JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

II. CLASSES AT THE UNIVERSITY OF WISCONSIN--MADISON

L. Business 850: Real Estate Equity Investment

3. Various Lecture and Discussion Notes

b. Assorted student transcriptions of lectures

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Real Estate 850
Lecture 14, March 23, 1987

Bill Morrell, Real Estate Advisor for Alexander Brown

Public pension funds have been behind corporate brother in doing new things.

Roger Meyer got Oregon Public Employees Retirement System interested in investing in real estate in 1978-79 long before other public funds.

Lesson is get entrpreneurial oriented persons on boards.

Alex Brown in Baltimore is involved in REIT's.

Oregon went to Alex Brown for REIT.

Couldn't find one to buy so decided to invest in RE directly.

Developer owns 50% of projects Oregon buys.

In 1985 began program to buy series of REIT's.

Wanted to buy investment that allows them to increase or decrease their share of real estate easily.

Can do that with REIT's.

Marketability and liquidity.

Greater diversification than direct portfolio.

Can get into types of properties that they can't do on their own - community shopping centers, apartments.

Ojectives

Want you to buy companies, usually REIT's, where income and capital appreciation that investor receives comes directly from underlying real estate that's owned in portfolios of companies in which we own shares.

Increased cash flow, increased depreciation over time.

Doing it thru REIT vehicle.

Important to consider this a real estate investment.

Makes sense for pension funds, especially small.

Not enough money to buy directly.

Advantages to this type investment.

Assets in R. E. securities fund are marketable securities.

Can increase or decrease allocations to real estate.

Greater flexibility.

Investor gets 3 kinds of diversification.

1. Geographical.

2. By product or project (apartments, shopping centers).

3. Management style.

Since 1978 REITS have performed very well. Some 15 to 20% returns.

Have very high current yields.

Makes them attractive from a common stock investment standpoint.

New tax law puts a great premium on current income.

REITS have to buy properties that are already generating a cash flow.

To maintain dividends.

Slightly less risky part of the market.

Keeps them from making major mistakes.

Have tended to invest in a niche.

Basically 3 to 15 million size.

Not as many players in this market - kept them from markets that were being badly overbid.

REIT's that they're investing in are infinite.

Management has responsibility and willingness to not only improve their existing properties but to add new properties to their portfolio.

Growth occurs.

Most of their REIT's appraise their properties each year.

Have advantage of knowing what properties are worth.

Try to find properties where market price is below appraisal.

Typically REIT's have sold at discount because of bad experience in 70's.

Another impact of new tax law:

Has led a number of very good real estate companies to consider forming REIT as way to get capital for future growth.

Will greatly increase the number of institutional quality REIT's that are out there and make it a better market.

A large number of pension have set up real estate security funds in the last 6 to 8 months.

Biggest is Fidelity Management group in Boston.

Guidelines they use in investing in these types of securities.

Invest in REIT's that allow the fund to benefit from the income and capital depreciation of the underlying real estate.

Concentrate only on those companies with portfolio of existing income producing properties.

Invest in companies with a specific market niche.

Companies with strong regional flavor.

Look for companies with conservative debt equity ratios that can raise additional capital at reasonable rates.

Concentrate on companies that own shopping centers, industrial properties, apartments and nursing homes.

Don't invest in REIT's that make mortgage loans without equity enhancements.

Don't do anything with REIT's that invest in construction loans.

Don't do anything with residential home builders or land development companies.

Monitor dividend coverage ratios. There have been 6 or 8 good REIT's that have cut their dividends. Bad sign.

Long-term real estate oriented investors.

Not afraid to invest in areas which depressed right now.

Have third category of investments - private (placements)

Usually niche oriented

(Kroger) co.

Started suburban office building business in 1950's.

Have 15 or 20 suburban office parks in So-Ea US.

Have 2 companies.

Kroger Properties

Build office buildings

Standard cookie-cutter type

Can keep costs well below competitors

Charge lower rents

Can keep tenants

Kroger Company

Buys the completed building once it reaches 90 or 95% occupancy.

Kroger Appreciation Notes

Give you a 9% coupon each year

Give you another percent equal to percent which selected properties have increased in value from one year to the next.

They take shares in Kroger Co. instead of additional interest.

Participating mortgage (Graaskamp)

At one time designed to be variable interest note.

Now being used as a back-handed equity because pension funds feel better being a creditor than being an owner.

They initially did convertible mortgages w/Oregon

Switched over to participating because better position

Participating mortgage did extremely well up until interest rates started to drop.

Market was dead for about 8-12 months.

No developer/owner wanted to do participating mortgage when he could get straight debt at 100 basis points higher than participating mortgage and not give up any equity interest.

With new tax law they've come back.

It's hard to find equity sources now.

A way for developer/owner to cash out, get 100% of his financing and get a lower interest rate.

Rates have changed dramatically.

Coupon rate could be only 8 or 8-1/2...

Tape flipped.

Also gives them an owner/developer who's in the project with them with his entrepreneurial skills, will make it a better project because he has a percent of the deal.

REIT not only public instrument but a rather neat private placements financing device.

Several funds out designed primarily for a selected investor.

Structured as REIT's because it makes neat corporate package.

You get a full conduit pass-thru at a time when the investors may have different tax status.

Example: Pension fund can be in leverage real estate but University Endowment cannot have investment in leverage real estate where the leverage exceeds the basis on the property - called unrelated business income, becomes taxable. REIT solves that problem in that only shares in the trust which are not leveraged and therefore they do not have unrelated business income as compared limited partnership type of venture in which the characteristics of the asset pass thru to the investor.

Some versions have split underwriting in which majority go to tax exempt and the rest to private investor.

He's taxed at his point of ownership.

May pay a small premium for his share.

There's a market made in the shares so pension plan can sell their shares at a future point.

In the meantime they buy at less than the private investor.

Get much more scale to the real estate trust than they've traditionally been able to get.

Hybrid trusts in terms of marketing of their shares because taxable character falls on each individual investor.

Interesting article out presently as whether real estate investment trusts provide the same kind of co-variants to the stock market as real estate asset does.

