnership, any partner may inspect the books; in a corporation, however, the identities of the stockholders are confidential and the contents of the business records rarely have to be disclosed, even to stockholders.

[4] Limited Partnerships

One of the most popular business forms used for owning and operating hotel properties is the limited partnership. A limited partnership makes it possible for the hotel developer to combine his own skills with the financial resources of passive investors in an organization that allows flexibility of operation, limited liability for his in-

vestors, and the tax benefits of the pass-through of taxable income, gains, and, in certain circumstances, losses to investors.

A limited partnership is one formed by two or more persons, having as members one or more general partners and one or more limited partners. The general partner or partners manage the affairs of the partnership and are personally liable for the debts and obligations of the partnership. The limited partners, who are the passive investors, are not bound by the partnership debts and obligations, except to the extent of their equity investment.

A limited partnership is a hybrid of a corporation and a general partnership. A limited partner's exposure, like that of a corporate shareholder, is limited to his equity investment, and his status as a limited partner does not give him the right to control or actively participate in the affairs of the partnership. A general partner's role and is analogous to that of the director or officer of a corporation.

In other respects, a limited partnership resembles a general partnership. For the most part, the rights and liabilities of the general partners in a limited partnership are similar to those of a partner in a general partnership. Additionally, a limited partnership has the same problems of continuity of existence and transferability of interest as a general partnership.

While it is possible for one person to be, at the same time, both a general and a limited partner in the same partnership, such a person will be in the same position as to the general partners except that, in respect to contributions, this partner will be treated the same as the other limited partners.

States have adopted either the original Uniform Limited Partnership Act (ULPA) or the later Revised Uniform Limited Partnership Act (RULPA). Any hotel developer should check his or her state statute to determine which act controls in the state the partnership will be created. The discussion that follows is based on both the original statute and revision.

[a] Creating a Limited Partnership

There are four factors to note when creating a limited partnership:

1. *Public filing of certificate.* The ULPA requires that a new partnership make a public filing of a certificate of limited partnership that sets forth its name, capital contributions, and profit shares of the partners.
2. *Use of partners' names prohibited.* Limited partnerships are prohibited from using the name of any of the limited partners' names as part of the partnership name. Also, no name that is deceptively similar to that of any other corporation or limited partnership may be used in the name of the partnership. Both the ULPA and RULPA require that the partnership name include the words "limited partnership" in full. In addition there is a convenient procedure to reserve names for future limited partnerships.
3. *Maintaining office and records.* The ULPA requires that the partnership maintain continuously within the state an office at which basic organizational and financial records are kept. This requirement assures certain minimal contacts between the partnership and its state of organization and assures that the limited partners have access to vital partnership information.
4. *Avoiding liability in case of a defect in forming partnership.* Under ULPA, a person who has contributed to a business (an "equity participant") erroneously believing that he has become a limited partner in a limited partnership, is not liable as a general partner, provided that when he realizes his mistake, he promptly renounces his interest in the profits of the business. Un-

der RULPA, if the equity participant wishes to avoid liability as a general partner, he must withdraw from the business and renounce future profits or file an amendment curing the defect. Nevertheless, this equity participant is liable to any third party who has transacted business with the enterprise before the withdrawal or amendment and in good faith, believes that the equity participant was a general partner at the time of the transaction.

[b] Status of Limited Partners and Extent of Limitation of Liability

The most appealing feature of a limited partnership is the limited personal liability it offers. However, this protection is subject to three conditions:

1. There must be substantial good-faith compliance with the requirement that a certificate of limited partnership be filed.
2. The surname of a limited partner may not appear in the partnership name.
3. The limited partner may not take part in control of the business.

As long as the limited partners abide by these conditions, their liability for any and all obligations of the partnership is limited to their capital contribution.

A general or managing partner of a limited partnership occupies a fiduciary position with respect to his limited partners. The fiduciary duty imposed upon the general partner protects limited partners who are, as a general rule, at the mercy of the general partners' managerial power.

All the limited partners stand on equal footing vis-à-vis each other as to the return of their contributions, their right to income, and any other partnership matter, unless there is an agreement providing for priority as to such items. Such priority provisions must be stated in the partnership certificate.

Generally, a limited partner cannot bind the partnership by his acts, nor is he liable to partnership creditors; however, this does not mean that he is completely free from obligations arising out of the partnership. For example, he is liable to the partnership for the contributions he has agreed to make to the partnership and for any breach of the partnership agreement by him. Also, he may be held liable to the partnership for a sum equal to the amount he has received, plus interest as a return of his capital contributions where necessary to discharge the partner's liabilities to creditors who extended credit to it, or whose claims arose before his contribution was returned to him.

An important question for a limited partner is at what point would he be considered a general partner and thus lose his limited partner status. RULPA imposes general partner's liability only on a limited partner who takes part in control. If the control exercised by a limited partner is substantially the same as the power of a general partner, then he assumes the liability of a general partner to all third parties who conduct business with the partnership. However, if the limited partner's participation in control of the business is not substantially the same as the exercise of the general partners, his liability extends only to those persons who transact business with the limited partnership with actual knowledge of his participation in control. This approach recognizes the difficulty of determining when the control line has been overstepped and reflects the fact that the purpose of imposing general partner's liability is for the protection of creditor's expectations.

