Joint Ownership
And
Its Challenges:
Using Entities to Limit Liability
Joint Ownership and Its Challenges; Using Entities to Limit Liability

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1. Jointly Held Title

a. Common Types of Joint Title.

When multiple owners hold title to real property, they normally hold title as tenants-in-common, as joint tenants with the right of survivorship or (for married couples living in community property states) as community property with the right of survivorship. In each of these types of legal ownership, each individual holder of an interest in real property owns an “undivided interest” in the property. That is, the owner cannot transfer the complete title to the property. The owner can only transfer the “undivided interest” he or she owns.

As a form of joint ownership, tenancy-in-common is often chosen as much for convenience as for any sound reason. Tenants-in-common often end up holding title in that form merely because it is the default form of ownership when property is taken in joint names without evidence of a different intent.

Unlike tenancy-in-common, persons who hold title as joint tenants with the right of survivorship generally do so intentionally. Holding title in that manner allows the property to pass to the other joint tenant(s) without the necessity of probate when one of the joint owners passes.


Despite many of the issues discussed below which make simple joint ownership undesirable, it is still common. One explanation for that is that simple joint ownership (as tenants-in-common) is easy. For example, joint ownership as either tenants-in-common or as joint tenants with the right of survivorship can be created in the deed through which property is acquired. No other instrument is necessary.

In fact, a deed which conveys real property to multiple parties without specifying any other type of ownership will create a tenancy-in-common. It is the default form of joint ownership and requires no particular formality in

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1 While not a complete list of the different forms of joint ownership, these constitute the most common forms of joint ownership.
the form of the deed. Therefore, joint owners who give the matter no real thought will end up taking title to property as tenants-in-common.

It is somewhat more difficult for joint owners to take title as joint tenants with the right of survivorship, because taking title in that fashion requires compliance with more legal formalities than is the case when title is taken as tenants-in-common. A prerequisite for taking title as joint tenants with the right of survivorship is that the four “unities of title” are present at the date of the conveyance. The term “unities of title” is a legal term of art, which refers to the *unities of time, title, interest and possession.*2 If the four unities are not present in a conveyance to multiple persons, then a joint tenancy with the right of survivorship will not be created. Instead, the conveyance will create a tenancy-in-common.

Another reason that the joint tenancy with the right of survivorship form of ownership is frequently used is as a simple means of addressing certain succession objectives upon a joint owner’s death. That is because holding title as joint tenants with the right of survivorship permits joint owners to pass title on death without the necessity of probate. Instead, property held in joint tenancy with the right of survivorship conveys automatically to the surviving joint owners when one joint owner passes.

As a consequence, it is not uncommon for joint owners to sometimes choose to hold title as joint tenants with the right of survivorship merely to pass ownership on death without the need to probate an estate. While doing that may not be a substitute for proper estate planning, it is not uncommon to see joint owners choose joint tenancy with the right of survivorship for that reason.

c. Joint Ownership and “Unwanted Partners.”

If anticipating common events which can impact parties’ business dealings is an important objective, the simple forms of joint ownership described above do little to accomplish that objective. Many common occurrences such as death, bankruptcy, disability and divorce can affect the ownership of investment assets. And, although the forms of joint ownership described above are easily established, they do not provide a framework for addressing some of the business relationship challenges which can arise from such common life events.

For example, although joint property owners may be very close to one another, their relationships with the spouses of their joint owners might not

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2 The unity of “time” means that all joint owners received their interests at the same time. The unity of “title” means that all joint owners received their interests in the same instrument. The unity of “interest” means all joint owners received the same quality of interest, usually a fee simple interest (as opposed to one receiving a fee simple interest and another receiving a life estate). The unity of “possession” means all joint owners have the same right to possession of the jointly owned property.
be nearly so close. Similarly, it is a near certainty a joint owner would not look favorably on a partnership with the bankruptcy trustee of his or her investment partner in a property. Finally, although ownership issues arising from death can often be handled through appropriate provisions in wills, that is not always the case. For example, joint owners are not always related, and a joint owner could pass his or her fractional interest in a property through his or her will to a person the remaining co-owners do not like. In such a situation, the fact that the property interest passed under a will creates rather than solves a problem.