Initial evidence is trust shares tend to behave more like stock than like a real asset.

Some are arguing that you lose the co-variant aspects of real estate for diversification.

Finite real estate trust may permit the trust to behave more like real estate in the marketplace and less like stocks.

In the past the rap on real estate trusts has been the price has never reflected correctly the underlying asset.

No way for investor to know what asset was worth.

Booked the asset at purchase price and took advantage of every bit of accelerated depreciation to keep as much income within the trust as possible so book value steadily declining.

No way of looking at the book to figure out where they're at and what should the book value be relative to the market value of the share.

Most did not report appraised value annually for the underlying asset.

Therefore market price slipped. Became an income security.

People are now looking for ways to see if the real estate trust can be created in such a way that it has the attributes of the underlying real estate in terms of its investment co-variant relationships to other kinds of securities.

Private REITS very useful local device.

- Often goes together w/development company.
- Very useful for financing development.
- University Physicians
  - Own their own building with private trust
  - Each Jan. 31st doctors leaving sell and those coming in buy.
    - Earnings are well tax-sheltered.
    - Doctors get increments over their fees.
  - Real estate very useful for this.
  - Alternative is master limited partnership.
    - Has appropriate characteristics.
    - Stronger conduit than the trust.
    - High target for IRS tax reform.
    - Tremendous accounting complexity.

BUSINESS 850
LECTURE 1-20-88

Real estate is simply a statement of Hope; it is based on Hope and is ironic, because we are making a premise of a 10-30 year investment. It presumes social, cultural, and technical activities will move forward at such a pace that theré will be enough time to change, improvise, and enough opportunity for creative advancement. It is a committment on Faith and then rationalized.

Real estate is based on the Future,-futuristic, extrapolations from what we think we know. We move from irrational Hope to rationalized attitudes and come up with an intellectual strategy. It is a basic dichotomy: real estate as assumptions about the future vs our ability to adjust in the present and survive in a changing world.

Real estate is a long term view, with leaping assumptions about the future. Helping the dichotomy is the question: How long is the time line of the Hope? In trying to get a handle on Hope and structuring it into a rational attitude, how often are we affected by <u>topical</u> (ie. investing against the tide-contrarian position against short term beliefs) short term attitudes? Pension funds can be more patient than the need to buy food and clothing from the sale as with the individual. Thus there is the time line of a pension fund vs that of the home buyer.

> British pension investment strategy(article): invest just before the country flips into socialism, because then you will have a monopoly since there will be no more entrepreneurial incentive to create supply. America is moving into an era of socialism--this is not a topical issue, but an investment strategy.

Observe current attitudes. We are going to run out of oil... by the year 2000 gas will be $2.50 a gallon. We need a responsible energy program. Thus, suburban and regional center are not teh best idea: neighborhood shopping centers which we can walk or bike to must be included in an investment strategy of a pension fund 20 years from now.

Electricity--atomically generated: the life cycle cost of atomic plants are negative; it costs more to run and build it than the power is worth--maybe they will be replaced or shut down.

If real estate is futuristic, what is your premise about the future and how far out are yóu taking that premise?

> Elderly Housing--40 years from now no one will be there; all young people are moving out. Alma is dying. How will the mortgage be paid? Housing Policy--(under Section 8) mostly elderly, permitted to live at 30% of their income; under contracts that expire in 6-8 years and will probably phase out in 12. There is no government policy as yet to deal with all of the homeless that will result. But investor expectations downstream--perhaps that under Section 8 the govt. will come out and rent the space which exceeds the elderly's income. Who is wrong?

Real estate is based on extrapolating cash flows and taking them forward in a vacuum; not looking at the anticipated context 5-10 years downstream. What is the Hope of the guys going in?

The profession real estate operator works by a series of short runs because he bases it on Fees managing, building, securitizing, brokering the project, syndicating, leasing. The real pro doesn't own anything: he structures the deals so that if for some reason unforeseen to him something occurs, he can share on the upside with a participation %, otherwise he can take a walk. The individual equity investor doesn't have a true sense of what he is doing.

Real estate is tied to future Money Markets, in a macro context--not just a micro. If Tokyo and Bonn don't like the next president, they don't have to support the treasury rate--and interest rates will move before the '88 election--and a recession will start before the election, in which case the Republicans would be dead. Saloman Bros. predicts interest rates will be 11-11.5% by the 3rd quarter of '88--note the impact on the resale of real estate.

And does the political agency have much to say anymore about interest rates? We have a trade deficit whereby people own your butt, and a federal deficit whereby people who buy your bonds own your butt. And real estate interest rates will be a function of these and + a considerable loading.

The debt cover ratio, instead of the loan to value ratio, is determining what you can pay for a project...Resulting in the need for more equity, less debt.

Liquidity is the objective of any enterprise to cover operating expenses(Drucker's article). Liquidity need of each enterprise increases each year; need more and more liquid to cover costs. It gives you the flexibility to survive.

> Builders lost last time because they were carrying inventory in land and unfinished tenant space. Dump it now and take options on land 2 years from now--the recession will begin by 88-89, no one will be buying houses--the land will sink you, get rid of it.

We tend to use goals and ratios that may not be relevant to our Hopes or future reality.

Real estate investment is passive and long term. Development is the exploitation of the short term.--exploitation of a short term opportunity and a spread.

The essential strategy is to improve your spread by A) enhancing the monopoly characteristics of the property and thus enhance revenues; or, B) Reduce costs including the cost of funds.

Active investors ie. developers create spread through opportunism at the Micro level: buy low sell high; insider information is very important.

Passive investors enhance the spread because of timing and the ability to arbitrage typically between money markets and also skill levels. Example: Olympia and York takeover(speculation on a commodity of sq. ft. of office space. He needs to manage it well, but enhances it because he can operate on a timing basis--buy low sell high; but he can arbitrage by reaching money markets that others can't reach, ie. current CMOs--the individual pays at retail of 10.5% on his mortgage, but the guy who buys the whole portfolio goes into the money market and bets against the treasury curve and gets an interest rate of 6.5% + 1% credit enhancement = a cost of funds of 7.5%. Take the present value of this and it works out real well.

