From the desk of Vladimir Turkeltaub, MS, CPA, EA

Real Estate investing: How to make all participants happy?

In general, any real estate project is financed through a combination of debt and equity. Developers/Sponsors (the term “Developers” is used below) are usually equity investors – they create a limited partnership or a Limited Liability Company (LP/LLC) that owns the project and contribute their own funds in exchange for a percentage of ownership of the created entity. The created entity buys and owns the real estate property.

In smaller projects, institutions, such as banks, serve usually as debt inventors – they offer loans with real estate as a collateral. Banks’ willingness to loan money depends on loan to property value ratio. One should expect it to be somewhere between 60% and 75%.

Private investors participate in both debt and equity financing. Return on their investment should justify the inherent risk of a project.

Investors and developers might set certain financial goals for different periods of the project when either inventors or developers want to receive disproportionate return on their investments. Developers receiving profits disproportionately higher than their capital contributions is known as “carried interest” or “promote”. The expected rate of return when the project reaches certain goals is called “hurdle rate”.

Below I will try to describe the legally available financing structures for developers and private investors that deliver desirable flexibility in generating return on the investment in real estate projects.   Note that acceptable scenario depends not only on the type of a project but also on some other factors such as short and long term tax consequences for example.

Scenario 1. We are lenders

In this scenario investors serve as lenders to the developers. Usually these are non-recourse loans that are not guaranteed by any collateral: non-recourse debt financing. Anticipated interest rates should justify the risk for the investors. Interest of the loan does not have to be fixed for the duration of the loan. The rate can change as certain milestones are reached.

This type of financing might not be suitable for some investors especially those who use retirement funds or who are concerned with immediate tax implications.

Scenario 2. We are partners

Equity financing implies that investors contribute assets – usually cash or cash equivalents – in LP/LLC in exchange for a percent of ownership. The percent of ownership is called interest in the entity. Profits and losses are split based on the percentage of ownership which does not necessarily have to correspond to the percentage of the capital contributed.

Usually it is advisable to create different types of ownership – different classes of units – for developers who are considered managing partners and investors who are considered limited partners. Developers hold units of Class A which entitle them to receive share of profits and to participate in management decisions. Class B is distributed among investors. It entitles them to percentage of profits only. Please note that the default laws are different in each state. You should create an operating agreement that specifies the voting rights of the managing partners.

Obviously, the income received in this type of the arrangement is directly correlated to the percentage of interest in the entity that each of the partners own. Flexibility in changing the percentage of profit is limited to the sale of the interest.

There is no income recognition on the initial contribution of a partner to the partnership. Tax basis for the partnership interest is equal to the amount of cash contributed. Partner's capital account equals partner's tax basis.

This is the most straightforward approach for LP/LLC owners and their accountants. But it very rarely satisfies investors as private investors expect guaranteed return on their investment even if the project does not generate adequate cash flow and developers expect higher returns when the investment goals are reached and exceeded. Basically, developers are looking for bonuses in case their delivery to the investors meets or exceeds the set goals.

Scenario 3. We are both lenders and partners

This is the most flexible and in my opinion preferred approach. Investors protect themselves by two different steps. First, they obtain a percentage of ownership in exchange for a certain initial contribution. And, as mentioned above, the percentage of interest does not have to have direct correlation with the percentage of capital contributed. Secondly, debt financing by the investors should provide desired cash flow by establishing interest rate schedule on the loans. The schedule should address the initial rate as well as future rate tied to achievement of certain investment goals.

Additional investor protection can be accomplished through what is known as mezzanine financing. Mezzanine financing means securing the right to receive pre-established interest in the equity in the LP/LLC in case of cash flow interruption. Please note that mezzanine debt is subordinate to all other types of debt. It is the last one to be satisfied if anything goes wrong before the payout of owner's own equity.

Putting it all together

I will be using the word "Profit" here which means the profit calculated using Generally Accepted Accounting Principles (GAAP).   For the discussion that follows there is no difference whatsoever between the profit calculated using GAAP or tax law.

Let's be realistic. GP properly assume that they bear the burden of combined risk and work related to any project. They view LP contribution and a small component part of overall strategy of any investor whose cash payout is more than adequate for the risk he is subject to.

