“Business Entities”

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I. Introduction. A real estate attorney must often deal with business entities in the course of practice. In the representation of developers and investors, an attorney is often called upon to counsel the client in entity selection and thereafter to organize the entity. Even lawyers who limit their practice to real estate closings must be familiar with business entities. An attorney must understand who is authorized to act on behalf of each respective entity in order to examine title, and to properly prepare conveyance and finance instruments.

This article discusses the business entities that a Florida attorney is likely to encounter in a real estate practice. The advantages and disadvantages of each entity are discussed; however, tax considerations are not dealt with extensively. This article does not address securities regulations or the use of entities for estate planning purposes. Issues regarding homeowner associations, churches and other non-profit organizations are also beyond the scope of this article. Land trusts are sometimes used as an alternative business entity; however, this topic is included in another section.

II. Selecting an Entity.

A. Entity Options. This article focuses on Florida corporations, partnerships, and limited liability companies. Other alternative entities include not-for-profit corporations, trusts, sole proprietorships, and foreign entities. Section III addresses the attorneys’ role in forming an entity. Below is a brief discussion of these entities.

1. Sole Proprietorship. The simplest form of business enterprise is not even a separate entity. The principals simply conduct their business in their individual name. In the context of real estate, the property would be titled in the name of the natural person who will own the interest in real property. No organization or agreement is required; however, if a business operation is to be engaged at the property, the proprietor will be required to obtain the requisite permits, and comply with laws regarding sales tax, self-employment taxes, workers’ compensation insurance, and unemployment taxes. If the business will be operating using a trade name other than the name of the owner, then the proprietor must also comply with Fla. Stat. §865.09, the *Fictitious Name Act*. The owner of a sole proprietorship is individually liable for acts and omissions of the enterprise.

2. Corporations. A corporation is an organization created under Chapter 607 Florida Statutes, the *Florida Business Corporation Act* by filing Articles of Incorporation with the Department of State. The organizers also adopt bylaws for the corporation. The equity is owned by the shareholders who are issued stock in the company. Shareholders may be of a common class or of different classes. Typically the shareholders elect directors to manage the company; however, for corporations with 100 or fewer members, the shareholders may operate without directors. Fla. Stat. §607.0732(i)(a). The directors appoint the officers, and officers are typically empowered to appoint subordinate officers. Officers have the authority delegated by the directors or specified in the bylaws. Florida law does not dictate which offices must be established, except that Fla. Stat. §607.08401 requires an officer be appointed with the responsibility to maintain minutes of director and shareholder meetings and to authenticate company records. This office is usually the secretary. The organizers can otherwise create and title offices as they desire. Only a single director is required and the same person can serve as the sole director and shareholder. The corporation must also appoint a registered agent. To maintain good standing, the corporation must file an annual Uniform Business Report promulgated by the Department of State pursuant to Fla. Stat. §606.06 and pay a renewal filing fee. The shareholders, directors and officers are usually not liable for acts and omissions of the enterprise.

(a) "C" Corporation. The terms "C" corporation and "S" corporation do not refer to distinct business entity types, rather these terms are used to designate the Federal and state income tax treatment of the corporation. "C" corporations are corporations which either (i) do not meet the requirements to be taxed as an "S" corporation under subchapter S of the Internal Revenue Code; or (ii) meet the requirements to be taxed as an "S" corporation under subchapter S of the Internal Revenue Code, but do not request such tax treatment by appropriate filing with the Internal Revenue Service. "C" corporations are taxed under subchapter "C" of the Internal Revenue Code (hereafter the "IRC").

(b) "S" Corporation. "S" corporations are corporations which both (i) meet the requirements to be taxed as an "S" corporation under subchapter S of the IRC; and (ii) elect such tax treatment by appropriate filing with the Internal Revenue Service. The Florida Business Corporation Act does not distinguish between an "S" corporation and a "C" corporation; however, care must be taken to organize an "S" corporation in a manner that qualifies for "S" treatment. The eligibility requirements were liberalized as part of the *American Jobs Creation Act of 2004*[N1]. Previously an "S" corporation could have only 75 shareholders, one class of stock, and no shareholders who were not U.S. citizens or resident aliens. The changes now allow up to 100 shareholders and treat all members of a single family, including spouses and lineal descendents up to 6 generations as a single shareholder. If, for instance, the corporation has more than one class of stock (with distinctions other than voting rights). The corporation would be disqualified from being taxed as an "S" corporation. In general, an "S" corporation is not treated as a taxable entity for Federal or State income tax purposes. Rather, the income and losses are passed through to the shareholders who report same on their individual returns. IRC §1366(a). When used in this article, the term "S" corporation and "C" corporation both refer to a Florida corporation which has elected the respective tax treatment.

3. Not For Profit Corporations. A not for profit corporation is an organization created under Chapter 617 Florida Statutes, the *Florida Not For Profit Corporation Act* by filing Articles of Incorporation with the Department of State. The organizers also adopt bylaws. The Articles of Incorporation may provide for member or elect to recognize only directors and operate without a membership. Membership, if provided for in the Articles of Organization, may, but need not be represented by certificates, and in either event the corporation is required to keep a record of the membership. The directors manage the company through the officers they appoint. Officers have the authority delegated by the directors or specified in the bylaws. Florida law does not dictate which offices must be established, except that Fla. Stat. §617.0840 requires an officer be appointed with the responsibility to maintain minutes of meetings and to authenticate company records. This office is usually the secretary. The organizers can otherwise create and title offices as they desire, and permit officers to be appointed by either the directors or superior officers. The corporation requires at least three directors who must be natural persons. Fla. Stat. §§617.0802, 617.0803. The corporation must also appoint a registered agent. To maintain good standing the corporation must file an annual Uniform Business Report promulgated by the Department of State pursuant to Fla. Stat. §606.06 and pay a annual filing fee. The members, directors, and officers are usually not liable for acts and omissions of the enterprise. In addition if the corporation recognized under IRC §501(c)(3), §501(c)(4) or §501(c)(6) as a qualified nonprofit organization or under IRC §501(c)(5) as an agricultural or a horticultural organization, Fla. Stat. §617.0834 provides explicit immunity from civil liability for the officers and directors under most circumstances.