He is arbitraging as a passive investor--never sees a single mortgage or house.

The essence of a strategy and tactics in real estate, for both the active and passive investor is to exploit the institutional and technical details at the appropriate time in order to achieve a spread. Example: Shidler is a consummate artist of operating within the guidelines of FASB rules and creating illusionary profits for corporations.

One of the problems with active and passive investors is that the relationship to real estate creates an EMOTIONAL factor; they are not always rational. Psychic income is important and probably accounts for 1% on the cap rate--because you can show your pride in real estate.

795 lecture

Late FEB or early March: Jerry Clays, JMB: Cadillac -Fairview deal

March 25: Todd Mansfield & Bill Rissell, Disney Development
April 8: Jay Shidler
April 29: Steve Jarkow, REIT formation and Lincoln Properties

Comments on the Futurism of Energy, Social/Political trends,--from the Economist· Entrepreneurship, Hope, and Strategy: possibilities of the future(in the articles). Sternlieb's view of cities as the home of the transfer payment--citizens are moving out and employers will follow.

Strategies of real estate for the long term: suggests an infinite degree of investment attitudes based on your hopes about the future-----This is what the entire first part of the lecture addresses.

Part two of the lecture addresses the economic scenarios about the future; add up the scenarios and **Establish the premise from which you operate.**

Scenario #1. Most industrialism in the US will go into a smooth transition into a new economic role with less significance in the world and will resolve social problems; there wil be steady economic growth with a few brief recessions, gradually declining Unemployment, and a decline in manufacturing moving toward a service economy. Lower interest rates into the millenium.

Scenario #2: Erratic transition, interrupted by recessions the like of the 1970's; economic growth is sporadic with stagnations and negative growth; aggregate unemployment will range from 7-12% and there will be regional pockets of unemployment, even poakets of rebellion in areas not getting their fair share of economic opportunity; debt loads remain high and there are increasing defaults; there will be considerable rescheduling of payments to protect the credibility of our financial institutions---$25-50 billion losses in S&Ls, but we can't afford to close some because FSLDIC is bankrupt; the problem is less severe with banks because they don't need to report losses, the statement doesn't need to reflect underlying value of the asset, but instead can be the amount of the note. Also, pressures to control deficits will cause increased taxes and severe spending adjustments.

> Where are the hot areas: New England because more defense spending goes there than anywhere in the US. If cuts in the budget to defense, then what? Plus, they also have Senators in key positions on important boards.
>
> Will real estate moderate gradually?--Will deflationary forces from the decline of excess capacity and higher debt loads keep pressure on borrowers?
>
> And what of the trade deficit? If interest rates fall, less foreign capital comes here...this scenario is not necessarily good for real estate.--As the dollar falls some jobs will come home. Example: Tandy saw cheaper labor in the south than in Korea; but it comes back to non-unionized, non-structured labor pools that can be exploited--look at the new Immigration law's effect if enforced in 1988 not enough help to pick cabbages or to work in your plant---All things work together.

Scenario #3: Economic disruptions; high defaults on foreign and domestic loans; the deficit will never get under control and we will need drastic control measures; rising unemployment in the areas of defense and manufacturing and spreading to other industries; real estate interest rates will stay high in the 80s: A) reflective of legislation and; B) to protect us from a run on the dollar by overseas money.

Scenario #4: Social disruption in cities where now 25% of the population is in poverty and getting restless.

Whichever scenario you take should influence your view of real estate. Put into action in the form of Development(exploit the opportunity of Active investment) or Investment(use diversification because we don't know where lighting will hit next).

To what degree is systemmatic risk carrying more significance then non-systemmatic in that it can be relatively easily stabilized?

Thus, with real estate investment, we must make a mushy set of assumtpions about the future context we are operating in and having a hope about the future, otherwise we will go into CDs and Treasury Bonds.

What is the hope and framework in which we build a rationalized, systemmatic method of selection and management?

Our Method, Strategy has 2 characteristics:

-increase Spendable income

-increase Net Worth so that we can pass it on to the next generation

(Reagan has allowed the middle class t pass on net worth by raising the exemption from the federal estate tax so to pass it with marginal liquidity exposure.

RE as an Equity Investment - Graaskamp

file name: notes850
tape: 1A1
25 ~~19~~ Jan 1988

R.Est. is based on hope
Heirarchy of concerns: 7

1 pol. exposure
2 the degree of mkt monopoly
3 deg. of mgmt intensiveness
4 economic/financial aspect of the enterprise
5 decision pts that allow for an abrupt exit (length of the committment)
6 Fed and st. inc. tax attributes
7 "fit" of the RE to the estate or distribution plan

In detail:

1 Pol expos. : 3 forms
   a changing land use patterns developers ask when am I vested ? (protected from land use changes)
   b sibsidy to the competition (TIF, catastrophy fin- financing from gvt., sect 8 housing etc..)
   c Flip side - what if your proj is subsidized and the subs. ends?
     IE; is gvt subsidizing supply or demand?

2 Degree of Mkt monopoly :object is to create a customer- 4 ways
   a direct contral of that customerL my bank, my bldg, my loan, you'll lease here.
   b reciprocity: bank would lease the space at a big discount to its good customers.
   c channeled demand: physical geological constraints ie: San Fran., Marthas Vinyard
     channeled as far as infrastructure, utilities among others. Synonym; monopoly
   d Mkt Research - identify the mkt through research

NOTICE THE NEED TO OPERATE IN A MONOPOLISTIC ENVIRONMENT. THERE IS CHRONIC OVERSUPPLY IN ALL FORMS OF R.E. THUS THE NEED FOR SOME TYPE OF CUSTOMER CONTROL.

3 degree of mgt intensity: stability or unstability of enter- prise depends on mgt to a high degree.
   Get around this thru tripple net lease back
   making mgt highly mechanized & thus highly replaceable (Western Sizzlin vs. gourmet)

4 Financial/economic (notice how far down the list)
   what profit ctrs are appropriate for this investor? REIT, RELP, passive, active?land, devlpmt, leasing, mgmt., which can we do & which must be farmed out.
   Also, what time frame for investment, concerning estimates of <u>expense</u>, <u>revenue</u>, and a risk mgmt device to control the variance bet. the two.
      a control the variance thru: leases, nonrecourse fin- ancing (if project fails, turn it back to the lender w/o liability), master leases (guarentee a min rev line
      b measures of variance: Cash Break Even Pt.

