The Kirwan Law Firm

Potential Problems When Transferring Real Estate Owned by an Individual to a Legal Entity

While there are many upsides of holding real estate in a legal entity like a limited liability company (e.g., including protecting personal assets from liability that stems from the property, etc.), there are, some potential downsides as well. This article will highlight four of the downsides of transferring property you initial purchased in your individual name(s) to a legal entity. Each of them are discussed separately below.

1. Florida Documentary Stamp Tax.

Florida Statutes Section 201.02(1)(a) requires anyone purchasing Florida real estate to pay something called "documentary stamp tax." The tax is based on the "consideration" (i.e., the purchase price) paid for the property. The tax rate is 7/10th of a percent or $7 for every $1,000 paid.

When property is transferred to a legal entity like a limited liability company ("LLC"), an interesting Florida Documentary Stamp Tax question is raised. In the past, the Florida Department of Revenue ("DOR") has argued that such a transfer should be treated as a sale of the property to the legal entity even though such a transfer is not treated as a sale for federal income tax purposes. For example, if you transfer a piece of Florida real estate worth $200,000 into an LLC, the DOR argued that the property should be treated as having been sold to the LLC in exchange for the LLC membership units which are deemed to have the same value as the property (i.e., $200,000). Under this reasoning, since the property was "sold" to the LLC, the transfer would cost you $1,400 in Florida Documentary Stamp Tax. This could result in your paying a double tax since you will pay Documentary Stamp Tax once when you first buy the property and then a second time when you transfer it into the entity. Of course, if you simply purchase property directly in the name of the legal entity, you would only pay Documentary Stamp Tax once

Thankfully, on May 19, 2005, the Florida Supreme Court rejected the DOR's "transfer equals sale" argument in the case of Crescent Miami Center, LLC v. Department of Revenue with two exceptions. The first of these exceptions is that if the ownership structure of the property being transferred is different from the ownership structure of the legal entity to which it is being transferred, the transfer will trigger the imposition of Documentary Stamp Tax on the entire fair market value of the property (I'll call this the Identical Ownership Requirement). The second exception is that if you transfer unencumbered property (i.e., property that is not subject to a mortgage) to a legal entity and the Identical Ownership Requirement is met, the Crescent Miami court held that no Documentary Stamp Tax need be paid "because nothing was exchanged . . .; thus, there [is] no consideration or purchaser in the transaction, just a 'mere change in form of the stockholder's equity in the corporation." It needs to be noted that if the property being transferred is subject to a mortgage, Documentary Stamp Tax is required with respect to the mortgage amount. For example:

> "T. Ferguson owns a rental home in his own name valued at $500,000. The rental home was originally subject to a mortgage of $300,000, but Mr. Ferguson has paid it down so that only $200,000 is left owing to the bank. He decides to transfer it to T. Ferguson Holdings, LLC, of which he also the only owner. When he records the deed to effectuate the transfer, he will owe Documentary Stamp Tax on $200,000 (i.e., $1,400 in tax) since that is the current amount outstanding on the mortgage."

It is important to note that after the Crescent Miami case was handed down by the Florida Supreme Court, the Florida legislature enacted Florida Statute Sections 201.02 and 201.0201. Florida Statute Section 201.0201 states, in relevant part:

> "The Legislature recognizes that the Supreme Court's opinion in Crescent is limited to the facts of the case and accepts the court's interpretation of Section 201.02 that no consideration exists when owners of real property unencumbered by a mortgage convey an interest in such property to an artificial entity whose ownership is identical to the ownership of the real property before conveyance."

This is in keeping with the interpretation of the Crescent Miami case as described above. Florida Statute Section 201.02, however, introduces the new concept of a "conduit entity." If a person transfers property to an LLC or other legal entity in a manner that avoids paying Florida documentary stamp tax and then sells an interest in the legal entity within a three year period of time for consideration (i.e., money or something of value), the stamp tax is still due. This is an oversimplified explanation of the statute and exceptions do exist. When transferring Florida real estate to any legal entity, it is best to engage a Florida attorney who is well versed in these tax laws as they provide numerous traps for the unweary.

Transfers of non-Florida real estate are not subject to this tax, however, it is always wise to check and see whether the state where the property is located has a similar tax on transfers of real estate.

2. Title Insurance Issue When Transferring Property to an LLC.

Another potential problem in transferring property that you previously purchased in your own name to a legal entity is that it could invalidate your title insurance. When you initially purchased the property, a title insurance policy was issued to the owner of the property (i.e., you). If the property is later transferred to an LLC, for example, and the LLC subsequently sells the property, if a title problem arises, the title insurance company may not have to pay since the seller of the property (the LLC) is uninsured. If you plan to transfer property to a legal entity, always check with the issuer of your title insurance policy to ensure the policy will continue to protect you.