4. Limited Liability Companies. A limited liability company is an organization created under Chapter 608 Florida Statutes, the *Florida Limited Liability Company Act* by filing Articles of Organization with the Department of State. Under Fla. Stat § 608.406, which became effective on January 1, 2008, the limited liability company name must be distinguishable on the records of the Division of Corporations; however, this requirement may be waived by written consent from the entity which is already using the same or similar name. Additionally, any limited liability company's registered prior to July 1, 2007 are exempt from the requirement of using a distinguishable name, except when the limited liability company files documents that affect the name of the entity, on or after July 1, 2007. The organizers also typically prepare and execute an Operating Agreement which details the ownership rights, and governance of the entity; however, an Operating Agreement need not be written and is not a requirement of formation. Fla. Stat. §608.423(1). The equity is owned by the members as personal property. Fla. Stat. §608.431. Membership may but need not be represented by certificates, and in either event the limited liability company is required to keep a record of the membership. Fla. Stat. §608.4101, §608.432(3). A limited liability company is managed by the managing member(s) or the manager(s). Fla. Stat. §608.422. The limited liability company may operate without any other officers or the Operating Agreement may establish offices with powers and duties as specified. Fla. Stat. §608.4236. The limited liability company must also appoint a registered agent. To maintain good standing the limited liability company must file an annual Uniform Business Report promulgated by the Department of State pursuant to Fla. Stat. §606.06 and pay a renewal filing fee. The members, managers, and officers are usually not liable for acts and omissions of the enterprise. Fla. Stat. §608.4227 provides explicit immunity for members, managing members and managers.

5. Professional Service Corporations and Professional Limited Liability Companies. Lawyers, accountants, doctors and certain other professionals are prohibited from practicing their profession through a traditional corporation or limited liability company. Chapter 621 Florida Statutes, the *Professional Service Corporation and Limited Liability Company Act* affords such professionals the opportunity to organize and operate through either a corporation or limited liability company. For most purposes such entities are organized and operated in the same manner as any other corporation or limited liability company. Fla. Stat. §621.13. The key distinction is that such entities do not provide liability protection for professional malpractice. Fla. Stat. §621.07 provides *"…any officer, agent, member, manager, or employee of a corporation or limited liability company organized under this act shall be personally liable and accountable only for negligent or wrongful acts or misconduct committed by that person, or by any person under that person's direct supervision and control, while rendering professional service on behalf of the corporation or limited liability company…"*, but also provides that the shareholders and members are generally not personally liable to third parties which are unrelated to their professional practice. The Professional Service Corporation and Limited Liability Company Act also limits the operations of the entity to and requires shareholders/members be licensed to practice the respective profession. The entity must distinguish itself from traditional corporations or limited liability companies by including the words "chartered", "professional association", "professional limited company" or approved abbreviations in the entity name. Fla. Stat. §621.12.

6. General Partnerships and Joint Ventures. A partnership is *"…an association of two or more persons to carry on as co-owners a business for profit"* Fla. Stat. §620.8101(7). Partnerships are created by a "partnership agreement" between the partners. Such agreement may be written, or even implied. §620.8101(8). A partnership may be formed without any filing with the Department of State. The lack of formal organizational requirements, does not excuse a partnership from compliance with the *Fictitious Name Act*[N2] and with all other Federal and state laws applicable to employers and operators of a business. Partnerships are governed by Chapter 620 Part II Florida Statutes, the *Revised Uniform Partnership Act of 1995*, sometimes referred to as "RUPA". A partnership is automatically formed, whether desired or not, when two or more persons began to carry on as co-owners in a business. Under RUPA; however, certain activities are not considered to create a partnership absent explicit agreement of the participants. The exceptions are (i) joint ownership of property; (ii) sharing of gross returns; or (iii) receipt of a share of business profits in payment of debt, wages or sums due for independent contract services, rent, a retirement benefit, or amounts due from the sale of the goodwill of a business. Fla. Stat. §620.8202.

Entities created for a specific project are often referred to as a "joint venture". RUPA does not define a "joint venture"; however, under common usage a joint venture is considered to be a general partnership whose purpose is limited to a specific project. Accordingly, a joint venture has the same legal status as a general partnership. If a joint venture is created, RUPA provides that the partnership will continue beyond the completion of the contemplated project as a partnership at will. Fla. Stat. §620.8406[N3].

Historically partnerships were not considered as being entities distinct from their partners; however, under RUPA a partnership is explicitly considered to be a separate entity. Fla. Stat. §620.8201. A partnership is owned by its partners each of whom owns a "partnership interest". Each partner has equal rights in the management of the partnership. Fla. Stat. §620.8401(6). Any partner can act on behalf of the partnership, unless the partnership agreement provides otherwise. RUPA allows a partner acting under apparent authority to bind the partnership even when acting without the approval or contrary to the other partners or partnership agreement. Fla. Stat. §620.8305. A partnership does not appoint a registered agent, and service of process against a partnership is effected by serving any partner, or in the absence of a partner on an employee of the partnership. Fla. Stat. §48.061. A partnership does not file a Uniform Business Report or pay an annual filing fee.

7. Registered General Partnership. Any general partnership can become a "registered general partnership" or "registered partnership" by voluntarily filing a partnership registration statement with the Department of State pursuant to Fla. Stat. §620.8105. Registration is made by at least two partners filing a statement identifying the name of the partnership and of each partner. The filing also must identify the "agent" appointed by the partnership who is required to maintain a current list of each partner and their address. The agent is obligated to be available with such list at the designated address every business day from 10 am to noon. Senate Bill 698[N4], which was proposed on March 4, 2008, would allow partnerships to file a certificate of conversion or merger (as opposed to a statement) with the Department of State with the same condition that the partnership must have filed a registration statement. A partnership may also file a separate statement of partnership authority which identifies which partners are authorized to execute instruments transferring real property held in the name of the partnership, Fla. Stat. §620.8303. The statement may describe the authority or limitations on the authority, of some or all of the partners to enter into other transactions on behalf of the partnership. The filing with the Department of State acts as conclusive proof of authority for all acts except transfers of real property. Fla. Stat. §620.8303(3)(a). The partnership must record a certified copy of the statement in the public records in order to give notice to transferees of such property as to who does and does not have authority to convey partnership real property located in such county. Fla. Stat. §§620.8303(3)(b), 620.8303(4) In all other respects a registered general partnership is no different than any other general partnership.