In addition, the RULPA enumerates certain activities that a limited partner may carry on without being deemed to have taken part in control of the business:

- Serving as contractor for an agent or employee of the limited partnership or of a general partner.

- Consulting with and advising a general partner with respect to the business of the limited partnership.
- Acting as surety for the limited partnership.
- Approving or disapproving an amendment to the partnership agreement.
- Voting on one or more of the following matters:
  - —The dissolution and winding up of the partnership.
  - —The sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary course of its business.
  - —A change in the nature of the business.
  - —The removal of a general partner.

The death or incompetence of a limited partner does not result in the dissolution of the partnership. The personal representative of a deceased limited partner has all his rights for the purpose of settling his estate, including the right to constitute an assignee of the limited partnership interest as a substituted limited partner. The estate also remains liable for the decedent's liabilities as a limited partner.

[5] Qualifying as a Partnership for Tax Purposes

An entity formed as a general or limited partnership by following appropriate legal procedures does not automatically qualify as a partnership under the Code. Rather, the classification of the entity as a partnership depends on meeting certain regulatory tests that distinguish a partnership from an "association taxable as a corporation." The determination is based on six criteria. Two of them—whether the entity includes "associates" and whether the entity has an objective to carry on a business for profit—are clearly common to both partnerships and associations (i.e., corporations). Thus the essential distinction rests on the remaining four criteria discussed in the following paragraphs.

The tax rules state that to qualify as a conduit for the pass-through of taxable gains and losses to its investors, a limited partnership must not show more than two of the following four corporate characteristics:

1. *Continuity of life.* Because a limited partnership can provide that death, insanity, or retirement of a general partner terminates the partnership, this characteristic is not usually present. The IRS has taken the position that a partnership subject to UPA or similar statute does not possess continuity of life.
2. *Centralized management.* A fundamental characteristic of a limited partnership is that the general partner (or partners) manages the partnership while the majority ownership usually lies in the passive investors who are the limited partners. Thus management is centralized. Consequently, this corporate characteristic is present in a limited partnership.
3. *Limited liability.* For income tax purposes, limited liability is not present and partnership treatment is indicated if the general partner is personally liable for the partnership's non-mortgage debts and also has substantial assets. Thus, neither a dummy corporation nor an individual who is judgment proof can be made a general partner so as to give the appearance, without the reality, of unlimited liability. Since most real estate partnerships are set up with

a general partner having substantial assets, partnership treatment should be indicated.

When a corporation, rather than an individual, is the general partner in a limited partnership, specific requirements have been set forth by the IRS in connection with the limited liability test. The limited partnership will not pass muster unless the following requirements are met:

—*Net worth requirement.* If the total contributions to the partnership are less than $2.5 million, then at all times during the life of the partnership the corporate general partner must have net assets equal to 15 percent of the total contributions or $250,000, whichever is less. If the total contributions are $2.5 million or more, the corporate general partner must have net assets equal to 10 percent of total contributions.

—*Ownership requirements.* The limited partners cannot own, directly or indirectly, more than 20 percent of the stock of the sole corporate general partner. If there are several corporate general partners, the assets of the corporate general partners can be combined for purposes of the net worth requirement. However, the ownership requirement is applied individually to each corporation; the limited partners cannot own more than 20 percent of the stock of any one corporate general partner.

4. *Free transferability of interest.* There is no free transferability of partnership interest, and partnership treatment is indicated if a limited partner needs the general partner's consent to transfer his partnership interest to a substitute limited partner. A provision requiring the general partner's consent is common in real estate limited partnership agreements. Likewise, there is no free transferability of partnership interests if a partner's right to assign his interest is limited to assigning his share in the profits of the enterprise. Free transferability of partnership interests is also lacking where the transfer of a partner's interest results in the dissolution of the partnership and the formation of a new partnership under state law.

There can be a modified form of transferability of interest under which each partner can transfer his interest in the partnership to an outsider only after offering it to the other partners at fair market value. This modified form of transferability is less likely to be viewed as a corporate characteristic than full transferability.

Because most hotel-formed limited partnerships do not show continuity of life, limited liability, and free transferability of partnership interest, partnership treatment—that is, the pass-through directly to the partners of taxable partnership income, gains, and losses—can reasonably be assured.

[6] Taxation of Partner's Share of Income, Gain, or Loss

The rules for the taxation of partnerships and partners (constituting Subchapter K of the Code) are among the most complex provisions in the entire tax law, and the advice of professional counsel is always beneficial in connection with partnership tax planning or tax reporting.

Each partner must report his distributive share (whether or not actually distributed) of partnership income, gain, or loss on his income tax return. The distributive shares of partnership items are shown on Schedule K and Schedule K-1 of IRS Form 1065.