When joint property owners encounter situations where unanticipated events have left one or more of the joint owners with an “unwanted partner,” solutions can be limited. Without agreements in place providing for purchase options and agreed upon valuation methods, joint owners can encounter significant difficulties trying to resolve their differences. For example, one joint owner may want to sell the jointly owned property while another may not. Even if joint owners agree that a property should be sold they may not agree upon the value of the property in a sale, or whether it is acceptable to carry back a note for all or part of the purchase price.

In cases such as these in which joint owners cannot agree upon a means of dissolving the joint ownership of a property, the only option for a joint owner who wishes to dissolve the relationship may be to commence an action for “partition.” An action for partition is a legal action in which a court will order the “partition” of jointly-owned property when the owner bringing the action no longer wants to own the property with his co-owners. When the property is of a nature that it cannot easily be physically divided (such as a parcel containing a single post office building), the court will order a “partition by sale.” In such a case, the court will appoint a commission or similar body to determine the value at which the property should be sold. When the property is sold, the joint owners divide the sale proceeds in accordance with their respective interests. Forcing unhappy co-owners to remain tied to one another is not generally favored, and partition is therefore generally considered to be a right of a joint owner of property.

Although the “partition” remedy is liberally granted and available to resolve conflicts among joint owners, it has disadvantages. First, rather than being an agreed upon solution among co-owners, “partition” requires commencement of a legal action. Second, in an action for “partition,” co-owners must accept whatever mechanism the Court or the applicable statute establishes for valuing the property being sold. The parties essentially forego their right to try to agree among themselves as to a sensible method for valuing their respective interests and making necessary transfers.

Another scenario in which a co-owner could find himself or herself with an “unwanted partner” is the one in which one co-owner sells his or her interest
to a third party. Because selling a co-owner’s undivided interest would require a buyer willing to join with other co-owners the buyer might not know, it seems somewhat unlikely there would be much of a market for the property interest of a single co-owner who wanted to sell. However, if such a co-owner were able to find a buyer, the other (non-selling) co-owners could find themselves with a new partner they did not anticipate.

The solution for these sorts of potential problems with joint ownership is to anticipate and resolve the possible issues contractually in agreements among the joint owners. However, in cases in which co-owners take title in one of the common forms of joint ownership, it is relatively unusual for them to enter into the types of agreements which would resolve potential co-ownership issues. Perhaps that is because co-owners entering into the common forms of joint ownership do so because it is easy and without considering such issues.

d. Joint Ownership and Personal Liability.

Another significant consideration for co-owners who own property in their own names in one of the common forms of joint ownership is the possibility of unlimited personal liability. For example, a landlord, along with his or her tenant (e.g., the USPS), can be liable to third parties injured as a result of dangerous conditions existing on the landlord’s property. The terms of the lease between the landlord and tenant may contain terms allocating responsibility for the damage between them, but both will be named in a legal action by an injured party.

The most common protection against such personal liability for a landlord is the acquisition and maintenance of adequate liability insurance. However, a potential judgment that exceeds the coverage limit of such an insurance policy remains a possibility. In the absence of such insurance, or in the case of such a judgment exceeding the coverage limit, a property owner’s other assets (including other properties) could be reached to satisfy the judgment.

Avoidance of unlimited personal liability is an important objective for any property owner. For this reason, the use of entities for holding real property is common and advisable, whether for properties owned by multiple owners or by a single owner. Entity ownership is explained in the following section.

2. Entity Ownership to Solve Problems of Liability and Contractual Succession.

a. In order to avoid the possibility of unlimited personal liability arising from the ownership of commercial real estate, property owners should hold their properties in entities that provide protection against such liability. Both corporations and limited liability companies provide their shareholders (in the case of corporations) and members (in the case of limited liability companies) with protection against personal liability for obligations of the entities. In other words, unless a shareholder or member has personally
guaranteed an obligation of the entity (which is common with loans), the shareholder or member will not subject his or her personal assets to potential liability if the assets of the entity are insufficient to pay a judgment. The owner’s risk is limited to the value of his or her investment in the entity.

Although all corporations and limited liability companies will provide the limited liability protection described above, tax considerations will impact the type of entity chosen for property ownership. Those considerations are discussed below.

b. Although all corporations provide shareholders with protection against personal liability for corporate obligations, most commercial property owners do not use what are called “C” corporations for the purpose of holding commercial real estate investments. That is because “C” corporations are generally said to involve “double taxation” and are therefore disadvantageous from an income tax perspective.

