Structuring real estate investments

Always consider your options

Structuring considerations, tax planning implications and financing alternatives are important determinations that require careful analysis in any real estate investment. Do you have it right based on your objectives?

Structuring real estate investments may take many forms and each form of ownership comes with advantages and risks that you should consider before breaking ground on any real estate project. Whether the purchase of a real estate investment is structured personally, corporately, in a partnership or in an alternative form, each real estate acquisition should be assessed on its own merits based on the underlying objectives of the ownership group. Typically, making an assumption that an approach that worked for a previous project is not optimal in all circumstances.
Real estate acquisition and subsequent development typically bring together developers, investors and landowners, as well as financing intermediaries. Each of these stakeholders come into a project with their own unique business goals. For each party involved in the development, the optimal tax result might vary and could take different forms depending on the ownership structure that is chosen. Each structure has financial, tax and legal implications, which are worth reviewing before getting started.

Even if you’ve been involved in successful developments in the past, the structure previously used doesn’t necessarily represent a blueprint for future ventures.

As you start planning new projects, it’s a good idea to take a step back and assess the structuring alternatives that meet your business needs.

The right corporate structure can help you reach your business objectives

Choosing the right ownership structure is a fundamentally important business consideration when entering into a new real estate project.

Before making a decision to invest in real estate, it’s important to evaluate the potential benefits of partnering with other real estate players in a business venture. Perhaps you want to bring additional expertise on board, reduce financial or legal risk, or obtain additional funding. Whatever the reason, it’s important to consider your business partners’ objectives, risk tolerance and timeframe as you move forward.
Corporations
Corporations offer tax benefits that must be navigated carefully

Corporations bring simplicity, but they also have real estate asset transfer limitations. Holding real estate assets in corporate form is a simple form of ownership and relatively inexpensive to implement.

One of the most important advantages of this ownership structure is that it provides a level of legal protection from creditors, so that ultimate liabilities are typically borne by the corporation. In addition, real estate developments that generate active business income are generally taxed at a lower rate in a corporation than if the income was earned personally (subject to personal income levels). This achieves a level of income tax deferral if the income in the corporation is reinvested in other business ventures.

Co-ownerships
Co-ownerships can be tax efficient but have different legal risks

In this type of structure, two or more co-owners have a direct interest in the real estate asset—each owning a percentage interest in the real estate asset itself. Typically, this structure is used when the legal risks of ownership are not significant and the co-owners agree to operate as co-venture partners.

It should be noted, however, that to avoid a disposition where one party is contributing real estate assets to a joint venture that would otherwise result in a tax obligation, a partnership structure may need to be evaluated. This would be required if, for instance, one co-owner owns 100 percent of the real estate property prior to entering into the co-ownership structure and then decides to transfer a percentage interest to the other co-owner to develop the property.

On the other hand, co-ownership structures are beneficial if there is a need to independently assess the tax position of each co-owner. This may be the case where one co-owner holds its investment in the co-ownership on account of capital and the other co-owner holds its investment in the co-ownership on account of income. Different tax results could ultimately apply on the disposition of the respective real estate.

For instance, corporate ownership allows a real estate business to qualify for the small business tax deduction—a tax rate that can be as low as 12.2 percent in Ontario starting in 2020.

There are certain nuances, however, that apply to the ownership of real estate held as inventory. Although capital property owned by another taxpayer can be transferred to a corporation on a tax deferred basis, this deferral does not extend to real estate inventory. For example, if the objective of the development is to build a residential property that is considered inventory for tax purposes, it cannot be transferred to a corporation on a tax deferred basis to take advantage of the potentially lower income tax rates.
Partnerships
Partnership distributes risk, for better or worse

Unlike a joint venture, where each taxpayer has a direct interest in the real estate asset itself, a partnership owns the real estate asset directly.

Each partner owns a percentage of the partnership through the ownership of partnership units.

For income tax purposes, a partnership must calculate each source of income at the partnership level. This structure also provides more flexibility on asset transfers since it allows for the tax deferred transfer of both capital property and real estate inventory without the incidence of taxation on the assumption that partnership units and debt not exceeding the cost of the property are taken back as consideration.

Partnership structures are used commonly in real estate transactions since they allow for multiple investors with differing objectives to come together in real estate projects.

Trusts
Trusts provide benefit of third-party administration, but are time limited

A trust structure may provide another vehicle to hold real estate property. The trusts key decision-maker or trustee manages assets and makes decisions for the benefit of the income and capital beneficiaries of the trust. As such, a trust structure may be advantageous when the objective is to leave the trust property for the benefit of children or grandchildren.

Transfers of property to a trust are taxable, meaning it is not possible to transfer property to a trust with a gain on a tax deferred basis.

In addition, unlike some of the structures mentioned above that have unlimited lives, an inter-vivos trust has a limited life of 21 years, so it will be necessary to reorganize the trust’s ownership prior to the 21-year life to avoid negative tax consequences.

We recently published an article discussing changes to the taxation of trusts, noting that those changes have limited the ways that trusts can be used. Although some of these changes have limited the usefulness of trusts for tax planning, investment vehicles like real estate investment trusts (REITs) have gained popularity. In the public market, REITS are a common method of holding real estate because they allow investment returns to be maximized by pooling together a large number of real estate assets. The 21-year “deemed realization” rule does not apply to REITs providing investors with longer-term hold periods.
Real estate structuring checklist

When making decisions around structuring your next real estate investment, consider these questions:

- Who are your partners?
- What is your intention for the project (e.g., a short-term or long-term investment)?
- How will it be financed?
- What are your financial objectives (e.g., cash up front, long term income)?
- What are the known financial risks and what is your risk tolerance?
- Are there legal risks you are concerned about?
- What business are you in?

With proper planning, you can capitalize on your real estate opportunities while maintaining tax efficiency and minimizing the legal risks posed by certain business structures.

If you’re thinking of starting a real estate project or evaluating the benefits of your existing structure, you should obtain the right tax, financial and legal advice before deciding which structure makes the most sense.

For more information, please reach out to the Grant Thornton Real Estate and Construction group.