4b (cnt'd) to what deg. fixed cost vbl expense? the greater it is the more critical it is that youcreate a monopoly for your R.E.

c measures of risk and variance; diff. for each proj.

5 decision pts.: At what pt. on time line can/should you bail out.

can you structure the deal so that you have a min sunk cost throughout?

Skillful procrastenation: taking time to pick the best path through the proj, study all aspects. Retain control but not have to make up your mind right away!

6 Tax

7 Estate Plans <u>To be discussed later</u>

File : Notes951
Class : Jan 27, 1988

Continuation of The Heirarchies of Concerns (there are 7. Here we'll continue with the last 2 - Taxes and Estates)

6. Taxes : Fed and St. Short term and long term
   a. short term - to minimize or avoid paying
   b. long term - crossover point #1= when tax depreciation is no longer sufficient to cover the principal pmts due
   c. Crossover Pt. #2 = when the tax on resale exceeds the net cashover available from the sale price. (project doing well; yourefinance; new loan exceeds the old basis; when time to sell, the tot tax bet sales pr. and now depreciated basis exceeds the tot net realizable gain from sale).
      Ask-can I net enough on resale to be ahead or at least break even?

AVOID THE CROSSOVER TAX TRAPS

   d. Ploys available :
      1. postponement
      2. leveling of the income to take advantage of the progressove tax rates
      3. shifting of the inc. to lower tax entities
      4. avoidance : sale of home after 59 1/2 $125000 freebee

7. Estate or Distribution plan
   a. individuals - when you die granted a stepped up basis don't haver to pay capital gains on the estate (the duplex youpassed down to heirs begins new basis at current value & you can start redepreciating it at that level

Tax and estate plans are complicated by the valuation of the project Valuation window opens at date of death til 6 mos. later. The lowest value app;ies. This mitigates possible market crashes like 1939.

This is expensive process. You should know pre mortum tha values especially so as not to fall into "crossover trap #2"

Continuity. Plan for the efficient transferral of your holdings. you control it not events. Individuals and corporations as well. (to understand the corp. is to know who the steak holders are. Gen partners who do not plan for their demist could force an early and unwanted (hi tax) liquidation od the partnership.

I. To succeed be creative, have a sense of cost controls, and understand gvt regs

II. Investment mkt has gone thru diff stages (fads)
   A. Finance driven - take advantage of spread in real/nominal int. long term loans, 3rd party fin leverage
      Not a pure RE invest. rather a play (futures) on money
   B. Tax driven - make $ by losing $ as long as cash loss/yr was less than tax savings to other inc.
   C. Fee driven - professionals milking a project by excessive fees
   D. Subsidy driven

These are not investments they are <u>plays</u>

III. Two rational factors make it an investment excluding psychic inc)
   1. increase spendable cash
   2. " liquidating val. of net worth
   A. the above fads might play a part but are not the essence

IV. Classical appraisal theory assumes
   A. NOI was constant or would fall along a predictable line and you could simply divide this by a cap rate that included:
      1. constant return on capital 2. a recapture of capital
      3. that inc was an instant inv. call broker,buy mall,done.
      4. Fixed pt of time in which you exited the investment
      5. you held investment for its entire useful life.
   B. this was asset mgmt. was the simple NPV positive. If so the invest. was good, justified.
      <u>the capital asset pricing model</u>

V. Next came Ellwood. He bought the above assumptions except #5
   could sell, refinance, or some modification of position
   5 to 10 yr forecast is more realistic and therefore figure on getting most of the capital back from resale vice income. De-emphasize recapture factor in the cap rate because of inflation nowadays there might be a negative recapture factor - more capital back on resale than we put into deal in 1st place.
   Recognized that diff sources of capital have diff costs
   " " there were assorted equity interests too and each interest has its own perception of risk thus its own capital asset pr. model
   View RE not as an inc. prod. asset but as a manipulation of liabilities

VI. Next school: Change in Net Worth, Changr in Spendable Cash
   Traditional assumptions are abandoned.
   A. You trickle in and clamber out of investment
   B. Income no longer on a predictable mathematical line
      1. Many of the equity positions dont get their gains from NOI phase but from the expense phase: construction co., leasing co., insurance co., etc. taking profits in the process of getting the property ready for NOI
      2. Lease structures which grant the first 5 yrs free in order to compete for the tenants

C. the only way ro account foer all this is through tracking spendable cash

Accountants are going towards economic prod., asset mgmt., & msmt. The RE fraternity is moving towards cash mgmt. The conflict comes when you must value the proj.. If in fact concessions were made and the tenant doesnt pay 9or pays at a reduced rate) for the first few periods the proj. can not be valued by NOI cap rates; the traditional way.

It boils down to the issue (perception) of solvency measured by income, or, Net worthe measure of values vs. liabilities
The banks in Texas are solvent but have negative net worths!

Cash. The P.V. of distributable cash to account for irregularities in the income line.

Determine how often will you distribute the cash.

Very difficult to measure performance in RE because of its long term nature and periodic interruptions in the revenue line. Valuation is not day to day process.

z '7

FILE. NOTES853
CLASS : FEB 1, 1988

I. Cash flow models calculated with greater detail

A. Expected reciept

1 base rent : In gap account. can be bad. eg: no cash flow for 1st 3 of 5 years ($10/yr contract , 18.50/yr for last 2 yrs). I.E. continued invest but negative cash flow.
PRO: known contractual income stream
can be sculptured to fit tenant needs

2 index to base rent (annual adjustmenr)
Converts base rent to step rent. usually steps up but can go down.
good for investoe - inflation fighter
bad for tenant could hamper ability to pay the rent. maybe he'll go broke, not renew, or break lease
careful win win must be structured

3 percentage rent % of sales. Tells investor what kind of property and its risk factors. High sales tenant high marginal participation. LOW SALES VOLUME could mean opportunity for investor to buy off the tenant's remaining lease terms.