8. Limited Liability Partnership. Any registered general partnership may become a limited liability partnership by filing a statement of qualification pursuant to Fla. Stat. §620.9001 in addition to the registration filing made pursuant to Fla. Stat. §620.8105. The statement of qualification includes (i) the partnership name which must include "Registered Limited Liability Partnership," "Limited Liability Partnership," or an approved abbreviation; (ii) the street address of the partnership's chief executive office; (iii) the partnership's street address; and (iv) the name and street address of the partnership's registered agent. The effect of registering as a limited liability partnership is to shield partners from individual liability. When operating as a limited liability partnership, a partner is not personally liable for an obligation of a partnership whether arising in contract, tort, or otherwise. Fla. Stat. §620.8306(3). A limited liability partnership must appoint a registered agent. To maintain good standing the limited liability partnership must file an annual Uniform Business Report promulgated by the Department of State pursuant to Fla. Stat. §606.06 and pay an annual filing fee.

9. Limited Partnership. A limited partnership is an organization created under Chapter 620, Part I Florida Statutes, the *Florida Revised Uniform Limited Partnership Act of 2005* (FRULPA) by filing a Certificate of Limited Partnership. The name selected must be unique from all other registered entities. Fla. Stat. §620.1108(4). The organizers also prepare and execute a partnership agreement which details the ownership rights, and governance of the entity. The equity referred to as a partnership interest is owned by the partners.

A limited partnership has both limited partners and one or more general partners. A limited partnership is managed by its general partners. Each general partner is the agent of the limited partnership and has the authority to bind the limited partnership when carrying on the ordinary business of the limited partnership. The general partner does not; however, have such power when dealing with a party who has actual knowledge that the act is ultra vires, or with respect to acts beyond ordinary scope not approved by the partnership. Fla. Stat. §620.1402. Limited partners have no authority to act on behalf of the limited partnership. Fla. Stat. §620.1302.

The general partner is the party named as such in the Certificate of Limited Partnership and in the partnership agreement. The partnership agreement may provide for one or more general partners and for multiple classes of general partners with distinct rights and powers. Fla. Stat. §620.1201. The limited partnership must appoint a registered agent. To maintain good standing the limited partnership must file an annual Uniform Business Report promulgated by the Department of State pursuant to Fla. Stat. §606.06 and pay a renewal filing fee. Limited partners are not liable for acts and omissions of the enterprise even if they participate in management and control. Fla. Stat. §620.1303.

10. Limited Liability Limited Partnership. A limited liability limited partnership is a limited partnership which files a statement of qualification under §620.9001(3) of RUPA, and complies with the name requirements under Fla. Stat. §620.9002. The effect of such filing is to afford the general partners of the limited partnership the same protection from personal liability afforded to a general partner in a registered limited liability partnership. Accordingly, in a limited liability limited partnership neither the general partner nor the limited partners are liable for acts and omissions of the enterprise under most circumstances. In all other respects a limited liability limited partnership is the same as a limited partnership.

11. Land Trust. A land trust is a trust established pursuant Fla. Stat. §689.071, the "*Florida Land Trust Act*". Such trusts are sometimes referred to as an "Illinois land trust", because of the origination of this form in that State. No filings are required to establish the trust. In fact, a land trust is not even an entity. Fla. Stat. §689.071(2)(d). The trust is created by a trust agreement executed by the trustee and by the beneficiaries. Legal title to the assets of the trust is held by the trustee who also acts on behalf of the trust. Fla. Stat. §689.071(3). The equitable title to the trust's assets is owned by the beneficiaries and is considered personal property. In the typical trust agreement the trustee has no actual authority to act except upon the direction of the beneficiaries. To avoid having to record the trust, title to real property owned by the trust is usually held in the name of the trustee for the trust specifying that the trustee has full power and authority "to protect, conserve and to sell, or to lease, or to encumber, or otherwise to manage and dispose of the real property" in accordance with Fla. Stat. §689.071. A trust has no registered agent or filing requirements; however if the trustee or the beneficiary is not a natural person they must comply with the requirements applicable to their own existence. Effective July 1, 2007, the provision regarding trustee liability now reads: "*(7) Trustee Liability – In addition to any other limitation on personal liability existing pursuant to statute or otherwise, the provisions of ss. 736.08125 and 736.1013 apply to the trustee of a land trust created pursuant to this section.*" The land trust statute was extensively revised in 2006 to codify common law, and add provisions for appointment of successor trustees. Chapter 2006-217 Laws of Florida.

12. Foreign Entities. Entities of every type created under the laws of other states or countries may do business and own property in Florida. Florida law provides for registration of the foreign entities with the Department of State. Registration is a prerequisite to doing business in Florida. Fla. Stat. §607.0505 requires every foreign corporation or alien business organization that owns Florida real property, or a mortgage encumbering Florida real property must maintain a registered agent and office. Failure may not impair the validity of any corporate act; however the company may be subject to civil liability. See Fla. Stat. §§607.0505(1)(b), 607.1502. Registration requirements are also specified for each type of foreign entity:

- Foreign corporations are required to register pursuant to §607.1501.
- Foreign limited liability companies are required to register pursuant to §608.501.
- Foreign non profit corporations are required to register pursuant to §617.1501.
- Foreign limited partnerships are required to register pursuant to §620.1902.
- Foreign limited liability partnerships are required to register pursuant to §620.9102.
- §620.9104 now specifies that owning real property in Florida by itself does <u>not</u> constitute doing business in Florida.