A partner may deduct his share of partnership losses only to the extent of the

adjusted basis of the partnership interest in the partnership. A partner's tax basis generally includes the amount of money the partner contributes to the partnership, the adjusted basis of any property contributed by the partner, and the partner's share of partnership liabilities that is allocated or assumed by the partner.

A partner's ability to deduct a share of partnership losses is further limited to the amount for which the partner is "at risk." A partner is considered at risk with respect to the sum of money and the adjusted basis of property he contributes to the partnership, including amounts contributed from funds borrowed by the partner or the partnership from third parties, but only to the extent to which the partner is personally liable to repay such amounts. In addition, nonrecourse financing (i.e., under which the partner is not personally liable) will be included as an amount at risk in either of the following two cases:

1. When the loan is from a qualified lender (i.e., one engaged in the business of making loans) or any federal, state, or local government or instrumentality, provided that the lender is not the promoter or seller of the property or a party related to either.
2. When a loan is from a qualified lender that has an equity interest in the venture as long as the terms of the financing are commercially reasonable and on substantially the same terms as loans by lenders that do not have an equity interest in the venture. The terms of nonrecourse financing are commercially reasonably if the following apply:
   - —The borrower executes a written unconditional promise to pay on demand or on a specified date.
   - —The amount to be paid is a fixed sum of money.
   - —The interest rate is a reasonable market rate of interest, taking into account the maturity of the debt.

Another significant limitation on the ability of partners to deduct losses are the passive activity loss rules. When the amount at risk is reduced below zero at the end of a taxable year, the partner must recognize income to the extent that his or her at-risk basis is reduced below zero.

[7] Organization and Syndication Fees

A partnership often incurs significant expenses in connection with its organization or the sale of a partnership interest. Such costs may not be deducted in the year incurred. However, the partnership can elect to amortize certain of these costs over a period of not less than sixty months, beginning with the month the partnership begins business. If the partnership is liquidated before the end of the sixty-month period, any remaining balance can be deducted as a loss. The costs that may be amortized are organization fees but not syndication expenses.

Organization fees are expenses related to the creation of the partnership and that are chargeable to capital accounts. They include legal and accounting fees related to the organization of a partnership, and filing fees. They do not include expenses of acquiring assets for the partnership, or those connected with the admission or removal of partners other than at the time the partnership is first organized, or those connected with any contract relating to the partnership trade or business. Syndication expenses are specifically nondeductible expenses. These are expenses connected with the issuing and marketing of partnership interests, and include the following:

- Brokerage fees
- Registration fees
- Legal fees of the underwriter or placement agent and the issuer
- Accounting fees in connection with the offering material
- Printing costs of the offering material
- Other expenses relating to selling and promotional material

[8] Disposition of Partnership Interests

The disposition of a partnership interest generally results in capital gain or loss to the partner. The amount of gain or loss generally is the difference between the amount realized by the partner and the adjusted basis of the partner's interest in the partnership. If the partner is relieved of any liabilities of the partnership, the amount of such liabilities is included in determining the amount realized by the partner.

¶ 15.05 REGULAR CORPORATIONS

A corporation is a separate legal entity—an artificial person—created in accordance with the laws of a particular state; the federal government does not have the power to create business corporations. A corporation's charter may provide that it will have a perpetual life, and it establishes its operation through a board of directors elected by the shareholders. However, for business and tax purposes, the corporation is an entity entirely distinct from its stockholders. Thus, the major advantage of, and original purpose for, the corporate form was to limit each shareholder's liability to the amount of his capital investment; a secondary purpose was to make shareholder interest freely transferable by means of assignable corporate shares.

The basic legal and economic incidents and consequences of operating under the corporate form of ownership can be summed up as follows:

- *A corporation:*
  - —Can hold and deal in property in its own name.
  - —Can sue and be sued in its own name.
  - —Has only those powers and can engage in only those activities that are within the scope of the powers expressly or impliedly granted to it under its state charter or certificate of incorporation.
  - —Continues to exist until it is dissolved by law, unless a statute limits its duration.
  - —Can raise capital by the sale of new shares, bonds, debentures, or other securities.
  - —Can, apart from its shareholders, seek out sources of credit and borrow funds. Also, in a closely held corporation, the corporate shares can be used as collateral for a corporate loan.
- *Corporate shareholders:*
  - —Are not, merely by reason of being shareholders, personally liable for corporate debts and liabilities; each shareholder has at stake only the amount of his capital contribution.

—Can freely sell or otherwise transfer their shares, in the absence of a provision to the contrary.

—Are not responsible for the management of the corporation or for any venture conducted by the corporation.

- *Corporate Directors:*

—Are the repository of the central authority of the corporation. The board of directors manages the affairs of the corporation and acts according to the vote of a majority of its members.

—Must account to and are responsible to their stockholders for their acts, or for conduct that is outside the scope of their charter powers, or that is otherwise improper or unlawful.

- *Corporate officers:*

—Can exercise only such authority as is delegated to them under the corporate charter or certificate of incorporation.