DON'T JUST LOOK AT $ AMOUNT, BUT ALSO WHAT DO THEY TELL YOU ABOUT THE TENANT AND YOUR RISK!

4 Amortized tenant improvement : Upon sale, the large imp's made to get the tenant in may not have been fully amor tized Seller should not forget to discount this upon sale. If tenant makes improvements himsrlf, he's got a vested interest. It is a sign of a quality tenant. ten. imp. clauses tell a story. Good for risk averse long termers. Bad if not ammort. & you sell early. & ten. sweat equity can be good too!

5 CAM : Common area maint. All areas come under cam - i interior and exterior areas. These fees typically give mgmt a 15 or 20% profit margin. THE INVESTOR SHOULD TAKE CARE NOT TO LET THIS CASH RESERVE FALL INTO THE CAPITALIZATION PROCESS. This profit center is a service component, and should not be bought at the same discount as the real est..

6 Reimbursables (annual pass thru) outlay by mgmt/owners recovered over time. in thr interim you lose interest.

7 Escalators with a stop good or bad depending where the stop is (how high) owner pays up to a certain amt, then tenant kicks in. Was tax stop indexed on 1st yr when none of the improvements showed up in the assesment? (annual review)

8 interest on reserves (quarterly sweep) Often times required by law (FHA) or by lender. How much, should be closely examined. reserve, sinking fund, there to protect the mortgage. Sellers will often try to hide these funds which can be substantial if project has bee around a long

time, then at closing add them to the dale price without having to capitalize them as part of the project. The interest on the reserves can be part of the income flow.

9 GVT transfer pmts EG the TIF funds can be included in the income stream, or guarentees by the small bus admin.

10 Total reciepts Value hidden in the leases that might be purchased or sold.

II. Loss os potential receipts

1. Vacancy loss: not only reflect the loss of base rent but but also reimbursements. Owners try to get tenant to cover the CAM fees lost so that 100% is still covered by the tenants. Sharp tenants refuse to cover more than typical V.R.'s for that type of bldg.
   - Concession losses can often be greater than V.L. Tenant improvements, lower rent, all to compete for tenants in an overbuilt mky.

2. Rent Collection losses: stem from the nature of the tenants. Do they have the net worth 9or the iclination) to continue to pay.[Houston firms left behind broke corporate shells and broken, uncollectable leases.

3. Reimbursement collection losses:

4. Recievables: Hinge on tenants willing ness and ability to pay as well as the owners ability to collect.

ANALYZE ALL POTENTIAL LOSSES FROM RECIEPTS TO ARRIVE AT REALISTIC REVENUE FROM OPS.

III. Actual revenues for operations

IV. Gross outlays for operations (should NEVER be "netted out")

1. CAM I
2. reimbursables I Note time delays ie. not netted
3. escalator items I
4. owners costs: Ask "what is the entity that I am evaluating"
   a. real est proper b. partnership or corporate psit
   c. entity which owns an equitable psit. in the R.E.

The RE has 1 set of costs and the Ownership has a 2nd set. Mgmt fees Vs liability, insurance costs. Each of A,B&C above have their own degrees of these costs. Asset mgr fees might take another .1%.

ASK WHETHER YOU ARE EVALUATING TEH R.E., THE PARTNERSHIP, OR THE PERFORMANCE OF THE CO-MINGLED FUND THAT OWNS THE PARTNERSHIP

5 refurbishments Too much implies shoddy const.
6. renewal tenant imps
7. renewal lease commissions
TOTAL OPERATING OUTLAYS

PROPERTY MGMT RESPONSIBLE FOR TODAYS CONTRACTS
ASSET MGMT " " TOMORROWS CONTRACTS

V. Total Cash From Operations

VI. Capital charges
1. interest pmts not necess. defined by ammortizing st. line
2. principal pmts reduced interest pmts. Sculptured financing.
3. capital imps.

VII. Net Cash from Ops before Taxes

+ transfers from cash reserves from previous period (in anticipation of expenses from some of the above)
+ net inc. in loan bal. outstanding (renegotiated terms, inc rents

VIII. Cash Avail. for Dist. &/or taxes

1. taxes: fed. and state and, as req'd, assessments on prop. such as Disney and surrounding hotels.
2. reserves retained in the enterprise before distributions. Such as requirement by contract to dist some funds to the community.

The investor is interested in a model which can handle the dynamic nature of all these in/outputs. Needs quarterly, semi, or annual.

Dollar amts are ok but ratios are a better toll for analysis. Which ratios? Risk and Return. Yield often thought of as a function of risk but an anomaly of R Est. is that Y is a function of the OPPOSITE of risk (the < the R, the > the Y).

Risk catagories: variance in: spendable cash
liquidating vakue of NET worth
Also look at relative risk/yield of R.E. Vs. other investments
Measures of yield. prospective and retrospective.
Retro: IRR, etc.. After all is said and done what is my rate of return. Most often type referred to.
Pro: How will I do if I continue to stay with the project for 1 more period? How long will it take me to move in and out?
1. Cash on cash - classic example of Pro.
ROR on equity (dn. pmt)

2. cash on sales proceeds avail. at the end of the previpos calculates opportunity cost of staying in the

3. Portfolio effect: $\frac{\text{Net search cost to find replacement}}{\text{Net premium for selling rhe portfolio}}$

you want this ratio to be <1
Ergo: portfolio avg's 9.5% cap rate but the whole portfolio is worth more to the big investor so he pays a premium for the package deal, like maybe 8.7% cap rate.
This spread is anothe type of prospective ror.

R.E. <u>investment</u> the profit is made at the purchase.
R.E. speculation, the profit is made upon the sale.

Bus. 850
Lecture/2/08/88

Options for owning realty by individuals include: 1. sole proprietorship, 2. general partnership, 3. limited partnership unit, 4. joint venture.

