# Chapter 6

# Equity sharing co-ownership

*This chapter explores the tax aspects that encourage the equity sharing co-ownership of a principal residence by a homeowner and an investor.*

## The investor co-owner

A young couple, with the help of their broker, finds their ideal home. It can be purchased for $349,000, a greatly reduced price brought about by rising interest rates, fewer employment opportunities, a diminished number of first time buyers and an increasing volume of retirees. They have accumulated $35,000, enough for a 10% down payment. Their joint incomes of $55,000 qualify them for a monthly loan payment of $1,783.

If the mortgage market's fixed interest rate is 5.5%, the couple's monthly payment of principal and interest is $1,783, qualifying them for a loan amount of $314,000 in purchase-assist financing.

However, fixed interest rates for home loans have risen to 6.5% and the couple does not want the future risk of loss inherent in a variable rate loan with an initial teaser rate of half the fixed rate. Now, the monthly payment of $1,783 on a loan at 6.5% barely qualifies them for a $280,000 loan. They are now $35,000 short on the purchase price of the home due to the 1% (100 basis points) upward shift in interest rates. This 18% increase in the **cost of borrowing** (i.e., interest) is represented by a 10% drop in the amount of money they can borrow.

Had rates gone up to 7.5%, the couple would be $59,000 short on the down payment, as the 2% increase in rates from 5.5% would drive up the cost of money 36% and reduce the loan amount available by 19%. Arguably, the seller's property would then be overpriced by $59,000 since real estate values are inextricably tied to mortgage rates, the same way bond market values are linked to interest rates.

The seller is unwilling to drop the price or carry paper for the difference. The price, he feels, justifies being cashed out in spite of weakening resale prices (brought about by the reduction in mortgage funds due to the increase in interest rates and the lack of a comparable increase in earnings or drop in home prices).

If they are to buy the home, the couple must increase their down payment to $70,000 because of the reduced loan amount available to them at the higher interest rates. The couple has no other sources for additional down payment funds, their parents having already committed to a portion of the $35,000 cash available for the down payment.

Fortunately, the broker knows of a small income property investor who acquires single-family rentals, but does not have the temperament to tolerate hassles with tenants or the negative cash flow caused by vacancies. The investor prefers problem- and management-free arrangements with long-term "tenants" — such as those provided by an owner/occupant buyer.

The broker proposes a resolution for the couple. He suggests the couple consider becoming a co-owner with the investor on the following terms:

1. The couple puts up their $35,000, representing one-half of the cash down payment for the home.
2. The investor also contributes $35,000, the other one-half of the cash down payment now needed.
3. The couple and the investor are 50:50 co-owners of the property.



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4. The couple qualifies for a purchase-assist, fixed-rate loan to provide funding for the remaining 80% of the purchase price.

5. Title is vested as tenants in common or as a limited liability company (LLC) formed for the benefit of the co-owners (which is taxed $800 annually).

6. The couple occupies the property under a triple-net lease.

The property has a mixed use since it is both the principal residence of the buyer/occupant couple under Internal Revenue Code (IRC) §121, and rental property providing §469 passive income/loss for the investor. The LLC, as the vested owner of the property, is classified as a **disregarded entity** for both co-owners' individual tax reporting consequences. [Revenue Regulations §301.7701-3]

The equity sharing co-ownership arrangement permits the couple to:

- buy a home without an oppressive down payment or demanding monthly payments;

- enjoy one half of the mortgage interest and property tax write-offs allowed for home ownership; and

- build an equity in real estate through the principal amortization in monthly payments and any market value increase due to inflation or appreciation (or reduction due to a loss in value) over the years of ownership.

Also, the financing allows the couple to avoid the long-term risks of ARM financing.

Under the lease, they occupy the home and pay all the monthly utility bills, loan payments and ownership and maintenance expenses as the rental amount due the co-ownership.

At the same time, the investor owns a one-half interest in a rental income property free of tenant demands and operating decisions typically associated with income-producing, single-family residential real estate. The investor receives his pro rata share of annual tax and financial benefits allowed on rental properties, including deductions for his co-ownership percentage of depreciation of improvements and interest paid on the purchase-assist loan.

To assure the couple's long-term home ownership goals are met, they will be granted an option to buy out the investor at a future date by paying off the investor's contribution to the down payment and his one-half share of any net equity buildup when the option is exercised.

Alternatively, the property can be sold and the investor will receive his one-half pro rata distribution of the net proceeds on resale of the property.

Will this co-ownership arrangement permit the parties to each enjoy their respective tax and economic benefits of owning a one-half interest in real estate?