B. Recent Changes. The 2005 Florida Legislature passed comprehensive reform to Florida's business entities by CSSB 1056 published as Chapter 2005-267 Laws of Florida. This law replaced the Florida Revised Uniform Limited Partnership Act of 1986 with the Florida Revised Uniform Partnership Act of 2005 to adopt reforms from a new model act developed by the National Conference of Commissioners on Uniform State Laws with modifications proposed by the Florida Bar Real Property Probate and Trust Law Section. In addition to changes pertaining to limited partnerships, other changes were made to standardize mergers and conversions between various entities harmonizing the discordant verbiage regarding such acts that previously existed in the various Florida business statutes.

The most extensive changes were to the formation and management of limited partnerships. Prior to the change, the limited partnership act was linked to the laws pertaining to general partnerships. In order to provide more flexibility and differentiation between these entity types, the new FRULPA now stands independent of RUPA.

Significant changes to FRULPA include dropping the requirement for an affidavit stating the capital contributions upon formation and reporting changes in capital subsequent thereto. Greater protection is now afforded against personal liability for limited partners even where they might participate in management in control of the partnership.

Another change contained in the law of interest to real property practitioners, is the provisions applicable to foreign limited liability partnerships. Fla. Stat. §620.9104 was amended to explicitly provide that ownership of real property in Florida by itself did not constitute transaction of business within Florida requiring registration. The changes in the law have limited affect on the real property practice and go primarily to formation, governance and operation of Florida's business entities.

In 2006 the legislature adopted the Florida Land Trust Act. This legislation was also a Section initiative to codify and clarify the laws pertaining to land trusts.

C. Issues to Consider. There are a number of factors to consider when advising clients in selecting an entity for their real estate transaction. Items to consider include:

1. degree of risk and limitation on liability taking into consideration whether personal guaranties will be required for financing;
2. contemplated term of the endeavor;
3. effect of death, disability, or divorce of the principals;
4. estate tax considerations;
5. potential number of investors;
6. anticipated need for transferring or hypothecating interests in the proposed entity;
7. control of the entity;

8. desired distribution of profits and losses;
9. initial expense in formation of the entity and anticipated future costs (legal, filing, & accounting) to maintain the entity;
10. income tax consequences relating to organization, operation, and liquidation of the entity;
11. sales tax on rent consequences; and
12. anticipated future conveyancing of real property and associated documentary stamp tax liability.

D. Discussion of Issues.

1. Preliminary Decisions. Often overlooked in the discussion of entity choice is taking title either as natural persons or in the name of an existing entity. Clients often approach the lawyer in the belief that a new entity is required without fully weighing the risks and benefits. Accordingly, the first consideration should be whether a new entity is really necessary or desirable. If after such analysis an entity is needed, the attorney should weigh the factors set forth above in choosing the form. In the past this decision would lead to a choice between a general partnership, a limited partnership or a corporation. More recently the selection process has become more complex. Florida now permits the formation of limited liability companies, registered general partnerships, limited liability partnerships, and limited liability limited partnerships. Further complicating the decision process is the flexibility under current IRS procedures regarding whether the new entity is taxed as a corporation, partnership or disregarded entirely as an entity for Federal income tax purposes. Although the basic factors guiding the decision are the same, the increased options have made the process of selecting an entity more difficult.

2. Tax Considerations. Although complex tax analysis of entity choices is beyond the scope of this article, the tax impact of the entity cannot be ignored. Income tax impacts are the primary focus; however, consideration should also be given to Florida sales tax, intangible tax, and documentary tax.

(a) Income Tax Considerations

The first determination in Federal income tax analysis is whether the entity will be taxed as a corporation, or as a partnership sometimes referred to as a "pass through" entity. Such determination governs the required filings, and tax treatment for the entity.

Entities taxed as corporations include "C" corporations, and limited liability companies which elect to be taxed as a corporation. Such entities are taxed at the applicable corporate rate on earnings. Distributions to shareholders or other owners are taxed separately at the tax rates applicable to each such shareholder or owner. Such entities obtain an employer identification number (Form SS-4) sometimes referred to as a taxpayer identification number. The entity is responsible to file an annual tax return (Form 1120) and remit its own taxes based upon corporate tax rates. Upon distribution of income each shareholder or owner of such entity must report any income received as either wages or as dividend on their personal tax return and remit the appropriate taxes based upon their individual tax rate. This is sometimes referred to a double taxation as the same earnings are taxed at both the corporate level and then again at the shareholder level when income is distributed. For many clients the corporate Federal income tax rate may be significantly less than their individual tax rate; however, unless the client does not intend to distribute the earnings from the corporation, the additional tax due upon distribution will negate such advantage. The double taxation will also be occasioned when the entity is sold and proceeds distributed to the owners.

Entities such as partnerships of all types and limited liability companies with two or more members are generally treated as "pass through" entities for income tax purposes. Although all "pass through" entities are not partnerships, the IRS refers to them as being taxed as a partnership. A "pass through" entity also obtains its own taxpayer id (Form SS-4). Such entity must also file an annual tax return (Form 1065 for partnerships and limited liability companies, Form 1120S for "S" corporations), but the entity does not pay taxes on the income. Income is deemed earned directly by the shareholders or owners of the entity. Each shareholder or owner reports their proportionate share of the income on their personal tax return which is taxed at their individual tax rate. Losses are generally treated in a similar fashion; however, there are a number of restrictions which go beyond the scope of this article. For example losses from an "S" corporation due to depreciation are limited to a shareholder's basis in the corporation. One concern that arises in a "pass through" entity is the possibility of "phantom income." Phantom income is when a shareholder or owner is taxed for their proportionate share of the entity's net income, but does not actually receive the income in the form of dividend or salary. In such an instance, the entity retains the income, but in a "pass through" entity the income is nonetheless treated as received by the owners. Phantom income also may occur when income that is received is used to pay down principal on debt. The income is treated as earned by the shareholders, but there is no offsetting deduction for the repayment of principal. The possibility of phantom income is of special concern when your client will not have a controlling interest in the entity. A controlling shareholder —absent a shareholders' agreement— can purposely create phantom income by refusing to pay dividends to drive out the minority shareholders while drawing a salary for their own services to avoid suffering from the same hardship.

