

## **CO-OWNERSHIP: WILL IT MAKE YOU OR BREAK YOU?**

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Real estate “co-ownership”, which is also commonly referred to as “equity sharing” or “tenants-in-common ownership”, can be a terrific benefit for the respective co-owners. Opportunities abound for individuals to acquire property together that would be impossible, impractical, or less desirable for less than all of the co-owners to acquire.

In the context of residential property, family members and/or close friends often purchase property so that an individual or couple reside in the property - the "occupant(s)" - and another individual or couple make an investment in it – the “investor(s)”. In the context of investment (residential or commercial), many combinations of individuals, groups and business entities purchase property, in which case one or more individuals may be passive (non-managing) investors, and others active (managing) investors.

When acquisition of a co-ownership interest is by purchase, the advantages to investors might include, among others: additional tax deductions; equity appreciation; ownership without management headaches; and a one-time capital investment, as opposed to one with continuing financial obligations. The advantages to an occupant might include, among others: the ability to become a property owner; little or no up-front capital requirement (downpayment and closing costs); equity appreciation; ongoing management control; and support from a more experienced co-owner.

When a co-ownership interest is obtained by gift, the advantages to the donee are obvious. The advantages to a donor may include those described above for investors, but often also include the good feeling of making a gift to a loved one or friend, and estate planning convenience (or perceived convenience) – usually taking the form of joint tenancy with the right of survivorship so that probate may be avoided on the death of the donee.

For many reasons - primarily limiting one’s personal liability arising from tenants, tenants’ guests, and property-related creditors - it is often wise for even a co-owner group as small as 2 or 3 investors to form a business entity, such as a Limited Liability Company (LLC) or S-Corporation, under which to hold title and manage the property. The business entity usually has (and should have) governing documents, such as an “LLC operating agreement”, “buy-sell” and/or “shareholders agreement”, that help define the respective rights and obligations of the parties. However, the focus of this article is on situations where either a friend or relative gifts a partial interest in a property to another, or a few people purchase a property together, typically without forming a business entity.

Despite the many potential advantages of co-ownership, many pitfalls exist. Any number of these pitfalls can result in the destruction of valuable relationships among the co-owners, if not

unexpected and sometimes devastating liability. Frequently when co-owners purchase a property together, they do not contemplate or they fail to address, let alone agree upon, many aspects of their prospective co-ownership. These issues range from how title will be taken, to what their respective initial and ongoing responsibilities will be, who will make material decisions about the property, how those decisions will be made, and when and how the property will be refinanced, improved, or sold. Without resolving these issues in advance, or at least providing a template or formula for doing so, the consequence may be unpleasant disagreements, at the least, if not ruined relationships, unanticipated costs, and expensive lawsuits.

When someone gifts a property interest to another, it is usually done informally, often without consulting with tax or legal advisors, and very often with no agreement (verbal or written) about many of the details involved in owning and managing property. Many times, particularly among close family members, people approach it casually with the attitude that the relationship is a strong and trusting one, and the details will easily resolve themselves. Many times this is the case. Unfortunately, all too often, it is not the case. Gifting an interest in real property cannot only result in the problems outlined above, but also other inadvertent problems, that may include: the reduction of the donor co-owner's estate tax exemption; the need for the donor to file a gift tax return, if not also to pay gift tax on the transfer; future detrimental capital gains tax liability on the part of the donee that could have been minimized or avoided with careful planning; partial property tax reassessment; and liability of the donor for debts of the donee - in the form of liens against the property (e.g. for non-payment of state or federal tax, and judgments).

In my law practice alone, I have seen quite a few of examples of co-ownerships that went awry. One involved two people who had been engaged to be married, purchased a property together, and later split up. As is often the case, Initially the couple worked things out reasonably well, in general; however, unfortunately, they did not receive adequate advice about how to take title (they took title as joint tenants, rather than as tenants-in-common). Thus, when they decided to sell the property a number of years later, one of the co-owners discovered a substantial federal tax lien imposed for non-payment of taxes by the other co-owner. This tax lien attached to the property, resulting in the loss of nearly all of the innocent co-owner's equity, and a former fiance from whom she could not recover her damages.

Another example involved three young people who casually purchased a condominium together, and wrote up a one page "agreement" without the advice of an attorney. Many years later, after the terms of the rather ambiguous agreement had been altered greatly, all of the three co-owners had long since moved out of the property, and other circumstances arose which were not covered by the agreement, one of the disgruntled co-owners filed suit to remedy perceived financial inequity. Ultimately, the case settled at mediation, but not before the parties had spent a tremendous amount in attorney's fees, not to mention suffering the stress and inconvenience associated with litigation.

I cannot emphasize enough the potential for disputes among co-owners. I once defended a mother who had been sued by her daughter over a very contentious real estate matter. No relationship is exempt from misunderstandings and hurt feelings, nor legal action. The purpose of this article is not, however, just to illustrate many of the things that can go wrong with co-ownership, or to scare or discourage anyone from purchasing property with others. My primary

intent is to inform you how to take reasonable steps to preserve the many benefits of co-ownership, without unnecessarily exposing yourself to its perils.

The most important method of preserving co-ownership benefits and protecting yourself from your co-owner, taxing authorities, and creditors, is to seek advice from a qualified real estate attorney and accountant before entering into the co-ownership transaction. It is far preferable to seek such advice even before signing and submitting any purchase offers, but certainly you should do so before escrow closes (or any deed is executed or transfer is made). Even if you have already closed escrow, however, seeking legal and tax advice should be done as soon as possible. Please note that in the case of gifting, it is frequently a better alternative for the donor to provide for the future distribution of the property or an interest in the property to a loved one in a living trust than in the form of a present transfer of a fractional interest. Of course, each person's situation should be evaluated by competent professional advisors on a case by case basis.

Another very important preservation and protection method is for the parties to enter into a comprehensive, written "co-ownership agreement" (aka "equity share agreement" or "tenants-in-common" agreement) drafted by a real estate attorney who has experience drafting such agreements. The agreement should include, among other things: a) how much capital each co-owner will contribute towards down-payment and closing costs, and when; b) which co-owner(s) will be responsible for paying the mortgage, property taxes, utilities, and other property-related expenses; c) which co-owner(s) will be responsible for handling general management duties, including tenant issues, keeping financial records, and maintenance; d) who will make capital contributions to make necessary and/or discretionary capital improvements; e) which co-owner(s), if any, will have the right to reside in the property, how much they will pay in rent to the others, if any, and what will happen if the co-owner vacates; f) what will happen if one co-owner wants to sell and the other co-owner(s) doesn't; g) which co-owner(s) have the right or priority, if any, to buy out the other(s); h) on a sale, what monies will be reimbursed, if any, to the co-owner(s) for amounts they each contributed toward down-payment, closing costs, loan payments, property taxes, maintenance, improvements and/or other property-related expenses; i) what will be the term of the agreement, and what will happen when the term ends (e.g., rights of first refusal, sale on the open market, option to extend the term, etc.); j) what happens if a co-owner defaults on his or her obligations; and k) what happens if a co-owner dies (typically, rights of refusal to avoid a co-owner being forced to co-own with the decedent co-owners heirs).

The "bottom line" is that co-ownership has a lot to offer, but co-owners should proceed with their eyes open, relevant legal and tax advice, and a comprehensive written agreement that clarifies all of the important rights and obligations of the respective co-owners.

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