—Can bind the corporation by their acts or conduct that is within the scope of their actual or apparent authority.

—Are answerable to the board of directors and must account to the board for their activities.

[1] C Corporations

The major disadvantage in using a C corporation to own a hotel development is that the corporation is recognized as an independent entity for tax purposes. Thus, tax losses from corporate-owned real estate cannot be passed through to the individual shareholders, but can be used only by the corporation itself; because it may not have any other income against which the losses may be offset, the losses may be of no use.

On the other hand, if the corporate property produces net income, a problem of double taxation must be faced. The corporation first must pay a corporate income tax on its net income; then, to the extent the income is distributed in the form of dividends, the shareholders must pay a personal income tax on such income. In the case of a closely held corporation (known as a close corporation), the problem of double taxation can often be avoided by distributing corporate income to the shareholders in the form of salaries or other compensation. In this situation, the corporation may deduct the cost of such salaries and thus reduce its own income, although the shareholder-employees will be taxed on the income they receive.

In addition, a corporation can accumulate income (up to a point) that can ultimately be passed through to shareholders as capital gain when the shareholders sell their shares at prices that reflect the earnings that have been accumulated. Important tax factors to consider in choosing the C corporate form of ownership include:

- Principals, as officer-stockholders or as employee-stockholders, can have a tax-favored retirement or pension plan set up for them.
- Principals can be paid a salary that the corporation can deduct as an ordinary business expense.
- The compensation paid to a principal as a corporate officer or employee is subject to withholding and social security taxes.
- While a shareholder can assign his shares as he sees fit in the absence of restrictions imposed by agreement, corporate charter, or otherwise, he cannot assign earnings separate from the shares.

- Corporate income is taxable to the corporation and not to the shareholders until it is distributed to them in the form of dividends.
- A corporation is subject to various sate and local taxes, which are deductible on its federal income tax return.
- Death benefits of up to $5,000 can be received tax-free by a stockholder-employee's beneficiaries.
- Income accumulated in the corporation is not taxable to the shareholders, but there is a penalty tax if the purpose of the accumulation is to avoid the corporate surtax and the accumulation is greater than is permissible.
- A corporation may be able to use a loss generated by a hotel investment to offset income from its other properties, or it can carry over the loss to offset future income.
- Low-bracket taxpayers can manage the hotel and be paid salaries by the corporation for their services. The salaries can account for a substantial portion of the corporate income and thus reduce the corporate tax burden. The salaries would be taxed at ordinary income rates, but only at the taxpayers' low tax brackets. The corporation would be entitled to deduct the amounts it paid as salaries from its gross income, provided the salaries are reasonable and are paid for actual services rendered to the corporation.

[2] S Corporations

The corporate form of ownership has many limitations as far as its use in hotel development. Since hotels are capital-intensive projects that generate substantially early deductions for depreciation and debt service, the hotels usually show losses for many years. Corporate ownership of real estate prevents those losses from being passed through to the individual shareholders. In addition, if the corporation begins to generate income sufficient for distribution, then the hotel earnings are taxed twice, once at the corporate level and again when distributed as a dividend.

However, for many closely held corporations, the Internal Revenue Code provides for loss and income passthrough similar to a partnership, if the owners have elected the S corporation. As will be demonstrated subsequently, the S corporation is ideal for the hotel development when either the investors contribute proportionally, or are family members using the S corporation as a means of splitting income among family members.

S corporations are organized for the purpose of insulating their shareholders from personal liability for corporate obligations, and for making the transfer of ownership of stock certificates a simple matter. At the same time, they are not independent tax entities and, just as a partnership, are able to pass through to shareholders the profits and losses from operations.

[a] Eligibility Requirements

The following are five requirements for S corporation status:

1. *Domestic corporation.* This category includes any incorporated organization taxed as a corporation.
2. *Number of shareholders.* The maximum number of shareholders is thirty-five, but spouses holding shares are treated as one shareholder. Shareholders must be individuals, estates, or grantor trusts; they cannot be nonresident

aliens or foreign trust. Shares cannot be held in a custodial account for a minor.

3. *Shares.* An S corporation must have only one class of outstanding stock, and all outstanding shares must carry identical rights to share in corporate profits and assets. Differences in voting rights in common stock, however, are permissible. In addition, a debt instrument may not be reclassified by the IRS as stock, so as to constitute a disqualifying second class of stock, if it complies with the safe-harbor rules for debt instruments provided by the Subchapter S Revision Act of 1982.
4. *Affiliation.* A member of an affiliated group of corporations cannot be an S Corporation.
5. *Companies eligible for special tax treatment.* Banks, financial institutions, and insurance companies cannot elect S corporations status even if they can meet the eligibility requirements of the act.

[b] Election and Termination of Status

An S Corporation election made on or before the fifteenth day of the third month of a corporation's taxable year is effective beginning with the year made if all eligibility requirements are met during the preelection period, and all persons who held stock during that period consent to the election. The reason for requiring such unanimous consent is to prevent the allocation of income or loss to preelection stockholders who are either ineligible or do not consent to such allocation. If the eligibility requirements were not met during the preelection period or if the election is made late, it does not become effective until the following taxable year.