In addition to a corporate tax entity (ie: "C" corporation) or a "pass through" tax entity (ie: "S" corporation or partnership) the IRS also treats some entities as "disregarded". A disregarded entity is an entity which is not recognized as being distinct from its individual owner. Although technically not an entity, a sole proprietorship is the most common disregarded entity in that all earnings and losses are attributed to the owners. Another example of a disregarded entity is a limited liability company with only one member, assuming that such entity has not chosen to be taxed as a corporation. The IRS recognizes in community property states that a husband and wife can be a single member, but they offer no guidance on whether or not a husband and wife who own their interest as tenants by the entireties would be considered a single member. *IRS Publication 1635 (12/09) Understanding Your EIN*. What distinguishes a disregarded entity from a “pass through” entity is that the entity is not required to file a Federal income tax return. Although the tax returns filed by “pass through” entity are informational, nonetheless the client must incur the expense of maintaining separate books and for preparation of the tax return.

Another distinction of a disregarded entity is in structuring an IRC §1031 like-kind exchange. If the seller/exchanger is a natural person then typically the replacement property must be titled in the name of the same individual. By use of a disregarded entity, the same transaction could be structured with the replacement property being purchased by a single member limited liability company owned by the same individual. The same analysis would also apply to IRC §1033 exchange occasioned by an eminent domain taking. Such arrangement also avoids the pitfalls which may occur where the seller/exchanger conveys the replacement property to a new entity shortly after closing. In the event a taxpayer were to exchange and then transfer title, the IRS might construe the two transactions as a “step transaction” and then disallow the §1031 exchange for the reason that the party relinquishing title to the original party was not identical to the party acquiring the replacement property. In Rev. Rul. 75-292, 1975-2 CB 333, an individual exchanged property used in his trade or business for like-kind property and, pursuant to a prearranged plan, immediately made a Section 351 transfer of the property to a new corporation. The IRS held that §1031 was inapplicable because the new property was effectively transferred to the corporation rather than to the exchanging individual.

Tax planning for real estate related entities also requires consideration of the impacts of passive activity losses on the entity and its owners. Generally passive activity losses can be applied only to passive activity income. These limitations apply to entities taxed as partnerships and to closely held corporations and their respective partners or shareholders. For partnerships, passive activities include rental activities, regardless of the partner's participation. However, a rental real estate activity in which the partner materially participates is not considered a passive activity. An individual partner materially participated in a rental real estate activity if the partner was a “real estate professional” for the tax year. The partner qualifies as a real estate professional if he or she met both the following conditions for the tax year.

- More than half of the personal services the partner performs in any trade or business are in a real property trade or business in which the partner materially participates.
- The partner performs more than 750 hours of services in real property trades or businesses in which the partner materially participates.

Limited partners are generally not considered to materially participate in trade or business activities conducted through partnerships. A corporation will not be considered engaged in a passive activity if the closely held corporation derived more than 50% of its gross receipts from real estate development, construction, rental, management, sale or brokerage provided that the corporation materially participated in such activity.

With respect to entities which will hold appreciating properties, when taxed as a partnership there is the advantage of the IRC 754 regulations. When an entity makes a 754 election a new partner or member's basis in the underlying real estate is adjusted by the purchase price paid for their respective partnership or membership interest. In practical terms, this means that when the real estate holding is ultimately sold by the entity, the new partner or member recognizes gain on the difference between their purchase price (prorated amongst all assets if the entity has multiple properties) and the sales price of the property as opposed to gain being owed on the difference between the original purchase price paid for the land by the partnership or limited liability company and sales price. Where property has appreciated significantly between the time the entity acquired same and the time a new partner or member is admitted this can result in a significant tax savings.

In the past an entity's treatment (corporation, partnership, or disregarded) depended on an analysis of the various elements of the entity (centralized management, term of existence, transferability of equity etc…). Depending on the provisions in the respective Operating Agreement or other governing document the entity would be classified as being taxable as a corporation or partnership. Under current law, the IRS employs a "check the box" entity classification. Entities are classified by default as corporation, partnership or disregard; however, subject to time limitations and other restrictions, the parties can change the classification by filing Form 8832.

Single member limited liability companies and sole proprietorships are classified as disregarded entities by default. Limited liability companies, partnerships, and any other business entity which is not a corporation or trust are treated as partnerships by default. Corporations are treated as "C" corporations by default and cannot elect to be treated as partnerships; however, if the corporation meets the eligibility criteria the shareholders can elect for the corporation to be treated as an "S" corporation with tax treatment similar to a partnership in many respects. "S" election is accomplished by filing Form 2553. Eligibility requirements limit ownership to 100 shareholders (husbands, wives and up to 6 generations of lineal descendents treated as single shareholder) and generally exclude ownership by non-natural persons and non-resident aliens.

Tax analysis should also consider the impact of the alternative minimum tax, and state income tax. Florida does not impose corporate income tax on limited liability companies —unless an election is made for the company to be taxed as a corporation— or on "S" corporations; however when there will be out-of-state owners, you need to consider the impact of the taxes imposed by their state of residence. Consideration should also be given to limitations on passing through losses beyond an owner's basis in the entity which applies to "S" corporations, especially where the property being acquired will generate significant depreciation losses. The stock must be limited to a single class, but differences in voting rights are allowed.

(b) Other Tax Considerations The attorney should also review the effect of employment taxes, sales tax, intangible tax, and documentary stamp tax when making entity choice decisions. Although the Florida Department of Revenue has aggressively pursued collections of documentary stamp taxes for real estate conveyances even in the context of entity reorganization, recent cases have favored the taxpayer. Kuro Inc. v. State of FL Dept. of Revenue, 713 So. 2d 1021 (Fla. 2nd DCA 1998); Crescent Miami Center LLC v. Fla. Dept. of Revenue, 903 So. 2d 913 (Fla. 2005). The effect of Crescent Miami was limited by the legislature in 2009. Ch. 2009 – 131 §§3 and 4 Laws of Florida. The legislation established minimum holding periods for conduit entities to avoid the imposition of documentary stamp taxes. §§201.02(1)(b) and 201.0201, Fla. Stat.