Earnings of “C” corporations are taxed as income at the corporation level, and distributions out to shareholders are thereafter taxed to the shareholders as dividend income. Since the same corporate earnings can be subject to tax at both the corporation level and the shareholder level, they are said to be subject to “double taxation.”

To avoid the disadvantageous tax attributes of the “C” corporation form, commercial property owners generally hold their properties in what are known as “pass through” entities. “Pass through” entities are given that name because they do not pay income tax at the entity level. Instead, they file tax returns merely to advise the IRS of the amounts of their earnings and the apportionment of those earnings among their owners. The owners report their respective shares of such earnings on their personal tax returns. There is no separate income tax on the earnings when they are distributed to the owners.

Both limited liability companies and corporations known as “S” corporations are “pass through” entities. Since “S” corporations and limited liability companies also provide protection against personal liability for the obligations of the entities, they are the types of entities which might be considered as vehicles through which investors could hold commercial real estate. However, there can be significant tax disadvantages attempting to remove from “S” corporation ownership a commercial property that has been held in an “S” corporation. For that reason, limited liability company ownership is often preferable for commercial real estate investment. The remainder of this article will deal only with the ownership of commercial real estate in a limited liability company.³

³ Although many characteristics of limited liability companies and “S” corporations are similar (including especially “pass through” tax treatment), the limited liability company form of entity is generally somewhat more flexible
When individuals organize limited liability companies for the purpose of holding commercial real estate investments, it is common for them to enter into contracts which resolve many of the risks of co-ownership described above. While such contracts are not unheard of among people who hold property jointly as individuals (meaning, outside an entity), they are unusual. That may be for no other reason than that owners who obtain the type of professional help involved in organizing an entity are advised of the desirability of entering into a contract to address such matters. Persons who enter into joint ownership arrangements may do so through less formal means and without the benefit of such advice.

However they arise, it is common for owners of limited liability companies to enter into agreements which set out certain rights and obligations of the parties when unforeseen events occur. Among limited liability company members, the relevant agreements would normally be contained in what is known as an “operating agreement.” The following paragraphs discuss the types of provisions that are common in such operating agreements.

First, it is common for operating agreements to contain purchase options which give the other members the option to purchase the interest of a member who dies or is the subject of a bankruptcy. Such provisions help give such other members the ability to avoid becoming partners with an unknown heir of the deceased member, or with a bankruptcy trustee of a bankrupt member. The agreements will normally include provisions which set forth the means the parties will use to arrive at a fair market value for the interest being purchased through the options. Normally, the preference is to arrive at the value through agreement if possible. If agreement is not possible, then such provisions usually call for determination of value through an appraisal or similar means. In the case of death, the agreement may require the parties to purchase and maintain life insurance in amounts sufficient to fund the purchase of the decedent’s interest.

Another common provision of operating agreements is a right of first refusal which gives the other members the right to match a third party offer a member receives for the purchase of his or her limited liability company membership interest. Such a provision protects such other members from being forced to accept an unwanted partner who purchases the membership interest of the member who received the offer. They can instead purchase the interest themselves before the unwanted partner.

than the “S” corporation form. For example, certain limitations exist with respect to the identities of “S” corporation shareholders. Those limitations do not apply in the case of limited liability company members. In addition, the economic interests of all shareholders of an “S” corporation must generally be the same, while a limited liability company has flexibility to create distinctions among members with respect to their economic and other interests in the entity.

The owner of an interest in a limited liability company is normally referred to as a “member.” The term is used the same way the owner of stock in a corporation would be referred to as a “shareholder.”
Finally, operating agreements will often contain terms allowing one or more unhappy members to dissolve the relationship. Such terms could permit a specified percentage of members to vote to sell the property, distribute the proceeds and dissolve the entity. Other forms of such provisions permit an unhappy member to name a value for his or her interest and then allow the other members to choose whether to purchase the first member’s interest or sell their interests to the first member at the same value as the first member placed on his or her own interest.

Note that the references above are to options to acquire interests in the limited liability company rather than interests in real property. That is because the examples assume ownership of the real property inside a limited liability company. Thus, an interest in the limited liability company is an interest in the real property, and the value of the real property held by the entity will determine the value of the membership interest. The common characteristic is that such agreements permit members to address in advance some of the risks of co-ownership.

