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Using Corporate Structures to Invest in Real Estate

By Parish Bhumgara

Parish Bhumgara
Associate
416.865.6732
pbhumgara@grllp.com

One of the more interesting aspects of corporate law is how it allows for the use of corporate structures to facilitate investment. This article discusses how corporate structures can be used to facilitate a group investment in commercial real estate.

While professionals and other high-net-worth individuals will find this article more beneficial, the same structures could be used on a smaller scale by families, friends or co-workers who wish to capitalize on the ability to pool their capital to invest in residential or commercial real estate.

There are several ways in which a person can carry on business. However, for the purposes of this article I will focus only on two of those ways: corporations and partnerships.

Corporations

For the purposes of this article, there are three key features to a corporation:

1. Separate legal entity;
2. Limited liability; and
3. Perpetual existence

Separate Legal Entity

- A corporation is a legal entity that exists separately from its owners.
- A corporation can own property, carry on business, possess rights and incur liabilities. It can also sue and be sued, and enter into contracts. Generally, a corporation has the same legal rights as a person.
- A corporation is owned by its shareholders, through their ownership of shares.
- A corporation is managed by a board of directors. Although directors do not need to be shareholders, they usually are.
- The rights and liabilities of a corporation are NOT the rights and liabilities of its shareholders.
- Example: Corporation X owns a house. Chris, Jon, and Jordan are shareholders of Corporation X.
    - This does not mean Chris, Jon, and Jordan have a right to use the house. Only Corporation X has a right to use the house. Chris, Jon and

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Jordan own Corporation X, they do not own the house.

Limited Liability

- An individual shareholder's liability is limited to the amount of assets they have transferred to the corporation.
- Generally, a creditor of a corporation cannot make a claim against the personal assets of a shareholder.
- A creditor's only recourse is to claim against the assets of the corporation.
- Example: Corporation X owns $500 worth of assets and owes a creditor $500,000. Jon, a shareholder of corporation X, invested $50 to buy its shares. Jon personally owns a condo worth $560,000. The creditor sues the corporation for its debt, and collects $500. Unable to pay the rest of the debt, the corporation declares bankruptcy and Jon loses his $50 investment, but Jon's condo is free from the creditor's claim.

Perpetual Existence

- A corporation continues on even if one of its shareholders sell their shares, or die.
- A corporation exists until it is voluntarily dissolved or mandatorily dissolved for non-compliance with its governing act

Income Tax Considerations – Corporations

- A corporation is a separate legal entity and therefore responsible for filing its own annual tax return.
- A corporation's income tax return is determined based on the income and expenses the corporation incurred throughout the year.
- This calculation is separate from personal income tax returns of the corporation's shareholders.
- A corporation can earn two types of income: active income (from carrying on a business) and/or passive income (i.e. investment income: interest, dividends, rent from a property and so forth)
- When earning passive income, a corporation is taxed at the highest marginal rate which is over 50%. If that money is then distributed to the corporation's shareholders as a dividend, the income is taxed again, in the hands of each individual shareholder. Generally, this makes earning passive income in a corporation inefficient.

Partnerships

- When two or more persons, whether individuals or corporations, carry on business together with a view to profit, the relationship is called a partnership, and the members of the partnership are called partners.
- A partnership is relatively inexpensive to set up. There are few legal formalities required to create it, and the partners carry on the business themselves directly, since the partnership is <u>not</u> a legal entity separate from its partners.
- The laws of Ontario recognize three types of partnerships: general partnerships (normally just called partnerships); limited liability partnerships (LLPs); and limited partnerships.
- In a general partnership, the liability of each partner for the debts and other obligations of the partnership is unlimited. Investors usually do not want this type of structure, so it will not form part of our discussion.
- LLPs are only allowed for professionals like accountants and lawyers and are not relevant to this article.
- Our focus will be on **Limited Partnerships (LPs).**

Limited Partnership Structure

- In a Limited Partnership, there are two types of partner, at least one general partner and one or more limited partners.

- The partnership is usually governed by a comprehensive limited partnership agreement.
- The limited partnership agreement will set out how profits are to be distributed, how the general partner is compensated for the time and effort it spends managing the business, how the partnership will resolve conflicts, under what terms a partner can exit the partnership, and other matters that the partners consider important.

General Partner

- A general partner is responsible for overseeing the management and day-to-day operations of the partnership's business.
- A general partner has unlimited liability. The debts and obligations of a limited partnership are also the debts and obligations of a general partner.
- A partnership is not a legal entity separate from its partners. Therefore, a limited partnership cannot own land. Instead, the general partner is required to hold legal title to the land on behalf of the limited partnership.
- However, as mentioned. the profits made from the property are shared by the partners.
- One source could be annual profits from the property being rented (assuming the rent generates a surplus after paying for all the expenses).
- The other source would be the net capital gain when the property is finally sold and the mortgage is paid off.
- Because the general partner has unlimited liability, the general partner is usually a corporation.
- A general partner is an agent of the partnership.
- This means the actions of the general partner bind the partnership so long as they are in accordance with the partnership agreement.