(i) Employment Taxes Any entity which will have employees must obtain an employee identification number. Disregarded entities are not exempt from this requirement. The entity will also be responsible to collect and remit employment taxes. Such taxes include social security and Medicare taxes, Federal income tax withholding, and Federal unemployment tax. For general information on Federal employment taxes see *IRS Publication 15 (1/2005) Employer's Tax Guide* available on the IRS website www.irs.gov.

Individuals who work for corporation or a limited liability company which has elected corporate tax treatment are subject to Federal employment taxes on their wages even if they own the entity. Individuals who operate as a sole proprietorship or through a single member limited liability company (not electing to be taxed as a corporation) as subject to the related self employment tax. If the individual is a member of a general partnership then the partnership must report the earnings subject to self employment tax on its Schedule K-1 tax return and self employment tax will be due on such income. If the individual is a limited partner, the partnership earnings are generally not subject to self employment tax; however, guaranteed payments received for services the individual performed for the partnership are subject to self employment tax.

In a "C" corporation where dividends and distributions are subject to double taxation there is little incentive to characterize income as dividends in lieu of wages. With "S" corporations and other "pass through" entities clients often wish to minimize Federal employment taxes. Accordingly, there is often the temptation to treat wages as dividends. Where a person performs substantial services for the corporation, the IRS on audit may re-characterize all payments as wages and thus subject to Federal employment taxes. The client should be advised where they work for their own corporation to pay themselves a fair salary for their services in addition to any dividend distribution to avoid a challenge. If properly managed, only the wages of an "S" corporation will be subject to the employment taxes and the dividends will not be subject to either corporate income tax or unemployment taxes.

A partner is not an employee of the partnership. The partner's distributive share of ordinary income from a partnership is generally included in figuring net earnings from self-employment; however, a limited partner generally does not include his or her distributive share of income or loss in computing net earnings from self-employment. This exclusion does not apply to guaranteed payments made to a limited partner for services actually rendered to or on behalf of a partnership engaged in a trade or business. If an individual partner has net earnings from self-employment of $400 or more for the year, the partner must figure self-employment tax on Schedule SE (Form 1040).

(ii) Sales Tax Often overlooked in tax planning for real estate entities is the significant impact of sales tax on rental income. Fla. Stat. §212.031 imposes sales tax on rent. There are number of exemptions; however generally tax is due on all leases excluding apartments and other dwelling leased for terms which exceed 6 months in duration. The exclusion of property used "exclusively as dwelling units" from sales tax in Fla. Stat. §212.031(1)(a)(2) must be read in conjunction with the provisions of §212.03(1) which imposes tax on hotel rooms, apartments and other accommodations leased for 6 months or less.

With sales tax at 6% before adding any local option discretionary sales tax, the cost is not insignificant. Rent for sales tax purposes is broadly construed to include almost any payment required by the tenant to retain occupancy. Accordingly sales tax is due on common area charges, real estate taxes, and other items not necessarily referred to as "rent" in the lease. Note however where there is joint ownership of the property and occupancy by one of the joint tenants, rent is taxable only as to the portion due the co-tenant not in possession.

It is not uncommon that clients seeking to limit their liability will want to form one entity to operate their business and occupy the real property, and hold title to the real property either individually or through a separate entity. If there is no financing involved, the client may follow such arrangement and charge the occupant little or no rent. In such event the client will pay little no sales tax. (No sales tax due for occupancy where there is no lease or rent required by parent company for subsidiary in possession of property even though IRS requires imputation of rental income.). If, however, financing is required few lenders will make a loan to the operating entity without a written lease. To minimize sales tax the client could choose to lease the property for a nominal rent; however, if the operating entity were to fail a below market lease would adversely affect the value of the property defeating the liability protection rationale for separating ownership in the first place. If the client elects to lease the property at market rate then the sales tax exposure could be significant.

(iii) Intangible Personal Property Tax Annual recurring intangible tax was repealed effective January 1, 2007. Ch. 2006 – 312 §1 Laws of Florida. Senate Bill 1406, filed on January 26, 2010, and identical House Bill 0675, filed on January 14, 2010, with the short title of "Millionaire's Tax Act", would recreate the annual intangible personal property tax.

(iv) Documentary Stamp Tax Another consideration when dealing with entities is documentary stamp tax due on conveyances. The tax rate for documents that transfer an interest in real property is $.70 per $100 (or portion thereof) of the total consideration paid, or to be paid, for the transfer. An exception is

Miami-Dade County, where the rate is $.60 per $100 (or portion thereof) when the property is a single-family residence. If the Miami-Dade property is anything other than a single-family residence, the tax rate is $.60 plus $.45 surtax per $100 (or portion thereof). Fla. Stat. §201.02.

Historically, the Florida Department of Revenue has aggressively pursued collection of documentary stamp taxes when real property is conveyed to or from even closely held entities. This practice was successfully challenged by the taxpayer in *Crescent Miami Ctr., LLC v. Fla. Dept. of Revenue* 903 So. 2d 913 (Fla. 2005) The Florida Supreme Court ruled that the transfer of property between a grantor and its wholly owned grantee absent any exchange of value is without consideration and not subject to the tax.

Another article in this publication deals at length with the applicability of the tax as well as exempt transactions. With respect to business entities, documentary stamp taxes should still be considered when contemplating merger, conversion, or other reorganization of an entity which owns Florida real property.

3. Liability Considerations. Limiting personal liability is one of the most significant benefits and motivations for using a business entity when dealing with real property. Liability of the principals is not limited in a sole proprietorship, or general partnership. The parties can in many circumstances avoid personal liability by use of the other entities.

The limited liability afforded by use of a business entity is often of no practical value to your client in the context of real estate transactions. Few lenders will make a loan to a business entity without personal guarantees of the stakeholders. In the context of single family residences, FannieMae and FreddieMac will not purchase home loans not made to natural persons (with some exceptions for living trusts). Accordingly, your client must either forego using an entity or typically pay a higher interest rate and larger down payment by procuring a commercial loan for such transactions.