A "joint venture" for individuals we're talking about is a ground lease of some form or a master lease, a ground lease being a vacant site which someone else is going to develop & for which the individual receives rent & possibly some participation of the revenues of the improvements; a master lease suggests a property perhaps improved at another time (e.g. 30 or 40 yrs ago) & the family doesn't have the money to improve it, reposition it, market it & manage it, so they master lease it off to a developer who has 40-50 yrs. of ownership of the structure & can best improve the property, with the individual still getting the rent with some kind of kicker in it, maybe indexed with some small participation, but generally the master leasee creates the value & budget for improvements so he takes most of the profits.

These are the 2 types of "joint ventures" that an individual can do, i.e. small scale enough & distinct from some major project that the "heavy players" might do.

The individual can invest in 5. a real estate investment trust (REIT), 6. he can invest in a subchapter-S corp. (notice all of these up to this point are single-conduit entities); finally, the double-tax entity, i.e. 7. the small, family-held corp., can be the ownership entity.

We are ruling out for the moment types of securitization that might involve participation in a CMO or something of that sort, suggesting these are more financial instruments than they are real estate. We're also ruling out for the moment an investment in a publicly traded stock, although that would obviously be an alternative, i.e. you could go invest in Rouse or Northern Pacific or Disney (a fairly good-sized real estate operation). We're treating this as a stock market play as opposed to an ownership of real estate play.

Now what are the attributes? 1. First is scale, "What can I do with $10,000?", "How big a chip do I have to play with, and how much am I wise to put into a single entity?" 2. The second thing is control. 3. The third is intensity of management (distinct from control).

For instance, I might want to use a master limited partnership in which what the city was going to do with the property was well spelled out, e.g. the family doesn't want the exterior of the building changead because of the historical significance. This could be written into the limited partnership agreement beforehand, whereby an investor can exercise some control, as opposed to a REIT where you put your money in and "shut up". Once a limited partnership is underway you have 3 options: 1. vote with the rest of the limited partners to displace the general partner for malfeasance, 2. vote when you're gonna refinance, & 3. vote when you're gonna dissolve; otherwise you "shut up" because if you do more you're a general partner & become fully liable. The distinction here is between degree of control (in terms of overall strategy) and intensity of ongoing operational management. The master limited partnership provides no intensity of management, i.e. you might as well go to Florida & hope for the best.

3. Next, we're concerned with liability. Under liability I would put 2 items: 1. liability on debt & 2. liability on 1st party torts.

4. The next is the standpoint of risk, i.e. the variance in our financial results relative to our financial plan.

5. The last major item is: ease of transfer by gift or by inheritance. Owning a building outright as a sole proprietorship means you have an appraisal problem immediately; you have the possible gap in management of the property & a problem with the administrator in your will who is permitted to retain ownership & operate the real estate without incurring liability to the estate. With a REIT share there's a nice clean valuation on the date you died, i.e. just look it up in the paper, and if you work it through as an off-shore trust or something of that sort ther's no estate or transfer tax (on a gift) at all.

6. One other attribute you might add: degee of anonymity, e.g. you're working for Coldwell Banker and can't own real property (because of potential conflicts of interest), so you need to find a way to hold real estate anonymously. If you're from overseas & your gov't won't allow you to take the money out, you may want to conceal who you are from your gov't & conceal the fact you're foreign from the U.S. gov't.

Now, you can mix & match these attributes against all those property holding types, & an individual investor can gegin to put together a strategy on how he's going to go about investing in a real estate "hard asset".

(story about Disneyland)

(question) "Where do tax considerations come in in defining the attributes vs. ownership of real estate?" (answer) "There are probably no tax savings to be had other than the estate tax; however you structure it there may be minor variations between the corp. & individual tax rate but as soon as you decide to go the individual route rather than the corp. route, you've lost your anonymity for one thing, & complicated your estate problems. One suspects that if we ever get an honest President the distinction between these 2 tax rates won't differ, since the 34% vs. 28% tax rate really isn't a true statement of the differential because the individual & the corp. can bury so many things, e.g. 25% of your net income can go into a profit sharing plan that isn't taxed at all, which you can use to invest in more real estate with; you can be the sole trustee of your own pension fund with a corp., so at that point we're saying the rate of the corp. is less, so it's a lot lower than the individual rate; and in addition you can buy your medical insurance and rent a care and a variety of other things, the tax ratio really isn't significant, it's the base line & how much you can monkey with it that counts. Otherwise, you can put tax rate on the list (of attributes), but the tax game has pretty well fallen out except for the "value-in" proposition - so what do you "value-in"? With stepped-up basis you pay no capital gains tax & you start the depreciation game all over again."

Now let's talk about the tax law. Given the format by which you choose to invest, ovviously you want to strauucture it in such a way that: 1. you acquire it with an audit trail that supports your basic strategy, so let's tald about planning your anticipated tax strategy in the acquisition process.

While you operate the property you also have certain elections to make, i.e. what's expensed, what's capitalized, etc.

And then when it comes time to dispose of the property, again there are disposition ploys that can mitigate to some degree the overall tax debt. Many of these games have changed significantly with the new tax law & I have handed out to you the hierarchy of critical decisions in the process of acquisition, operation & disposition.

One basic element that's relevant on what the individual can do is that the tax law has completely flipped its perspecitve, & while it was favorable to the well-to-do & rich, today's law is definitely biased in terms of the small investor.

The application here is is Part 4 of what I've taken out of some seminar notes prepared for something else, "Think Small", i.e. the real estate investor with $125,000 of active income or less. The double taxation of small corps. isn't too serious, but there's a 15% tax rate on the 1st $75,000 of small corp. income, which isn't a bad thing, as an individual can create a corporate holding vehicle for his duplexes & rental property & with addroit handling of the pension fund, his leased car and a few other things can bring that net income down below $75,000.

The at risk rules require a general partnership with no more than 10 partners, so a large equity investor may prefer the general partnership form. Real estate as a family business with material participation may still take a relatively desirable tax shelter position, so the basic law is certainly oriented towards the small investor.

The outline here is essentially that there are 3 buckets worth of income under the new tax law: 1. passive activity - has to do with all rental real estate, limited partnerships & all businesses where the taxpayer does not materially participate - "materially participate" - is fairly narrowly defined - a general partner by assumption has regular, continuous & substantial involvement, hence the real estate is a general partnership.