3. <u>The Cost of Property and Casualty Insurance</u>.
Many times when property is transferred to a legal entity, the cost of obtaining property and casualty insurance (like a typical homeowners insurance policy) will rise. I have no idea why insurance companies charge more for the exact same insurance coverage for the exact same property just because it is owned by a legal entity, other than they feel they can get away with it. Don't you hate insurance companies.

4. <u>Real Property With a Mortgage</u>.
Finally, if you already own property in your individual name and that property is subject to a mortgage, you will need to obtain the permission of the lender before you transfer the property into a legal entity. All mortgages have something called a "Due on Sale" clause which gives the bank the right to immediately call due the entire mortgage balance if the property is ever transferred (including to a legal entity). If the current mortgage is a Fannie Mae mortgage, you will need to refinance.

In addition, even when you directly purchase property in the name of an LLC and want to keep a mortgage on the property, your options will be less than if you purchased the property in your individual name. First, you will not be eligible for a Fannie Mae loan. This stems from the fact that a requirement to obtaining "Fannie Mae" financing is that the property must be owned by natural persons (i.e., not legal entities). In short, Fannie Mae mortgages are "standardized" so they can be bundled together with other Fannie Mae mortgages and sold in the open market similar to commodities like pork bellies or soy beans. One of the standardized requirements is that the property be owned by an individual and not a legal entity. Because a bank or mortgage lender can easily sell the mortgage on the open market (and thereby divest itself of the risk of your possibly defaulting on the loan), the interest rate with a Fannie Mae mortgage is usually slightly lower.

Even with respect to non-Fannie Mae financing, if you want to own the property in a legal entity, the interest rate will typically be slightly higher than if you owned the property in your individual name. Even if you can find a competitive interest rate, other mortgage terms are usually more restrictive (such as having a shorter term (i.e., 10 years rather than 15)). Some banks even refuse to extend mortgage financing with respect to property being purchased in a legal entity. Beware of the bank employee (who will be paid only if your mortgage closes) advising you to close in your individual name(s) and then quit claim the property into the LLC or other legal entity post closing. He is setting you up to all three of the negatives listed above (including breaking the terms of your contract with his employer). I want to point out that this practice (i.e., closing on a property in your name and then transferring it to an LLC later) is fairly common and that as long as payments are being made, banks oftentimes do not exercise their right under the Due on Sale clause. But people who choose to do this risk having their loan called due and sometimes with little notice.

5. <u>10% Cap Assessment Limitation for Non-Homestead Property</u>. Under Florida law, there is a 10% cap assessment limitation for non-homestead property (I'll refer to this as the 10% Cap) which places a cap on the amount your property value can increase in any given year for purposes of levying property taxes. For example, assume you buy an investment property for $500,000 in Year 1. Next assume that the following year in Year 2, the value of the property increases to $600,000. The 10% prevents the state from levying property taxes on the full $600,000 fair market value. Instead, the value is only allowed to increase by 10% of the taxable value of the property for the previous year. So in this example, property taxes could be levied on the value of $550,000 rather than the full $600,000 value. Next assume that the following year (Year 3), the fair market value of the property jumps to $800,000. Once again, the 10% Cap only allows the taxable value of the property to be 10% more than last years taxable value of $550,000 (i.e., $605,000 ($550,000 x 10% = $55,000 PLUS $550,000 = $605,000). Now assume, that in Year 3, rather than keeping the property titled in your individual name you instead transferred it to an LLC because you plan to rent the property and want the liability protection offered by an LLC. Unfortunately, by transferring the property to the LLC, the savings that you were enjoying due to the 10% Cap is lost, and property taxes will be levied on the full $800,000 rather than on the $605,000 value. Understand that you lose the benefit of the 10% Cap even if you own 100% of the LLC and owned 100% of the property prior to transferring it to the LLC.

The 10% Cap may not be as advantageous as you might think on a long term basis because, unlike the 3% cap on homestead property where the assessed value can never go up by more than 3% or the CPI, whichever is lower, the assessed value for the 10% Assessment Cap can go up by as much as 10% in years where the property value stays the same or even goes down. This allows the state to "recapture" or take back the advantage gained in previous years.

Please understand that the above explanation has been simplified and that there are nuances to the 10% Cap which I completely omitted, but I wanted to make sure that you were made aware of it so that you can make an informed decision when making the decision as to whether it makes sense to your to transfer a property to an LLC.

Conclusion

All of the factors mentioned above need to be taken into consideration before you decide whether or not to use a legal entity to hold real estate presently titled in your individual name(s). In most cases, the benefits to be gained by using a legal entity far outweigh the costs, however, this will be a personal decision. I have seen a person decide not to use a legal entity to hold property because they did not want to pay Florida's Documentary Stamp Tax only to be sued later for a significant amount. With the benefit of hindsight, that person regretted their decision to forgo using an LLC to save the Documentary Stamp Tax.