The goal of limiting liability is also frustrated by Federal and state environmental laws. The Comprehensive Environmental Compensation and Liability Act ("CERCLA") 42 U.S.C. §§ 9601 et seq. is the primary federal statute establishing liability for environmental contamination. Said act together with the significant 1986 amendments, referred to as the Superfund Amendments and Reauthorization Act of 1986, (SARA) is often referred to as "Superfund." Superfund broadly defines a hazardous substance excluding only petroleum and petroleum products from the wide ranging scope of its coverage. CERCLA §101(14), 42 U.S.C. §9601(14). The Superfund holds the current "owner and operator" of a contaminated property liable and also holds any past owner liable who owned the site at the time hazardous materials were disposed. CERCLA §§101(20)(A), 107(a), 42 U.S.C. §§9601(20)(A), 9607(a); State of New York v. Shore Realty Corp. 759 F.2d 1032, 1043-44 (2d Cir. 1985). Liability also extends to lessors who may be liable for the acts of their tenants. *United States v. South Carolina Recycling and Disposal, Inc.*, 21 ERC 1577, 1581(DSC 1984) (Lessee who sublet to subtenant is an owner.) *United States v. Cauffman*, 21 ERC 2167, 2168 (CD Cal 1984). The tenant may also be liable for contamination it causes, *Caldwell v. Gurley Refining C*o., 22 ERC 1588, 1593 (8th Cir. 1985), and although there are no current cases, it is possible that the tenant may also be considered an "operator" and thus liable not only for its own contamination, but also for contamination which occurred by prior users or occupants of the property it is leasing.

A trustee may be liable under the Superfund for actions taken on behalf of its trust. *United States v. Burn*, C-88-94-L District New Hampshire September 12, 1988 DNA Environmental Reporter. Stockholder have been found liable individually where they are involved in management of the corporation, *Shore Realty*, 759 F.2d at 1052, and officers of the corporation who exercise authority for company operations may also be found individually liable. *United States v. Wade*, 577 F. Supp. 1326, 1341 (EDPA 1983). Although there are defenses for innocent purchasers (CERCLA §107(b), 42 U.S.C. §9607(b)) and lenders (CERCLA §101(20)(A), 42 U.S.C. §9601(20)(A)), they reflect on the liability of the owner as a defense and if unsuccessful, nonetheless, leave the ultimate individuals personally exposed to extraordinarily high liability.

III. Entity Organization and Operation.

A. The Attorney's Role. When approached to create a business entity an attorney must be careful to avoid violation of the Florida Bar Rules of Professional Conduct ("RPC"). If there is more than one organizer or contemplated investor in the entity the attorney must determine who the client is. The problem arises whether initially approached by one individual or by all of the potential participants. In either circumstance the attorney must determine if the client is one participant, all the participants, the entity itself or some combination of the preceding.

Rule 4-1.7 RPC is the general rule regarding conflicts of interest. It provides that a lawyer may not represent a client adverse to the interests of another client. There is an exception to the rule. If each client consents after consultation <u>and</u> the lawyer reasonably believes that such representation will not be directly adverse to the interests of the other client. Accordingly, consent alone does not permit representation of adverse interests. The comments to the rule provide some guidance.

> *For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference of interest among them.*

Rule 4-1.113 RPC provides that the lawyer employed by an organization represents the organization acting through the organizations directors, officers, or managers. 4-1.113(e) RPC clarifies that *"A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders, or other constituents…"* Such rule still requires the lawyer to comply with 4-1.7 RPC requiring consultation and prohibiting directly adverse representation.

The ethical considerations during the formation process may thus be distinct from considerations after the entity is in existence. When approached by individuals seeking to form a joint enterprise, the approach that clearly avoids an ethical challenge is to require each individual to procure their own attorney to represent their respective interests. Regardless of which lawyer undertakes drafting of the instruments there would be no dual representation. This approach significantly increases the cost to the clients and can cause significant delay. Another approach is to represent only one party and prepare all documents on behalf of your client. If the other parties are unrepresented, as is typically the case, the attorney should notify all parties in writing that the attorney is representing only the identified client and advise them to seek independent attorneys to understand the legal implications of the proposed transaction.

The most challenging approach is to represent the mutual interests of all parties. Sometimes an attorney may propose that they are representing only the entity and not any of the promoters or investors; however, prior to formation such position seems hollow as this would place the attorney in the position of having no client at all.

There is no ethics opinion that directly answers these questions. An opinion regarding a lawyer acting as closing agent does give some guidance. Opinion 97-2 states that an attorney cannot ethically act as a closing agent for a transaction where parties have not agreed to the material terms of the contract. The opinion answers in the negative an inquiry of an attorney seeking to represent both the buyer and the seller in the closing of a business sale. The opinion distinguishes a business sale as an inherently complex and adversarial transaction from a simple closing of real estate where dual representation might be permissible. Applying this analysis to business formation would suggest that the attorney could ethically represent all parties in the formation of a new entity where the arrangements were relatively simple and where the parties have agreed on the fundamental arrangements of their business structure prior to retaining the attorney. Accordingly, dual representation might be ethical with consent in forming an "S" corporation for two entrepreneurs who will own equal shares and jointly participate in management, but might not be acceptable if there were unequal ownership and a desire for shareholder and employment agreements.

The ethical considerations after formation are less complex. If the attorney is acting for the organization the organization is the client not the associated persons. 4-1.113 RPC. Separate representation of associated persons is permitted if not adverse to the organization. More interesting is the attorney's role when a dispute between shareholders or other stakeholders arises. Opinion 65-66 gives some guidance. In this opinion a lawyer who represents all parties in the preparation of a contract was prohibited from representing any of the parties in a subsequent dispute relating to the same contract. Applying this principal to business entities would suggest that the lawyer organizing an entity not represent any of the associated persons in a dispute regarding the same entity.

B. The Mechanics of Organization. The actual steps necessary to form the entity are set forth in the statutes applicable to each entity type. Numerous publications provide checklists and suggested forms. The Department of State permits on-line paperless filing at www.sunbiz.org.