The following events will cause the S corporation status to be terminated effective on the date on which the event occurred:

- Exceeding the maximum number of shareholders
- Transfer of stock to an ineligible shareholder
- Creation of a second class of stock
- Acquisition of a subsidiary

In addition, an S corporation can be voluntarily revoked by its shareholders. If holders of more than 50 percent of the voting stock agree, the corporation may voluntarily revoke the S corporation status of the corporation. A revocation, filed up to and including the fifteenth day of the third month of a taxable year is effective for the entire taxable year unless a prospective date is specified. A new shareholder cannot terminate an election by refusing to consent to the election, unless he owns more than 50 percent of the voting stock.

[c] Comparison With Limited Partnerships

Many people assume that the limited partnership and S corporation are the same, but there are some major differences that usually make the limited partnership the preferred form of hotel ownership. Some of the more important differences are listed as follows:

- *Allocation of income and losses.* Both the S corporation and the limited partnership are conduits for tax purposes. However, the limited partnership has a greater flexibility in allocating income and losses to its partners than S cor-

porations. A limited partnership can allocate income and losses to the partners providing economic substance to the transaction. For example, a partner contributing property to the partnership may receive the depreciation expense, whereas the S corporation must allocate income and losses to each shareholder in direct proportion to their percentage of stock ownership.

- *Unlimited members.* A limited partnership has no specified limit on the number of partners, while the S corporation is limited by law to thirty-five shareholders.
- *Tax basis.* A major distinction between an S corporation and a partnership involves the tax basis for the investment. In a partnership, each partner receives a tax basis in his partnership interest equal to his capital contribution plus his share of partnership debt. Even limited partners share in partnership nonrecourse debt (but they may share in recourse debt only to the extent of any unpaid capital contributions). By comparison, S corporation shareholders receive only basis for their capital contributions plus their loans to the corporation.

  Basis is important because losses may be taken by the individual investors only to the extent of their basis (assuming other hurdles, such as allocations, at-risk, and passive loss limitations, are overcome). In addition, excess financing and refinancing proceeds can be distributed tax free only to the extent of basis.
- *Tax status.* The Subchapter S Revision Act of 1982 simplified the rules affecting S corporations, making it far less likely that an S corporation's status as such will be challenged by the IRS. Partnerships are subject to a somewhat greater risk of challenge. In either case, a successful challenge by the IRS would bar the pass-through of taxable losses to investors, because the corporation or partnership would be considered a C corporation and taxable as such.

¶ 15.06 LIMITED LIABILITY COMPANIES

The Limited Liability Company (LLC) is a fairly recent entity development that has been adopted in many states. The LLC can limit liability more effectively than a limited partnership and is less restrictive than an S corporation; for certain hotel developments, it may become the preferred form of ownership.

An LLC is an entity formed under state law to conduct a business or investment activity. It is created by filing articles of organization with the appropriate state agency in a manner similar to that required for corporations. Its bylaws are called regulations and its participants are called members. The three major advantages of an LLC are as follows:

1. *No double taxation.* When properly structured, an LLC is treated for federal income tax purposes as a partnership; therefore, no tax is payable at the partnership level but only by the individual partners.
2. *Flexible ownership.* Like a partnership, the LLC permits its members significant freedom in making disproportionate allocations of income, gain, loss, and cash flow. A major advantage of the LLC over an S corporation is that no limitations are imposed on the types and numbers of owners. For example, corporations and partnerships may be members of an LLC, but are ineligible to the shareholders of an S corporation. More than thirty-five individuals and/or entities may be members of an LLC, whereas S corporation shareholders are limited to that number. (However, an LLC must have more than one member as compared with an S corporation, which can have a single shareholder).

3. *Limited liability.* As its name indicates, an LLC puts only the assets of the company at risk. In comparison with a partnership, in which the general partner or partners must accept personal liability, all members of an LLC are protected against personal liability. Furthermore, any member of an LLC can be active in the management of the business while still retaining limited liability; in a limited partnership, the limited partners must be careful not to step over the line between passive investment and active management.

The four significant disadvantages of an LLC are as follows:

1. *State taxation.* Although an LLC is generally exempt from federal income tax, state tax rules may differ. For example, in Florida (which does not have an individual income tax), LLCs are treated as corporations subject to the Florida corporate income tax rate. At the same time, partnerships and S corporations are exempt from Florida income taxation. In addition, a state may seek to apply its franchise tax, which does not normally apply to a partnership, to an LLC.
2. *No perpetual life.* As in the case of a partnership, the LLC cannot have a perpetual life. For example, in several states, an LLC dissolves upon the earlier of the following:
   - —Expiration of its state term
   - —Agreement of all members to terminate
   - —Death, retirement, insanity, bankruptcy, or expulsion of a member (unless all remaining members consent to continue the business pursuant to rights stated in the organizing articles).
3. *Limits on transferability.* The LLC (like a partnership) lacks the easy transferability of corporate share. Recipients of membership interests in an LLC often do not have full rights of ownership or management participation unless consent to the transfer is received from all members, thus restricting free transferability.
4. *Lack of legal precedent.* Finally, the short existence of the LLC as an entity means very few court decisions have been rendered. Thus, a good deal of uncertainty exists as to the legal status of the LLC and its members. Furthermore, it is not all clear as to the status of LLC members in states not having LLC statutes. For example, would a member of an Florida LLC be protected from personal liability for LLC obligations incurred while the LLC was operating in a state without an LLC statute? Additionally, the application of the partnership's tax concepts to an LLC may become complex. For example, allocating liabilities to determine tax basis and amounts at risk may produce unexpected results.

¶ 15.07 TRUSTS

Trusts are the least frequently used form of ownership entity for hotels. A trust is a legal relationship in which a trustee holds legal title to property (the hotel property or otherwise) with the responsibility of administering it and distributing the income for a beneficiary who is deemed to be the holder of the equitable title.

Three kinds of trusts can be distinguished. The first is a real estate investment trust (REIT), which is a creation of the federal tax laws. This form of business entity will be discussed in more detail in the following section.

Personal trusts are those set up for the benefit of members of a family, particularly the spouse or children of the grantor of the trust. They can be an effective means of shifting the tax burdens of property to persons in lower tax brackets, while at the same time reserving essential control of the property to the grantor or his associates. However, the Tax Reform Act of 1986 (TRA) limits the tax benefits formerly available from trust. Because the subject of trust and estate taxation is highly specialized, and because such taxation is applicable to all forms of property, not merely hotel development, a discussion of trust and estate taxation is not included here.

The third type of trust, the business trust (also known as the Illinois Land Trust, because it originated there), has a long history as a real estate–owning entity. However, its use today is limited to five states besides Illinois: Florida, Virginia, North Dakota, Hawaii, and Indiana. The land trust is a device by which a hotel or other real estate is conveyed to a trustee under an arrangement reserving to the beneficiaries of the trust the full management and control of the property. The trustee executes deeds and mortgages or otherwise deals with the property at the written direction of the beneficiaries, who exercise all rights of ownership, other than holding or dealing with the legal title.

The benefits of a land trust include the following five points:

1. *Secret ownership.* In states that recognize the use of a land trust, the identity of the beneficiaries is not contained in any public record. Only the name of the trustee, the date of the trust agreement, and the number of the trust is disclosed in the deed in trust. By comparison, all other states require that the name of an owner of real property, be it an individual, corporation, or other legal entity, be shown on the deed and be available for public inspection in the appropriate records office.
2. *Transfer tax avoidance.* In those states that recognize the land trust, the use of the entity may permit the avoidance of payment of a real estate transfer tax, since the real estate in the trust is not transferred as such; instead, the beneficial interest in the trust is assigned or sold, and these are designated as personal property.
3. *Insulation from judgment liens.* In Illinois, and possibly in other states that recognize the land trust, a judgment against a beneficiary does not create a lien against the title of the real estate held in the trust. The trust property, in effect, is insulated from the legal process (although the judgment creditor may be able to claim against the beneficial interest).
4. *Ease of transfer.* Because the beneficial interest in the land trust is treated as personal property, it may be transferred from one party to another by means of an assignment rather than by the more cumbersome process involved in transferring real estate, which involves examination of title, agreement as to covenants and warranties by the seller, and so forth.
5. *Not subject to partition.* Unlike other forms of concurrent ownership (i.e., tenancy in common and joint tenancy), land held in trust is not subject to the remedy known as partition, by which one co-owner may seek to have the property sold and receive his share of the proceeds. Usually, the withdrawal of a beneficiary from a land trust is a matter of voluntary agreement among all the beneficiaries.

¶ 15.08 REAL ESTATE INVESTMENT TRUST

Real Estate Investment Trusts (REITs) have been around since 1960, when they were made part of the Internal Revenue Code. A REIT is strictly a creation of the federal

tax laws. It must have at least 100 shareholders to qualify for special tax treatment, and more commonly is in the form of a corporation, rather than a trust. A qualified REIT is entitled to conduit tax treatment (i.e., it may distribute income to its shareholders without the imposition of a corporate tax, thus avoiding the "double tax" burden on regular business corporations). The congressional purpose for creation of REITs was to make real estate investments more accessible to the general investing public; at the same time, REITs enabled real estate developers and owners of large real estate portfolios to tap the general capital markets for financing.

As Exhibit 15-1 indicates, REITs have shown a high rate of return in recent years. It will be interesting to see if they are able to maintain that high level of return.

Exhibit 15-1 Total REIT Returns (1990–1997)

Source: NAREIT. (NAREIT reported a total return of 30.09% for lodging REITs in 1997.