3. Special Case: Single Member LLCs.

a. A final topic with respect to the ownership of commercial property in an entity involves the “single member” limited liability company (“LLC”). Because of its special tax treatment, the “single member” LLC is a very convenient vehicle for use by individual owners of commercial property (including for this purpose a married couple domiciled in a community property state).

Even an individual who owns a property by himself or herself should consider holding the property in an entity which provides protection against personal liability for business debts. Because a “single member” LLC provides such limited liability protection, forming such an entity to own the property is preferable to having the property held by the individual owner. As discussed below, having the property held by a “single member” LLC will not complicate the owner’s tax reporting, and doing so gives the owner protection against personal liability for obligations arising from the investment.

b. “Single member” LLCs have a unique history. When states originally began legitimizing the LLC form of entity in the late 1980s, it was as a reaction to the fact that state laws generally required general partners in partnerships to be personally liable for all obligations of such general partnerships. General partnerships also offered the benefit of “pass through” tax treatment (discussed above). By creating the limited liability company form of entity, state legislatures intended to provide the benefit of “pass through” tax

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5 Although limited partnerships were permitted to provide limited liability benefits for limited partners, even they were required to have at least one “general partner” that remained personally liable for all partnership obligations.
treatment in an entity which offered the same protection against personal liability for entity debts as the protection enjoyed by shareholders in corporations.

However, although state legislatures could pass the laws authorizing such limited liability entities, they could not themselves guarantee that the Internal Revenue Service (IRS) would accept such entities as “pass through” entities for tax purposes. And, in fact, the IRS initially responded by establishing various tests by which the IRS would (a) attempt to determine whether an LLC created under state law was more like a corporation or a partnership, and (b) allow or deny “pass through” tax treatment based on the result of that examination.

While a variety of factors were considered by the IRS for that purpose, the one that is relevant to “single member” LLCs is that an LLC would not be allowed “pass through” tax treatment unless it had more than one member. The logic used by the IRS was that the IRS was making a distinction between the corporation entity form and the partnership entity form. Because “partnerships” were universally defined as “associations of parties engaged in activities for profit,” it was impossible to have an “association of parties” if there was only one owner of an entity. Therefore, an entity owned by a single person could not be a partnership and was disqualified from treatment as a “pass through” entity for tax purposes.

In the ensuing years, there was much commentary which was critical of the formula used by the IRS to determine whether a properly created LLC should be considered a “pass through” entity for tax purposes. In approximately 1997, the IRS finally relented and adopted new standards known as the “check the box” regulations. Under the new regulations, an entity could choose (by “checking the appropriate box”) whether it was to be taxed as a “pass through” entity, or was to pay its own tax as in the traditional “C” corporation entity form.

With regard to the “single member” LLC, the “check the box” regulations also established the “disregarded entity.” Under the “check the box” regulations, an LLC which is owned by a single member is disregarded for tax purposes. That means that an individual who has reported his or her commercial real estate profits and losses on his or her personal tax return as a sole proprietor can continue to do so even if he or she establishes a “single member” LLC to own his or her properties. Taking advantage of the limited liability protection of owning a commercial property in an LLC will not complicate the property owner’s tax reporting.

c. Due to the simplicity of the “single member” LLC form of entity, it has become very popular for ownership of commercial real estate. Because the organization documents essentially involve the property owner agreeing with himself or herself, they are not generally complicated or expensive. As a
result of that simplicity, many property owners organize a separate “single member” LLC in which to hold each separate property they own. That way, liability for obligations relating to each individual property can be segregated, so as to avoid having a liability that affects one property compromise the value of a different property. Since “single member” LLCs are normally fairly inexpensive to organize, they can kind of act as another layer of insurance against excess liabilities.

For example, even if multiple property owners jointly own a number of properties, they might use “single member” LLCs to keep liabilities related to a single property from affecting any of the others. They can form a multiple member LLC (itself a “pass through” entity) to establish a parent company they all own. Then, they can form separate “single member” LLCs in which to hold each separate property. The “single member” LLCs holding the properties are “disregarded” for tax purposes and do not file separate tax returns. The parent entity (the multiple member LLC) files its tax return and does so in the same manner as if the parent entity actually held title to the separate properties. However, if an excessive liability affects a single property, it is only the value of that property which will be at risk.