Chapter 18

Structuring Real Estate Investments: Organizational Forms and Joint Ventures

Organizational Forms - Legal

- Sole proprietorship (no legal entity)
- State laws govern legal entity formation
- Corporations
  - C Corporation
  - S Corporation (special tax rules)
  - REITs (special tax rules – Corp or Trust)
- Partnerships
  - General partnership
  - Limited partnership (LP)
  - Limited liability partnership(LLP) (professionals)
  - Limited liability limited partnership (LLLP) (new)
- Limited liability company (“LLC”)
  - Series LLC

Organizational Forms – Why?

TAXATION

LIMITED LIABILITY

Corporations:	Double Taxation, generally
Partnerships & LLCs:	No entity level taxation

Organizational Forms – and Taxation

- Corporate: (NOT favorable for real estate ownership*)
  - Double taxation
  - Simple
- Pass-through Entities
  - Partnerships and LLCs
  - No entity level tax
  - “Attributes” (taxable income, capital gain) pass through to owners
  - Can be extremely complex - burdensome

* REITs are a very special exception as they can be in corporate form

Limited Partnership in Real Estate

- Once the most common form of Partnerships used in Real Estate
- Most Partnerships – Structured to avoid taxation
  - No continuity of life
  - General partner has unlimited liability
  - Limited transferability of interests
- Use of Corporate General Partners

Limited Liability Companies (LLC)

- Now the most common form entity used in Real Estate
- Flexible rules
  - No concern about management and liability
  - Designed to maximize management flexibility, liability and taxation
- Treated as partnership (by default) for tax purposes
- Series LLC
  - Multiple sub-entities formed under a single “holding” LLC entity
  - Allows compartmentalization of liability without any added complexity

Joint Ventures – A Concept

- Not itself a “legal entity”
- Capital formation concept
- Combine expertise with capital
    - Developer/operator/sponsor
    - Investor
- Risk sharing
- Objectives
- Legal form - flexibility
- Often in a partnership format

Public & Private Syndicates Securities Law

- S.E.C. (Securities and Exchange Commission) Federal
- Private vs. Public Offerings*
- Securities Laws
  - Federal and State level
  - Regulation D
    - Accredited Investors
      - Security issuers officers, directors, etc.
      - $1 million net worth rule
      - $200,000 income (2 years) rule
      - http://www.sec.gov/answers/accred.htm
  - Recent rules under JOBS Act (in transition).

* Sometimes called “syndications” – where financial investments offered to a group of investors

Crowdfunding

- JOBS ACT
  - Jumpstart our Business Startups Act (2012)
- SEC role
- Regs
  - Approved 2015
  - Continuing to change

Capital Raising and the SEC

– a few details

	Reg A - Tier 1	Reg A - Tier 2	Reg D: Rule 506(c)*	Crowdfunding (Reg CF)
Maximum Offering	$20,000,000	$50,000,000	Unlimited	$1,000,000
Offeree Types	All, including non-accredited investor	All, including non-accredited investor	Accredited Investors Only	All - Unaccredited
Individual Investment Limits	None	Unaccredited: Greater of 10% of income or 10% of net worth; 10% of revenue for entities	None	All offerings: $2,000 minimum; 5% of income or net worth below $100k, 10% above $100k, $100k max
Investor Verification	N/A	Self-Certification	Heightened Accredited Verification; Financial Infrmation Required	Self-Certification
Advertising / General Solicitation	Unrestricted	Unrestricted	Unrestricted	Limited to Notices; All must occur on internet
Pre-filing / Testing the Waters	Testing the waters allowed with no pre-filing; must file solicitation materials with first offering statement; offering circular must be filed 48 hours prior to first sale	Testing the waters allowed with no pre-filing; must file solicitation materials with first offering statement; offering circular must be filed 48 hours prior to first sale	No filing requirements (yet)	Pre-filing with SEC required before any offer (no testing the waters)
Closing Speed	**Slow - SEC and State Qualification Required**	**Slow - SEC Approval Required**	Fast - NO SEC Involvement	Medium SEC Pre-Filing Required
Offering Documents	Robust - SEC Qualification and State Approval	Robust - SEC Approval	No Specific Requirements	Robust, SEC Filing Required
Financials Disclosure	Reviewed Financials	Audited Financials	No Specific Requirements	None under $100k; Reviewed $100k - $500k, Audited above $500k
Ongoing Disclosure/Filing	None	Annual, Semi-Annual, Current Reports including audited financials	None	Annual Disclosure & Financials
Termination of Ongoing Reporting	N/A	Less than 300 holders of Reg A+ stock	N/A	Retirement of all Crowdfunded Securities
Transfer Restriction	None	None	1 Year	1 Year or to Issuer or Accredited
Shareholder Limit	None with conditions	None with conditions	2,000 accredited investors	Unlimited
Intermediary	None Required	None Required	None Required	Funding Portal or Broker-Dealer Required; Internet Portal Required
State Pre-emption	No; Coordinated Review	Yes	Yes; but expensive blue sky filing fees	Yes, but must make filing in home state and any state with greater than 50% of crowdfunders
Liability	Standard 12(a)(2) Liability	Standard 12(a)(2) Liability	Standard 12(a)(2) Liability	Portal Liability; Burden of Proof for "Diligence Defense" is on issuer
Investor Education Req.	None	None	None	Tests Required

Key	Favorable to Issuers	Moderate to Issuers	Unfavorable to Issuers

*Assumes that the proposed Reg D rules related to pre-filing, filing of general solicitation materials, etc. are not adopted.