Year	All	Equity
1990	(17.35)%	(15.35)%
1991	35.68	35.70
1992	12.18	14.59
1993	18.55	19.65
1994	0.81	3.17
1995	18.31	15.27
1996	35.75	35.27
1997	18.86	20.26

[1] Organizational Requirements

A REIT must be a corporation, trust, or association managed by one or more trustees or directors. Many REITs have chosen the corporate form over the business trust form, because it is simpler in terms of state law considerations.

The REIT must have beneficial interest represented by transferable shares or certificates of beneficial interest. There may be two classes of stock or shares (e.g., a second class with a preference as to dividends and liquidation). A REIT must be beneficially owned by at least 100 persons for at least 335 days of a tax year of 12 months, or a proportionate part of a short year. The attribution rules under the Code are not applied in making the determination; consequently, the number of shareholders, not the relationship among them, is the only determinant of whether the test is made.

The tax year must be the same as the calendar year.

At no time during the last half of the REIT's tax year can more than 50 percent of the value of a REIT's outstanding stock be owned by five or fewer individuals. Certain attribution rules are applied in this determination.

A REIT can be self-managed or can operate through an external adviser. A self-managed REIT operates in much the same manner as a corporation, with a board of directors (or trustees), officers, and employees. A REIT may also contract for an external entity to manage its operations and investments. Both types of management forms are widely used—the objective of the REIT determines which form is more desirable. A self-managed REIT is more logical for an active organization needing full-time operators, while an externally advised REIT is probably more useful in instances in which the REIT is one element of a larger organization.

[2] Income Requirements

REITs are required to receive 95 percent of their gross income from the following sources: dividends; interest; rents from real property; gains from the sale or disposition of stock, securities, and real estate; abatement and refunds of real property taxes; income from foreclosure property; commitment fees; and gains from the sale of real estate assets that are not prohibited transactions (i.e., assets that were held primarily for sale, with the exception of foreclosure property).

Of the foregoing, 75 percent of the gross income of the REIT must be derived from the following income sources: rents from real property; abatements and refunds of real property taxes; foreclosure sales; commitment fees; gains from the sales of real estate assets; interest on obligations secured by mortgages on real property or interests in real property; gains from the sale of real property not held primarily for sale to customers; dividends or other distributions and gain from the sale of shares in other REITs.

Income derived from rents contain a number of restrictions, the most important of which is that any amount received with respect to property is not rent if the REIT furnishes services to the tenant or manages or operates the property without an independent contractor. The independent contractor may be affiliated with the adviser to the REIT; however, the independent contractor cannot hold more than 35 percent of the shares or beneficial interest in the REIT. In addition, the REIT is not to receive any income from the independent contractor.

Less than 30 percent of the REIT's gross income can be derived from the sale or other distribution of the following: stock or securities held for less than six months; sales or dealer property; and real property (including interests in real property and interests in mortgages on real property) held less than four years, other than foreclosure property or involuntarily converted property.

[3] Asset Requirements

At least 75 percent of the value of the REIT's total assets must consist of real estate assets, including land, interests in real property mortgages, shares in other REITs, and partnership interests to the extent of the interest's proportionate share of partnership real estate assets; cash; cash items (including receivables); and government securities. Mortgage-backed securities qualify as real estate investments.

No more than 25 percent of the value of the REIT's total assets can be securities (other than those included in the 75 percent asset test above). The securities of any one issuer cannot be more than 5 percent of the REIT's total assets, and the REIT's interest in an issuer's stock cannot be more than 10 percent of the outstanding voting securities of the issuer.

[4] Dividend Distributions and Taxation

To avoid paying taxes at the corporate level, the REIT must distribute to the shareholders dividends in the amount of 95 percent of its taxable income, less net long-term capital gains, any net income from foreclosures, and certain other items. If the REIT does not distribute at least 95 percent of its taxable income during each taxable year, it is subject to a 3% excise tax on the amount of the underdistribution.

There is generally no tax liability for a REIT, because its income is taxed only at the shareholder level. The REIT is not a true pass-through entity like a partnership, but it is still effectively not subject to taxation because it is eligible for a deduction

for dividends distributed and must distribute nearly all of its taxable income as dividends. As a result, the typical REIT has an insignificant amount of taxable income, taxed at the corporate level.

Dividends received by the shareholders are ordinary income to the extent of the REIT's earnings and profits. The earnings and profits of a REIT are computed using a forty-year straight-line depreciation. Distribution of greater than 100 percent of earnings and profits, however, are treated by the shareholder as return of capital.

The sale of a shareholder's interest in a REIT is taxed in the same manner as the disposition of stock. The return of capital, as opposed to payment of dividends, reduces the shareholder's basis.

[5] Types of REITs by Asset Holdings

In terms of the type of assets held, REITs are of three types: equity REITs, mortgage REITs, and hybrid REITs.

[a] Equity REITs

An equity REIT is one that owns real estate directly. The purpose of an equity REIT is primarily to generate rental income that will be passed through to shareholders. The vast majority of REITs are considered equity REITs.