Yes! As long as the equity sharing arrangement is negotiated as an arms' length deal, i.e., offering no economic favoritism to either party beyond their pro rata share. The shares are based solely on the **portion of the down payment** represented by each party's cash contribution to the price paid for the property, not by their future payments of rent and interest. [Internal Revenue Code §§280A(d)(3)(B), 280A(d)(3)(C)]

Besides the tax aspects, a legal and financial bond must be established between the buyer/occupant couple and the investor to create a practical, long-term arrangement.

Also, the co-owners must be aware of the risks and responsibilities of joining together as partners vested as an LLC. A co-ownership vesting as tenants in common would be more risky, but

would allow for a homeowner's exemption from local property taxes equal to $70.

## Matching buyers and investors

In the recessionary period following an increase in real estate prices, institutional and government-mandated mortgage rates are still high. How can first-time homebuyers afford to finance a home through their own means when sellers are not yet willing to reduce their prices to reflect the economics of higher interest rates?

One temporary solution, as shown in the prior example, is "equity sharing."

Co-ownership in an **equity shared** arrangement is established between:

- buyer/occupants and sellers;
- buyer/occupants and their parents; or
- buyer/occupants and cash investors.

When a seller uses equity sharing co-ownership arrangements to cash out a major portion of his equity (up to 80% of the value), the seller retains a portion of his ownership interest in the property as a 50:50 co-owner (partner) with the buyer.

Resale sellers and homebuilders avoid the carrying costs of vacant, unsold residential property while at the same time receiving cash for a portion of their net equity by entering into co-ownership arrangements with qualified homebuyers.

Parents use the equity sharing arrangements to help their children enter the home market by providing both the credit history necessary to qualify for purchase-assist financing and the cash capital needed for a down payment on the price.

Cash investors use equity sharing techniques to become co-owners with first-time buyers when sellers and parents are unwilling or unable to assist them.

## Basic concepts

Underlying the co-ownership concept of equity sharing is the federal tax code policy that a homeowner is not entitled to deductions on a *principal residence* since the property is put to a **personal use**. [**Bolton** v. **Commissioner** (1981) 77 TC 104]

Exceptions exist to the personal use exclusion that allow for an **itemized deduction** from the homeowner's adjusted gross income (AGI) for payment of accrued interest and real estate taxes. The deductions reduce the homeowner's standard taxable income.

However, an owner who uses a property as his principal residence is then not allowed to take deductions for depreciation or operating expenses to maintain the property.

Additionally, elaborate tax rules allow for the **mixed use** of property as follows:

- business deductions for the exclusive use of a portion of a principal residence as a **home office** [IRC §280A(c)];
- depreciation deductions for a **vacation rental** used occasionally as the personal residence of the owner or his family [IRC §280A(d)(1)]; and
- property leased to **family members** as their principal residence. [IRC §280A(d)(3)]

A co-owner who manages his ownership interest as an investment in an income-producing property, called a *rental property*, is entitled to annual depreciation deductions. Conversely, his co-owner, who uses the property as his personal residence, is not.

## Shared-equity financing

In the early 1980s, Congress recognized the homebuyer's need to employ alternative financing arrangements to combat rising interest rates, spurred by the deregulation of portfolio and institutional lenders. Its solution, equity sharing, reshaped the national housing policy to encourage homeownership.

An equity sharing financing arrangement is an agreement:

- between two or more persons;
- to acquire ownership of a dwelling;
- entitling at least one of the co-owners to occupy the property as a principal residence; and
- setting a fair rental value to be paid to the investor co-owner, by the occupant co-owner. [IRC §280A(d)(3)(C)]

Any fractional co-ownership interest in real estate will qualify for equity sharing if the interest acquired has a term of **more than 50 years**. The over-50-year time requirement ensures the interests owned will either be a fee or long-term leasehold interest. [IRC §280A(d)(3)(D)]

The equity sharing arrangement is initiated by using an equity sharing contingency addendum as part of the offer made to purchase a home. [See **first tuesday** Form 265]

In California, the co-ownership of real estate is most commonly vested as:

- joint tenants;
- community property with right of survivorship;
- tenants in common;
- a partnership or limited liability company (LLC); or
- an inter vivos trust.

The best method for holding title to real estate in a shared equity plan is a limited liability company, a type of partnership entity, in spite of the disadvantageous annual $800 franchise tax. An LLC provides protection against death and other events that normally interfere with tenants in common vestings.