Source: Seedinvest.com

Structure

- Investor puts up the money
- Developer/Promoter/Sponsor does all the work
  - Requirement for some equity (“skin” in the game)
  - Earns a “carried interest” or a “promote” or “sweat equity”
- Share the profits
  - A few details……

Structure Issues

1. How to share (allocate) cash flow

   - Economic “deal” issue

2. How to share (allocate) tax attributes

   - Complexity this creates

Deal Structure

- Share Cash Flow
  - Sponsor/Manager/Promoter/Developer
  - Investor (the “money”)

- Sponsor Goal
  - Collect on-going fees
  - Create an upside “equity” (type) interest (the “Promote”)

- Investor Goal
  - Achieve high risk-adjusted return
  - Make sure “promote” is reasonable
    - Often the entire comp structure is called the “promote”

Deal Structure – Sponsor Compensation

- The equity "Promote"

- Acquisition Fee
- Disposition Fee

- Asset Management Fee
- Property Management Fee

- Entity/Capital Fee
  - Committed funds
  - Contributed funds

Deal Structure

- Many different formats – complex, confusing, important
  - We'll consider two basic conceptual approaches

- Single deal – historic model
  - Ch18
  - Promote kicks in during holding period (operations)

- Multi-deal - Private Equity Model
  - Ch23
  - Promote back-ended only after IRR hurdles (See Appendix slides)

Deal Structure – Ch18 - Concepts

- Chapter example separates “Operations” from “Sale”
  - This bifurcation of distribution rules is different than typical private equity model (more later)
- Sharing Cash Flow – Operations
  - In Proportion
    - Pari Passu distribution
  - Preferred Distribution
    - Disproportionate sharing
    - Preferred Return
    - Cumulative vs. non-cumulative
    - Priority payback
    - “Promote”
  - Specified Fees – usually entirely separate

Deal Structure

- Sharing Cash Flow – Property Sale
  - Repay any debt
  - Return of initial investment (if not repaid previously)
  - Remainder Distributed
    - Predetermined portions
    - IRR Preference or "catch-up" on Capital
    - IRR Lookback (caps the return to money partner)

- Need for "Waterfall Analysis" of cash flow

Deal Structure Example Ch18

Investor Contribution (LP):	$45,000,000	90%
GP Contribution:	$ 5,000,000	10%
Total Amount:	$50,000,000	100%

Economic "Deal" (who gets cash flow)

Operations:
- 5% non-cum pref to LP (non-cum)
- 5% non-cum pref to GP
- Then, 50/50

Sale Proceeds:
- Payback of LP Investment
- Payback of GP Investment
- 100% to LP until 12% IRR achieved
- Then, 50/50

- Excel file Ch18 IRR Pref

Waterfall Analysis

Partnership Agreement

- Investors have additional analysis
  - What’s in the agreement?

- Evaluating the Investment
  - Risk & return of comparable investments
  - Third party syndicators involved?
  - Compensation to syndicator and/or operator
    - General partner “carve out” of fees
    - Is there an equity investment by the operator?
    - What is the “promote”?

Partnership Agreement

- Financial Considerations
  - Initial equity contributions
  - Provision for “future assessments” (more $)
  - Distributions & allocations of tax attributes
    - Special allocation of tax attributes
  - **Capital accounts**
    - Tracking money (*capital in* and *distributions out*)
    - Tracking tax attributes (allocations)
    - Complexity and reconciliation.

Entity Considerations: **Summary**

- Real estate CFs separated from investor CFs
- Deal IRR ≠ Investor IRR
    - Promoter carves out some upside

- Another "layer" of analysis.
    - NOI (unleveraged property return)
    - BTCF (after debt service – or leveraged return)
    - Allocation to partners *[reserves/capital calls]*
        - Partner CF
        - Finally, Partner can do ATCF analysis

Partnership Agreement : Taxes?

- Flow-thru entity
- Substantial Economic Effect (Tax req't)
  - Do tax "special allocations" align with actual distributions?
  - Was an allocation accounted for by an adjustment to the capital account?
- Equalizing Capital Accounts (Reconciliation)
  - Adjust cash distribution to partners
  - Change the allocation of the gain from sale
    - Gain charge-back methods and concepts

Examples

1. Economic “deal” structure
   - Unleveraged
   - Excel file Ch18 IRR Pref
     - *Should have been reviewed with earlier slide*
2. Capital Accounts and Partner Tax Issues
   - Excel file Ch18 Partners (Tax)
   - *Advanced issues – beyond scope of this course*

APPENDIX 1
Deal Structure – Private Equity Format

- Overall IRR Hurdle(s)
  - Before sponsor promote kicks in
  - Independent of fees
    - Still negotiated and charged
- See Excel Ch23
- Deal Example (Ch23)
    - $1 million investment
    - 100% funded by investor (this simplifies – we can discuss)
    - 20% CF “promote”; only after 10% IRR Hurdle
      - Cumulative, annually compounded

APPENDIX 1 continued
Waterfall issues

- Definition of “promote”
  - Is it clearly indicated and separate from equity?
  - More complex that initially apparent

- Determining the hurdles

- Applying the hurdles
  - Are the IRR hurdles as calculated:
    - To the deal
    - To the equity

Appendix 2 Trends – P3 Deals

- Public-Private Partnerships (P3)
  - Complex joint ventures between public (government) and private sectors
  - Creative financing models allowing government to finance infrastructure with private funds
  - Risk sharing