When creating an entity for multiple parties the attorney should suggest that provisions be made to address future conflicts between the participants. In addition to the minimum documentation required to create a corporation, the attorney should recommend adding a shareholder agreement to the scope of incorporation services. Such agreements typically protect minority owners from abuse by majority shareholders address the election of directors and officers, provide the opportunity for an unhappy shareholder to force the other shareholders to buy his or her stock, or permit the shareholder to buy the stock of one or more of the other shareholders at a fair value. Typical arrangements value the stock at a price establish by the unhappy shareholder at the time of invoking the clause; at a formula accepted as an appropriate measure of value; at a price established by future appraisal; or at price established in the shareholder agreement itself. In any event such agreements, and similar provisions incorporated in the governing documents of other entities act much like a pre-nuptial agreement in that they lead to an orderly separation of the stakeholders should one or more of them become dissatisfied with the enterprise or the conduct of the other stakeholders.

In addition to creating the legal entity it is equally important that the attorney either file the appropriate tax status forms or assure that the client does so. An immediate need for most any business is to obtain an employer identification number ("EIN") from the IRS to open banking accounts. An EIN requires completion of Form SS-4 available for download on the IRS website. It is important that the client authorize the attorney to act for the new entity by completing the 3rd party designation at the bottom of the form. The EIN can be obtained by phone 800-829-4933, by faxing the SS-4 to (631) 447-8960 or by mailing the SS-4 to the IRS Attn: EIN Operation Holtsville, NY 11742. EINs for most entities can also be obtained on the internet at https://sa1.www4.irs.gov/modiein/individual/index.jsp When applying by fax or phone you are obligated to retain the signed SS-4 with the business records.

Another critical item is the timely filing of Form 2553 when incorporating and seeking "S" tax status. If not timely filed the corporation will be automatically taxed as a "C" corporation which could create significant undesired tax consequences. Form 2553 must be signed by all of the shareholders. Accordingly, sufficient time should be allowed to circulate the document. When dealing with an entity that does not wish to be taxed according to its default status, Form 8832 must be timely filed.

Finally, the inexperienced client should be counseled in the myriad of other start-up requirements. Areas that should be discussed include occupational licenses, sales tax, and payroll taxes. Most such clients will benefit from association with a qualified accountant.

B. Conveyances and Finances of Real Property. When effecting a conveyance of real property or examining prior conveyances by entities the attorney is directed to three primary references for guidance. Florida Statues, Uniform Title Standards, and the Fund's Title Notes.

The Florida Statutes are the primary source to be consulted as to who has apparent authority to act on behalf of each respective entity.

- Corporations – Chapter 607
- Limited Liability Companies – Chapter 608
- Non Profit Corporations – Chapter 617
- Partnerships – Chapter 620
  - Florida Revised Uniform Limited Partnership Act – Part I
  - Florida Revised Uniform Partnership Act – Part II
- Professional Service Corporations and LLCS – Chapter 621
- Land Trusts - 689.071
- Homeowners Associations – Chapter 720

On a contemporaneous transaction the attorney should also review the applicable governing documents to ascertain who has the authority to act on behalf of the entity. When dealing with documents not available from the Department of State, the attorney should require that the documents be certified as true, correct and complete by the secretary of the entity, and preferably by all stakeholders in a closely held organization.

The Florida Bar - Real Property, Probate and Trust Law Section promulgates the Uniform Title Standards. The last complete publication was in 1981; however, as revisions are adopted they are available at the section website. www.rpptl.org.

The third important reference is the Title Notes published on an annual basis by the Attorneys' Title Insurance Fund, Inc. The following notes are applicable:

- Chapter 11 – Corporations and Limited Liability Companies
  - 11.01.01 A. Conveyance of all assets of a corporation.
  - 11.01.01 B. Conveyances by foreign corporations.
  - 11.04.02 Conveyances by dissolved corporations.
  - 11.04.08 Deeds to dissolved corporations.
  - 11.05.03 Requirements for execution of documents by corporations.
  - 11.06.02 Conveyances by foreign corporations.
  - 11.08 Non profit corporations.
  - 11.08.04 Procedures for conveyance by non profit corporations.
  - 11.09.01 Conveyances by professional service corporations.

- 11.10.01 Deeds and Mortgages from Florida LLC.
- 11.10.02 Deeds and Mortgages from Foreign LLC.

- Chapter 23 – Partnerships
  - 23.01.01 Deeds and Mortgages from existing general partnerships.
  - 23.01.02 Deeds and Mortgages from dissolved general partnerships.
  - 23.02.01 Deeds and Mortgages from existing limited partnerships.
  - 23.02.02 Deeds and Mortgages from dissolved limited partnerships.
  - 23.04.01 Deeds and Mortgages from limited liability partnerships.

IV. LIST OF EXHIBITS

A. IRS Form 8832 – Entity Classification Election.
B. IRS Form 2553 – Election of "S" Status by Small Business Corporation
C. Title 25 §1361 et.seq. U.S. Code – "S" Corporations
D. Ethics Opinion of The Florida Bar

1. 97-2 – *An attorney may not ethically act as a "closing agent" for a transaction where the material terms of the contract have not been agreed to or have not been discussed by the parties.*
2. 65-66 - *A lawyer who was employed by all the parties to prepare a contract for them should not thereafter represent either of them in a controversy relative to the contract.*
3. 69-32 - *An attorney may represent a plaintiff in litigation against a corporation organized by his firm or against one of the principals, provided the suit is unrelated to the incorporation and no relevant confidences were gained in the prior representation.*
4. 66-60 - *A corporation's attorney who acted for both the corporation and its president in drafting a noncompetitive agreement formalizing the understanding already reached by them may later represent the corporation in proceedings to enforce the agreement. This assumes that nothing of a confidential nature was learned by the attorney from the president and that the operative facts surrounding the alleged violation of the agreement will not involve events that might have come to the knowledge of counsel at the time of the preparation of the agreement.*

E. IRS Publication 1635 – Understanding Your EIN.
F. Chart of Florida Business Entities.