Annually, the investor controls the LLC as its *manager*. All the co-owners are members with percentage of ownership shares, based on their contribution toward the acquisition of the residence.

## Fair rental agreements

Regardless of the vesting chosen, the buyer/occupant under equity sharing arrangements must enter into a lease agreement calling for payment of a fair rent. [IRC §280A(d)(3)(B)(ii)]

The nonoccupant/co-owner must be compensated with rent for the occupant's use of the non-occupant's one-half ownership interest in the property. *Fair rent* means the payment of an amount of rent equal to rent charged to lease comparable rental properties in the neighborhood.

Abuses of the fair rent requirement do not occur in bona fide arms' length transactions entered into by sellers or investors who become co-owners with the buyer/occupant.

However, abuses are prevalent in the equity sharing financing agreements between family members, such as the charge of lower-than-market rents or failure to collect rent. Parents tend to handle their involvement as a gift, not as a long-term business arrangement. [**Bindseil** v. **Commissioner** TC Memo 1983-411]

When the parent/co-owner charges rent but never actually collects it, or charges rent equal to a "management fee," which in turn is paid to the child/occupant of the property, the equity sharing arrangement collapses. Any deductions taken for depreciation by the parent/co-owner under a below-market leasing arrangement with his children will be disallowed. [**Gilchrist** v. **Commissioner** TC Memo 1983-288]

The investor may discount the rent for a good, upstanding tenant, or when the tenant agrees to improve the property (as in "sweat equity" arrangements), provided the bargained terms are economically sound. If the equity sharing arrangement lacks fundamental economic sense, it will be attacked by the Internal Revenue Service (IRS). [Bindseil, *supra*]

However, the fair rent does not need to equal the principal and interest payments on the loan to be considered reasonable. As a rental, property may produce a "negative cash flow" when the fair rental amount of income does not cover operating/ownership expenses and purchase-assist loan payments. Still, the rent must be reasonably close to market conditions in order to avoid an IRS claim that the rent is too low, prompting their disallowal of rental write-offs to the investor. [**Kuga** v. **U.S.** (1986) 87-2 USTC 9449]

## Calculating the rent

The amount of rental income due an investor co-owner is the investor's pro rata share of the fair market rental value of the entire dwelling, based on his fractional ownership interest in the dwelling.

For example, two 50:50 co-owners vested as tenants in common enter into an equity sharing agreement calling for a fair rent of $2,500 a month. Here, the buyer/occupant pays the investor $1,250 (one half of $2,500) monthly as rent.

In turn, the rent is used to pay the investor's half of the ownership costs, consisting primarily of the loan payments, taxes and insurance. This rent is paid by the buyer/occupant for the privilege of occupying the entire home, which includes his undivided half interest and the investor's undivided half interest in the co-ownership of the property.

After acquiring the joint ownership of the residence, the homebuyer occupies the unit and pays the following:

- a fair rent for the right to occupy the investor's one half ownership interest in the property under the terms of a lease; and
- his pro rata share of loan payments, taxes and insurance, called *implicit rent* in economic terms, and any operating costs agreed to in the lease agreement with the investor.

Additionally, the investor co-owner is entitled to deduct operating expenses he paid himself out of his share of the rent, deduct interest paid on the mortgage based on his pro rata share of ownership and deduct depreciation on his cost basis in the ownership.

When the buyer/occupant, as a tenant, leases property from an LLC formed to hold title to the property, the occupant pays the full fair rent to the LLC. The LLC does not file a federal return. Deductions taken by the investor for depreciation and expenses are allocated to him based on the percentage of the down payment he contributed.

## The downpayment note

A buyer/occupant who puts little or nothing down while the co-owner puts up the bulk of the down payment cannot claim to be a 50:50 owner. A 50:50 co-ownership does not withstand an economic analysis if the investor puts up all (or most) of the down payment and the occupant agrees to qualify for the mortgage

and make all the payments or pay rent equal to the loan, taxes, insurance, etc. Thus, to establish a percentage of ownership, the buyer/occupant must contribute to the down payment.

The dollar amount of each co-owner's contribution toward the purchase price sets the ratio for allocating tax benefits. Thus, an equity sharing agreement does not exist when the buyer/occupant does not contribute downpayment funds, but has good credit and can qualify for purchase-assist financing.

In this situation where the buyer/occupant does not have enough cash for a down payment, the co-owners can structure the equity sharing to provide for a **downpayment note**, executed by the buyer/occupant in favor of the parent or investor who is the source of the entire amount or nearly all of the downpayment funds.

The downpayment note solves the dilemna of the buyer/occupant's lack of funds for a down payment.