With respect to real estate, dealers are determined to materially participate, & therefore at one time it was bad to be "a dealer" - today it may be a useful device if you have more income in the passive category than otherwise.

The general rule is that net losses from passive activity are not allowed as a reduction to other income; the exception is that the small income, active rental owner is allowed a $25,000 active rental property loss; you have to have a significant & bona fide involvement in the property & have to own more than 10% of the property (i.e. less than 10 people must be in the partnership) and the active rental property loss is phased out between $100K & $150K, so as your income goes up your ability to allow tax losses to slop over & shelter gradually evaporates.

Determining if there is a passive loss limitation: 1. determine the net "active" (i.e. the above-stated exception for bona fide involvement of owners with more than 10% interests) real estate rental activity; if the net amount is a loss, the AGI limitation is applied (i.e. loss allowance for taxpayers having less than $100,000 adjusted gross income/phase-out between $100,000 & $150,000); if the net amount is income it's combined with other passive activity income. 2. determine the net other passive activity: if it's a loss the loss is not allowed, except for the phase-in rules (65% in '87, 40% in '88, 20% in '89, 10% in '90 & 0% thereafter), but can be carried over to other tax yrs; if the net amount is income it's taxable. Passive activities engaged-in after the date of enactment do not qualify for the phase-in rules. Nondeductible passive losses carry forward until passive income absorbs them or the activity is disposed. If you have an unused portion of passive loss you can apply it against the capital gain on sale to compute the base for capital gain.

Bucket #2 is portfolio activity - interest, dividends and gains & losses from portfolio assets and ground lease rent. (It was kind of clever of Congress to include ground lease rent, because otherwise you could have converted a good deal of your real estate rental income to ground lease income and thereby have enough passive income - from ground leases - to soak up the tax shelter you might have had from the real estate rental activity - passive activity. There is still a push from realtors to get ground lease rent re-classified as passive income, in which case you could then have essentially a tax bond, because the shelter on the building which might be 20 to 1 relative to the value on the land would be more than sufficient to cover the rent on the land.

Everything else falls into bucket #3, i.e. earnings.

To decide whether it's tax deductible, there's a 4 hurdle screen:

1. First there are the "at risk" rules. This disallows the interest deduction from any loans from related parties, sellers or persons receiving contengent fees. That was one of the favorite games in partnerships, i.e. to invent a series of fees for the seller, i.e. a consulting, property inspection, etc. fee, all deductible for the buyer as a 1st yr expense that allowed you to hike the tax shelter in the 1st yr. All that's gone - there is a provision that says a related party can make the loan & quality for the interest deduction, but it has to meet all criteria of an arm's-length loan, with the burden on the borrower (it's difficult to get).

You can have non-recourse financing only as long as it's obtained from a legitimate, 3rd-party institutional lender in the business of making loans. It makes a fairly nararow window for full deductibility of interest and full-deductibility of appreciation on the property.

What happens if you don't meet the at-risk rules? 1. There's a cap on how much shelter the individual owner can take - limited to the maximum amount at risk. It was striking directly at the ability of syndicators to artificially structure excessively high prices by providing less-than-market rates of interest on wrap-around loans provided by the seller; that exaggerated the tax base for depreciation purposes & often meant that all the income went to the seller with the buyer simply getting the shelter. And if you structured that right on a nonrecourse basis the buyer could step away from the property 7 or 8 yrs later & would have gotten all his money back, i.e. a return of at least 10% on his money & the property would revert to the original seller. If it was done as a land-sale contract, it could be renegotiated between buyer & seller without a trax penalty on the reduction of the balance due, and therefore there was no constructive receipt by either buyer or seller so it wasn't a taxable event.

The 2nd hurdle is the passive loss limitation (i.e. passive net losses can't offset income from the other 2 sources - portfolio & earned). There is a phase-out - by 1990 none of it is eligible beyond dollar-per-dollar in the passive bucket.

If your adjusted gross income is less than $100K and your active rental loss is less than $25K, don't cash in your bonds to pay off the mortgage on your property - it won't reduce your tax bill. But, instead, pay off your mortgage if your nonpassive income exceeds $100K, your active rental losses exceed $25K and any time you have a mortgage debat on passive rental property. What happens is that when you take the soft loss (depreciation, a non-outlay kind of expense), and you tack it onto the interest rate, your losses exceed available income, & at taht tiem you're burning up the depreciation until such time as you sell the property & can recoop the unused part of your shelter. What you have to do is then get less debt & have a lower "hard dollar" deduction on the interest rate, & therefore the shelter can slide in and cover real earnings & be used immediately. This suggests taht leverage is not the game employed at this point.

Passive activity income is earned from rental activity & other passive activity, but doesn't include interest on escrow accoutns.

Gains on sale of rental real estate are passive activity assets; interest earned on installment notes from the sale of such assets is passive activity income.

Hurdle #3: investment interest limitations. They weren't taken seriously before, but now are significant constraints.

The new law prohibits deductions for investment interest expense in excess of investment income. For this purpose, net passive losses which are deductible are deemed to be negative investment income. If you have $100K of investment income but have a negative passive income of $25K, you only have $75K of passive income now & therefore can only use $75K of interest as a deduction in that period. This is one of the few places where it "slops over",i.e. you can't carry the negative tax loss in the passive category to shelter income. But it does carry over to reduce the definition of how much interest is deductible, because what they don't want you doing is borrowing money on your life insurance & paying interest to your lender under the investment account, & then using that as a down payment to hike the depreciation in the passive account and carrying back that depreciation to shelter something else.

So this discourages you from collateralizing your real estate with your bond or stock portfolio. You can get too much passive loss that will reduce the deduction of the interest & thus discourage over-collateralization of the real estate with securities.

There's no $10K allowance as there once was, i.e. interest paid to related passive activity is not investment interest. For example, if you make a loan to your own subchapter-S corp. & get the money out in the form of interest income (that the S-corp. is getting) it doesn't count - you can't borrow on your investment portfolio & by changing the character of the way you get money from the real estate to the investment account make it something it ain't.