GP cash flow from the real estate project is usually their main income. This means that GP always try to withdraw their own money as soon as possible to remove any possible risk related to the project, increase their personal cash flow, and enjoy higher promote percentages. Interestingly, goals of GP and LP coincide. Both sides have risk aversion. But GP control the project while LP have to trust GP in delivering the promised project performance.

Typically, a multitiered structure is created to satisfy both GP and LP. This structure uses equity and debt mechanism at the same time. The structure depends on whether it is an income generating project such as rental real estate or a flip when property is bought, expeditiously improved, and then sold hopefully at a profit.

For the flip, investors are usually debt investors. They might hedge their risk by partial ownership of the project.   They receive their principal when the property is sold.

For rental projects, which usually have longer terms the available cash flow is split per a predetermined schedule. The best option is to utilize Scenario 3 from above. It might look something like this.

First, GP receive compensation/fees related to the project. They are entitled to receive compensation for providing services and for their decision making. There are different fees that in theory can be applicable. Some of the fees to be mentioned are: property management, property maintenance, project money management, asset management, construction management, lease management, financial management, etc. The total range of these fees should be between 2% and 5% of initial GP and LP investments. This may be a guaranteed payment or a deferred one until the cash flow can support payouts of the fees. GP sometimes decide to forfeit their fees during initial stages of the project.

Secondly, LP receive a fixed percent on their initial investment. This percentage is normally set somewhere in the 10-15% range depending on the scarcity of money and risk associated with a particular investment. This is typically a guaranteed payment.

Thirdly, the next batch is split between GP and LP until a pre-established hurdle is reached. A fair arrangement is 50/50 between GP and LP till LP get 20% of total interest on their investment. The fourth and final step of cash splitting normally tilts towards the GP to provide them with bonus (promote) for the outstanding performance.

Note that all four steps above affect the final profit of the project.

Profit and loss distribution is an additional icing on the cake for LP. At this stage of the project profit is randomly available. LP cannot utilize the loss for tax purposes, as it is a passive loss. However, they can apply it against other passive income if they have any or carry it forward until they sell the interest in the investment.

Return of the principal happens either on the sale of interest in the investment or at the property refinance. Refinance should not affect GP/LP interest in the entity and corresponding split of profit and loss if no explicit sale of interest by any of the partners occurred. When LP receive back their initial investment and keep the interest in the property their cash flow from the project normally goes down to reflect the increased promote for GP and elimination of any risk to LP.

Sheltered Income

One of the attractiveness of the real estate investment is the ability to have positive cash flow even when the project does not generate day-to-day profit. Both GAAP and tax law profit calculations include depreciation expense. Depreciation expense means that the cost of an asset is deducted as an expense over the useful life of the asset and not in the year when this asset started being used in the business. Thus, the real cash flow is higher than the profit of the business on the amount of the depreciation taken.

Here is an example that will help to clarify my point. Let’s assume that my calculated profit from the rental activity is zero. Evidently my tax liability will also be zero as there is no taxable income. Let’s also assume that my original cost of the building was $275,000 and that it is residential. My yearly amount of depreciation is around $10,000. It means that after all rents are collected and all expenses are paid I will have

$10,000 left in the bank. A $10,000 question is: Can I write myself a check for $10,000 and will there be any tax consequences on this cash distribution? Here is the catch: Yes, I can use this money and pay no tax.

Sounds like a tax shelter. I got the money free of tax and it is absolutely legal. Tax shelter it is not. When I sell my interest in the property I will have to pay taxes on all of this ‘sheltered’ cash. This is known as recapture of depreciation deduction. The Federal government imposes 25% tax rate on these amounts. The states tax this amount at standard marginal tax rates.

The distribution of this ‘sheltered’ income to GP/LP is a decision made by GP individually for each project. Usually the cash is distributed to the owners’ proportionally to their share of interest in the entity. Sometimes GP use the logic, unfair in the opinion of the author, that LP accumulated enough losses to cover the recapture of the taken depreciation deduction and no sheltered income should be shared with them. It usually takes additional effort to track disproportionate distribution. Please also beware that the distribution in excess of basis will cause the recognition of gain on the distribution.

And as always consult your CPA or tax advisor before making any decisions.