The parent or investor lends the buyer/occupant a sufficient amount of money so the buyer/occupant has funds for his half of the downpayment amount. The loan from the investor will be evidenced by a note, bearing interest and payable monthly.

The downpayment loan should bear interest at market rates to keep the transaction at arm's length. In any event, interest on the note should be at no less than the IRS Applicable Federal Rate controlling credit financing. [See Chapter 21]

The due date on the downpayment note should be no later than the date for expiration of the buyer/occupant's right to buy the investor's interest under any purchase option.

As security for the downpayment note, the buyer/occupant should collaterally assign to the investor his ownership interest as a member of the LLC, or if a tenant-in-common vesting is used, a trust deed on the owner-occupant's one-half interest in the real estate.

In turn, the buyer/occupant signs a lease with the LLC, agreeing to pay rent to the LLC at a fair market rental rate. Together, the note, the collateral assignment and the lease collectively evidence the buyer/occupant's economic commitment to the investor and to the LLC.

## Family equity sharing partnerships

Parents are typically reluctant to charge their children market rental rates when they contribute funds to purchase a residence as co-owners with their children. This reluctance presents a tax reporting dilemna in family equity sharing agreements. The financial and ownership arrangement between family members must be an **arms' length transaction** with a bona fide economic function.

Frequently, family equity sharing partnerships start off as economically sound arrangements, but end up as shams. Parents often fail to charge market rents, and when they do, they refuse to enforce collection under the lease or note for any downpayment loan.

If the arrangement is structured as a business transaction for tax purposes, then it must be strictly enforced. Parents cannot take depreciation deductions on what in reality is, or becomes, a loan or a gift.

*Editor's note — This position was taken in a series of proposed Treasury Regulations. While the regulations were never adopted, they provide sound economic advice for equity sharing partnerships. [Proposed Regulations §§1.280A-1(e), 1.280A-1(g)]*

## Equity sharing and co-ownership allocations

The equity sharing tax rules are less flexible than the tax rules applied to partnerships and LLCs owning properties that are not occupied by partners or members as their principal residence.

In an LLC, the members can negotiate the percentage of ownership they will receive for their initial contributions, as well as their allocated share of the depreciation and maintenance expenses.

For example, to encourage an owner to contribute his raw land to an LLC, the other members might agree to give the landowner 65% of the depreciation write-offs but only 50% of the income and profits generated by the improvements that will be constructed on the land.

Taxwise, this is called a *special allocation*. It differs from a *value-related allocation* system that is based on the value of the different types of property contributed to the LLC.

Under **value-related allocations**, the member contributing the raw land receives only his proportionate share of the LLC's income and expenses based on the dollar value of his land compared to the dollar amount of the other members' contributions.

**Special allocations** are allowed in LLCs if they are justified by some legitimate business reason, other than mere tax avoidance. Usually a Class A and B priority/subordination sharing arrangement exists between members employing special allocations.

Under the land and cash contribution example, the members reached an arm's-length agreement. The landowner would not have entered into the LLC operating agreement unless he received 65% of the depreciation deductions. This is a direct contrast to the use of proportionate allocations required in equity sharing arrangements when all partners contribute cash and must receive parity ownership interests.

## Cash contributions bar special allocations

Consider a son who needs $50,000 as a down payment on his first home. He has only $25,000 available.

His parents offer to advance the $25,000 needed to complete the down payment on two investment-related conditions:

- the son will pay all the monthly operating expenses to maintain the property; and
- on resale, he will return their $25,000, plus 50% of any net appreciation.

The parents do not know if they can deduct all of the interest payments, property taxes and depreciation, nor on what ratio they and their son must share in deductions during the life of the family partnership.

In this case, special allocations are not allowed since the ownership arrangement involves only cash contributions. Even though the parents would receive far greater tax benefits for the deductions than their son, they can only take interest and depreciation deductions based on their contribution's percentage share of the down payment, which sets their pro rata share of the co-ownership.

Thus, the son claims a deduction of 50% of the monthly interest payments and allocates to his parents the remaining 50% of the interest deductions, even when just the son qualified for the loan and, in reality, paid all the interest on the loan.

Similarly, the parents' share of the depreciation deductions can only be 50%. However, the son is allowed no depreciation deduction for his one-half ownership since he is making personal use of the residence. Despite this, the parents' share is in direct proportion to their contribution to the arrangement, which is one half ($25,000/$50,000).

Thus, the parents, as 50% cash contributors, cannot claim more than a 50% share of the interest or depreciation deductions.