

BUSINESS ENTITIES IN RELATION TO COMMERCIAL TITLE POLICIES

BY GUARDIAN SETTLEMENT AGENTS, INC. SEPTEMBER 12, 2014

Guardian Settlement Agents, Inc. provides title insurance for both residential and commercial transactions. For commercial transactions, it is not uncommon for us to work with varying real estate business entities. While we cannot advise our clients which business entity to choose, we can help with the transaction regardless of the business entity chosen.

Some functions during the title insurance process are to determine the legal capacity of whatever business entity is utilized by the customer, the authority that the entity has to enter into and complete the transaction and that the person signing papers for the entity has the authority to do so to bind the entity to the transaction.

Commercial real estate investors generally choose which entity type they will use depending on if or how the entity will be taxed by the state of incorporation. After taxation is addressed, then the next consideration is the potential degree of liability of the parties involved with the entity. The procedures for forming a corporation vary widely by state.

For the purposes of this discussion, we are going to deal with the six most common business entities that commercial real estate investors employ:

1. Corporations
2. General Partnerships
3. Limited Partnerships
4. Limited Liability Partnerships
5. Limited Liability Companies
6. Trusts

CORPORATIONS

Corporations have the advantage in commercial real estate transactions of limiting the liability of their shareholders, but this can come at a cost. One cost is the expense of forming, maintaining and observing state-required formalities. A second potential cost is double taxation for C-Corporations (i.e. corporations pay taxes on their annual earnings and shareholders pay taxes on dividend payments, which were already taxed at the corporate level).

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An S-Corporation is another option. While the entity pays no tax on their annual earnings, individual shareholders are liable for tax payments on income they derived from the entity. There are a few hurdles an entity must meet to become an S-Corporation. An S-Corporation has to be recognized under the federal government, have no more than 100 shareholders, have no more than one stock class and all shareholders must be residents or U.S. citizens, or certain qualifying trusts.

For a title insurer to satisfy its due diligence on a corporation, materials to review include: copies of the Articles of Incorporation, a certificate of Franchise or Tax Account Status, an annual report showing its principal officers, a Corporate Resolution, Certificate of Corporate Secretary and Certificate of Good Standing with the State Department of Revenue.

GENERAL PARTNERSHIPS

A general partnership is simply the agreement of two or more people to run a for-profit business. This could include individuals, corporations, organizations, estates, trusts, or any other legal entity.

This can be a very simple and cheap way of doing business because partners don't have to write or file documents. Instead, all that needs to be done is the creation of a partnership agreement. There are also very few restrictions on how this entity needs to be managed.

On the tax side, all partners are responsible for all debts and financial obligations of the entity. As a title company, we will need to review the Partnership Agreement in order to determine who is authorized to sign on behalf of the partnership. If there is no written agreement, a signed affidavit that spells out who all of the partners are, along with a partnership resolution authorizing the transaction will be required.

LIMITED PARTNERSHIPS

This type of entity involves an agreement with one or more general partners and one or more limited partners. General partners have the same liability that they would in a general partnership, but limited partners are not personally liable for the obligations of the limited partnership. This limited liability can be endangered, though, if the limited partner participates in the operations of the business.

The costs of forming a General Partnership can be higher. Specific documents might need to be filed with a locale's Secretary of State. No federal income taxes need to be paid by these entities, but depending on the state, there could be other tax considerations.

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Title insurers need to review the limited partnership agreement, and resolutions and consents may be required in certain transactions. As a limited partnership is traditionally governed by a general partner, the entity documents of the general partner should be reviewed as well.

LIMITED LIABILITY COMPANIES

You can find Limited Liability Companies (LLC) in every state. If these entities are formed correctly, those involved with the LLC have liability protection similar to that of a corporation and the federal income-tax benefits of a partnership. This applies to all members of the LLC, even if they are active in the commercial real estate endeavor. State taxes might apply in some cases, though.

The title insurer needs to review the Company or Operating Agreement in the case of LLC's, and a company resolution will give the authorization for a particular individual, member and/or manager to act on behalf of the entity.

LIMITED LIABILITY PARTNERSHIPS

These are general partnerships in which the liability of partners is greatly limited. Though Limited Liability Partnerships (LLP's) are preferred by many commercial real estate groups, some states don't allow limited liability for professional malpractice.

LLP's may require extra filing fees in some states and the requirement of a certain amount of liability insurance. Unlike a general partnership, those involved in LLP's are not personally liable for the actions of the partnership unless there is a case in which those actions are directly attributable to a partner. Like Limited Partnerships, federal taxes do not apply to these entities, though they may be subject to pay state taxes.

In reviewing documentation for an LLP, the title insurer requires review of the partnership agreement, and most likely will require all partners to execute the closing documents for the transaction.

TRUSTS

Trusts are fiduciary relationships between more than one person, typically a Settlor/Trustor and Trustee. Trusts are not considered a legal entities and are, instead, legal relationships between the parties. In most cases, a trustee is the individual who is the legal holder of the title to the real estate. The Trustee is the person (either an individual, corporation, or other appointee) who administers the trust for the benefit of the beneficiary(s).

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Typically, a trust is created by a written trust agreement or by the Will of a decedent (a testamentary trust). The title insurer will want to review the trust agreement or Will to obtain more information about the Trustee's powers.

Land trusts are a vehicle in which a settlor retains control of a commercial real estate property and its proceeds in certain legal cases, as long as the trustee makes it known to contracted third parties that he or she is acting only as a trustee. However, since a land trust's beneficiary has the ability to manage and control a commercial real estate asset, the land trust won't necessarily shield the beneficiary from personal liability for negligence, the violation of statutes or other claims. One plus is that the trustee does not have to reveal the beneficiaries of the trust unless a court order is filed, and beneficiary's interests likely won't come up in a public records search. Even if the IRS takes a lien from the beneficiary, there is a chance that it might not impact the real estate.

For title insurers, it is imperative that they are able to rely upon the trustee in its interaction with the party and the commercial real estate property. In some cases, the title insurer may require the original grantor of the land trust to consent to the transfer of the title. Title insurers might also want more details into a trustee's powers. This might require the filing of a certificate of trust, which would identify the trustees, their successors and their relative powers/duties. Note that many title agents and title insurers may decline to insure a Land Trust transaction in certain states if they do not recognize or permit the use of land trusts within their underwriting guidelines for that state.

We'd like to stress that while there might seem to be benefits and drawbacks to all of these aforementioned entities, we aren't tax advisors or providing legal advice, and are not suggesting that you choose one in particular for your commercial real estate endeavor.

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