Some equity REITs invest in a diversified portfolio of income-producing real estate, while others specialize in a single category of property (e.g., hotels). Similarly, some REITs concentrate their investments in one geographic area of the country while others buy properties in various locations.

[b] Mortgage REITs

Mortgage REITs are lenders involved in financing real estate rather than owning it. Only a small percentage of REITs engage in this form of lending activity. However, because traditional lenders to the hotel industry have reduced their lending activities, mortgage REITs could play an important role in the future.

Mortgage REITs have one major advantage over traditional lenders in that REITs are subject to virtually no regulation as to the type of mortgages that they can make. Thus, a mortgage REIT can make loans in the form of participating mortgages that not only provide the REIT with a fixed return on invested capital, but also offer the prospect of a share in future growth or a share in the proceeds from any subsequent sale or refinancing of the property. REITs also are in a position to make the various forms of subordinate loans, including second mortgages, wraparound loans, and various forms of refinancing. They can also be a source for gap or bridge loans and other forms of interim financing for borrowers unable to find other lenders, particularly when interest rates are high.

Some mortgage REITs have engaged in land purchase–leaseback arrangements, whereby the REIT purchases the land on which income-producing property has been constructed. The REIT then leases the land for a long term (up to ninety-nine years). With various equity features built into the purchase-leaseback, the REIT can return in the form of ground rent. Finally, REITs still are involved to some degree in short-term construction and development lending.

[c] Hybrid REITs

As its name implies, a hybrid REIT combines the features of both an equity and a mortgage REIT. The hybrid attempts to structure a mixed portfolio that includes ownership interest in income-producing property, financing of property through mortgage loans, and holdings of short-term government securities and mortgage pass-through securities. The object is to create a balanced portfolio that provides a fixed income return to investors as well as the prospect of future growth in income.

[6] Structuring a Hotel REIT

A number of hotel chains are currently weighing the advantages of going public, possibly as REITs. The major benefit would be the ability to raise large amounts of equity capital to finance ongoing renovations and new development while avoiding the burden of high debt-service costs. The incentive for public investors would be the opportunity to participate in the enormous growth in travel that is anticipated by the end of the century.

It is true that hotel chains in the past often did not meet standard investment criteria for publicly traded companies. The returns from hotels, as already noted, often come as much from appreciation in value and tax benefits as from operating earnings. Ratios used to measure performance of public companies, however, focus almost exclusively on earnings (in the form of such ratios as price/earnings, return on equity, and return on assets). These and similar factors ignore the appreciation element and the prospects of tax-free distributions resulting from debt refinancing. Finally, earnings of many hotel chains often are extremely volatile because of their highly leveraged position and high level of fixed costs.

If hotel chains can raise equity capital via REITs or other public structures, earnings volatility would be substantially lessened. At the same time, hotel earnings could stabilize at relatively high levels if the trend to increasing travel materializes. The result could well be transformation of a hotel investment from one fraught with risk for the investor to one that compares favorably with other forms of real estate investment.

Hotel REITs are unique because hotel profits are considered "unqualified" income, i.e., not the type of passive income that a REIT is permitted to earn. Thus, instead of a REIT operating its hotels, that REIT must enter into participating leases with an outside entity. To comply with REIT tax rules, the participating lease payments made by the lessee to the REIT must be based on gross revenues (rather than net cash flow).

The debate concerning this structure is whether the lessee should be an independent third party having no interest in the REIT or an entity affiliated with the REIT sponsor. Each structure has its advantages and disadvantages.

The primary appeal of an independent lessee is that the lease terms are negotiated at arm's length and thus gives greater assurance that the lessee's profits are not excessive. The practical problem with this approach is that few, if any, creditworthy lesses are available. Furthermore, even an independent lessee would want a substantial share of the operating profits in light of the risks involved; this would require the REIT to give up a substantial portion of the upside potential. The net result is that the REIT would, in effect, hold a net lease with limited upside potential.

Historically, hotel management companies receive a fee (e.g., 3 to 4 percent) of gross revenues rather than of net cash flow. One cause of the hotel problems of the late 1980s was that third-party lessees were motivated to increase gross revenues without regard to bottom-line performance. The result was that their fees increased while the owners' return declined. For this reason, many investors now favor a lessee affiliated with the owner.

Leasing to an affiliated party has a reverse set of advantages and disadvantages. If the REIT sponsor is also the lessee, questions of fairness can arise from negotiations not made at arm's length. On the other hand, an affiliated lessee offers two advantages to the REIT. First, if the lessee has a substantial investment in the REIT itself (which usually should be the case), it not only has a fiduciary duty to the REIT but also is likely to earn more through REIT dividends than through a management fee. Second, an affiliated lessee is much more likely to accept a rent structure that mirrors the operating performance of the underlying hotel properties, passing as much upside (or downside) as possible to the REIT.

Possibly the best approach is to combine an affiliated lessee with various credit-enhancing structures that reduce the risks of conflicts of interest. For example, the lessee may be required to maintain a substantial reserve to guaranty lease payments before any profits can be retained by the lessee.