Limited Partner

- A limited partner is basically a passive investor rather than an active participant in the operation of the limited partnership.
- The limited partners have limited liability. They are only liable up to the extent of their investment.
- Example: Jon invests $250,000 as a limited partner. Jon has $2,000,000 worth of personal assets. Jon is only liable for up to $250,000 worth of damages if the partnership is successfully sued. Creditors have no recourse against his $2,000,000 of personal assets.
- Limited partners usually share the profits of the limited partnership in proportion to their contributions.
- Example: Jon contributes $250,000 to a limited partnership. Assume this represents a 25% interest in the limited partnership. Therefore, Jon will receive 25% of the net profits the limited partnership makes.
- A limited partner has the same rights as a general partner to inspect the records of the limited partnership and to receive full disclosure of the affairs of the partnership. The limited partner may also from time to time investigate the state and progress of the limited partnership business and advise as to its management and act as a contractor, agent, or employee of the limited partnership or the general partner.
- While a limited partner may give advice from time to time as to the management of the limited partnership, if a limited partner takes part in the control of the business, then that limited partner loses the limited liability and becomes a general partner.

Income Tax Considerations – Limited Partnerships

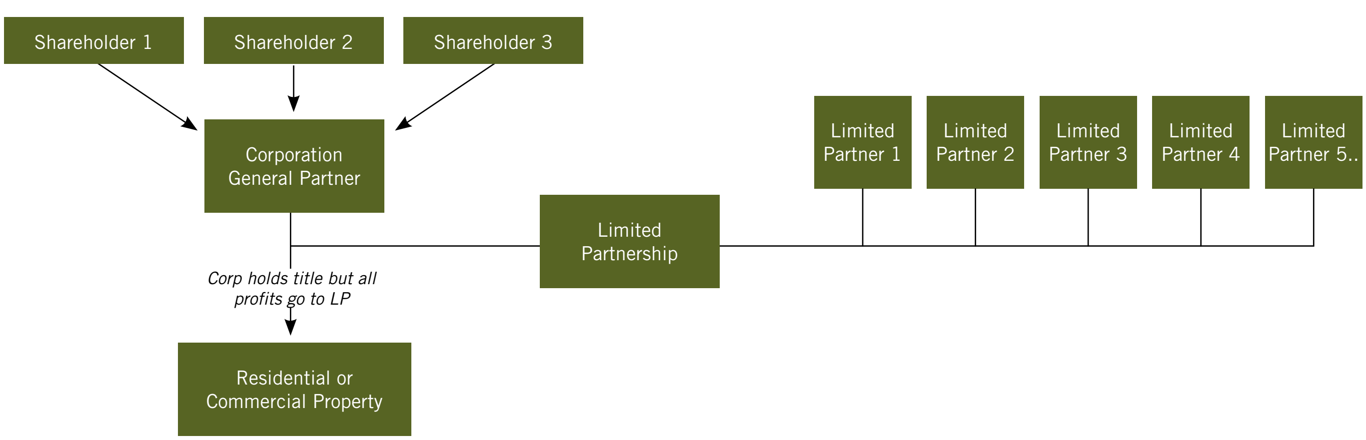
- A limited partnership is a “flow-through” structure. This means the income earned and tax deductions available flow through the partnership to the individual partners. The partnership itself does not pay any tax.

- The partnership is required to report the amount of income it earns at the partnership level, but, to reiterate, it does not pay tax.
- The income the partnership earns is taxed in the individual hands of the partners, as their income.
- Example: The partnership earns annual profits of $100,000 from its property. Jill is a limited partner with 25% equity in the partnership, Jill's share of the yearly profits are $25,000. This $25,000 will be taxed as Jill's income on her personal tax return at her marginal rate.
- However, assume that to make that $100,000, the partnership had to incur various tax deductible expenses totalling $40,000. Jill would be allowed to deduct her corresponding 25% share of those expenses, meaning Jill could deduct $10,000 from her taxes owing.
- Therefore, the net amount taxable to Jill would be $15,000.

Using a Limited Partnership to Own an Investment Property

- This article assumes every investor would be a limited partner.
- The general partner would be a newly formed corporation.
- Depending on the size of the group and the capital contributions of each limited partner, logistical considerations suggest the corporation's shareholders and directors be limited to the three (3) people who contribute the most to the partnership.
- Three is generally an optimal number for simplicity and tie-breaking reasons. If there's a disagreement amongst the three board members between two courses of action; it's a simple majority rule to break the tie. It is generally unlikely that three people will want to do three different things.
- Since these three people make the biggest contributions, they would own and control the corporation, and the corporation in turn, would be the general partner.
- This means that the three people would effectively, through the corporation, be in charge of making decisions regarding the property, contracting to have repairs done to the property, finding tenants and so forth.

Limited Partnership Organizational Chart



- Assume 15 investors decide to start a limited partnership to purchase a commercial property worth $10,000,000, with a $3,000,000 down payment. Commercial mortgages typically require a higher down payment.
- Two (2) people, X and Y contribute $450,000 each and each have a 15% ownership interest in the partnership
- One (1) person, Z, contributes $300,000 and has a 10% ownership interest in the partnership
- The twelve (12) remaining people contribute $150,000 each and each have a 5% ownership interest in the partnership
- All 15 people are limited partners. Together their contributions total $3,000,000 (450k+450k+300k+1.8 million) and ownership interests equal 100% (15%+15%+10%+60%)
- A corporation is set up to be the general partner and the three people who contributed the most, (X, Y and Z) become its shareholders and directors.
- A comprehensive partnership agreement would be made between all fifteen limited partners and the corporation.
- The Limited Partnership through its General Partner would then get a mortgage from a bank for the remaining $7,000,000.

Note: As mentioned earlier, the same model could be used on a smaller scale to purchase a residential property as a group investment.

Contact Us

If you have a corporate matter and are in need of legal advice, please do not hesitate to contact Parish Bhumgara at 416.865.6732 or pbhumgara@grllp.com.

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