Interest disallowed carries over indefinitely, i.e. speculating with land becomes an expensive game to play. Whereas in the old days if you bought investment land & it had a 10% interest rate on the land contract & you were in the 50% tax bracket, your real cost was 5%, as long as the land continued to appreciate at greater than the net cost of your interest (and the shelter factor was applied) then you did well.

Debts which generate investment interest expense are 2nd in line to consumer loans when it comes to retiring debt. Consumer loan interest rates are no longer deductible, but home mortgage loan interest is still deductible, as long as the loan doesn't exceed the basis of the house.

Hurdle #4: the alternative minimum tax (AMT), has become a much more meaningful factor. There is one AMT for individuals and 2 for corps.

All taxpayers must recompute tax liability under the AMT and pay the greater of the 2 taxes.

Take investor's gross income, add back the tax preferences (see handout), subtract certain allowed deductions, subtract your standard deduction under the minimum tax ($30K for single taxpayers/$40K for married filing jointly), which gives your alternative minimum taxable income, & then multiply that by the tax rate applicable to minimum taxes (not the regular 25% rate), which is a flat rate of 20%, and that gives you your AMT.

In 1987 capital gains will no longer a preference, so that that doesn't get built back in there, accelerated depreciation on all property is a preference. It used to be the accelerated depreciaiton taken on office bldgs was a prefereance but not that on apartment bldgs.

Installment gains on dealer property or rental real estate is a preference. That was never before a preferential item, e.g. if you sold your farm & got 5 annual payments from the buyer you were taxed at the progressive tax rate which applied to the lower level payment - the one that fit the principal minus the basis. Now that installment gain over the amortized basis against that gain is preferential income.

Passive losses, without phase-in credit are another preference.

Minimum tax credit: to the extent that the AMT exceeds the regular tax, a minimum tax credit is carried over to future yrs to offset regular tax. This provision adjsuts for timing differences which may cause AMT in 1 yr & regular tax in another yr. So if you have sporadic gain, you can level that out. It's really a back-sided income-leveling device - you can't average income anymore, but where you have a big year and owe the AMT rather than the regular tax, you begin to recover that payment against future regular tax, so it's kind of a back-sided income tax averaging.

Interaction with Wisconsin minimum tax: under the Wisconsin rules, Wisconsin's minimum tax is assessed at 55% of the excess of AMT over the regular tax, & Wisconsin will assess tax on the timing differences without future tax credit or other relief.

Finally, by 1988, when the regular tax rate falls to 28%, the imnpact will be much more noticeable.

(handout) Ex. #1: an MBA with $70,000 in salary has $25,000 from a land-sale contract, $5,000 in interest & capital gains from real estate & other income of $17,000 for total gross income of $117,000. So far no differences with the previous ('86) tax law. The capital gains credit of $10,000 is for the 60% that wasn't taxabale under the old law. Rental & partnership losses are less in '87 (less depreciation allowed) and there's no married couple deduction anymore. Under the new law ('87) depreciation cut is a little lower & taxable income is higher (due to less allowed itemized deductions). In figuring the alternative minimum tax (AMT) all accellerated depreciation on real estate must be added to adjusted gross income (as a preference). In figuring itemized deductions, interest on home mortgages & land-sale contracts remain fully deductible. Deductible interest paid on investments is $9,000 in '86 but only $5,900 in '87 because investment income (as defined) has gone down (see hurdle #3). The consumer deductible interest, $2,000 under old law & $1,300 in '87, is being phased-out, so 65% is deductible in '87. Miscellaneous deductions are also less in '87. Total itemized deductions were $32,000 under old law & are $26,500 under the new law. The personal exemption has gone up considerably. The taxable income in '86 was $5,000, is $23,400 in '87 under new rules & under AMT in '87 is $31,500. Tax is $500 in '86, $3,400 in '87 or $6,600 under the AMT - in '87 they have to pay the AMT.

Ex. #2: a similar case, where the taxpayer repositions himslef for real estate by refinancing his home, paying off the consumer loan & the loan on the investment (with the home refinance money). His '86 tax is still $500, and under the '87 tax law it's $2,800 (lower), but the AMT has dropped from $6,600 to $4,300, so he is obviously better off to refinance the home, pay off the consumer loan and get rid of the payments on the investments.

Ex. #3: Here, having repositioned himself as in Ex. #2, what happens now if he cashes in his "other interest" assets, buys a passive income asset or pays some rental debt obligation? He is again with $70,000 wages, his land sale contract gets him $25,000, and he now cashes in his "other interest and dividend assets", having real estate gains of $16,000 and "other" gains of $1,000. His gross income is $117K in '86 vs $112K in '87 now, his capital gain & married couple deductions are lost under the new law, partnership losses have gone down for '87, and adjusted gross income is $41K in '86 vs. $55.4K in '87. His itemized deductions in '87 are almost what they were in '86 due to home mortgage refinancing; taxablea incoem has dropped a little in '87, to $2,500, & his AMT has dropped all the way down to $3,100. When we get to Mr. Clifford, we may have to reconstruct Mr. Clifford the same way, in terms of positioning for real estate and then coming up with a balanced asset account, "passive bucket", so his shelter matches his income for real estate, a little tougher to do than it once was, but obviously a critical element in trying to avoid the AMT.

(question) "What happened to the married couple deduction?"
(answer) "There isn't one available anymore?"

OK, let's start to build on that. The basic elements of the tax strategy, 1st in acquisition, has to do with what kinds of shelters I want. 2nd, recognition that once you buy a property you are likely to be in it for a relatively long period of time. There's no advantage in taking capital gains anymore, since it's the same as income. You do get the benefit of a multiplier if you move the income from $10K to $20K and double the value of the property. You can sell it & take your gain & pay the tax in 1 lump sum, but presumably you'de pay the same tax if you'de taken that income as $20K per yr.

So looking at real estate, you want real estate that has: 1. durability, i.e. will sustain its value over a longer term & 2. can be enhanced, i.e. by care & some further investment to increase the value of the property, and transfer it to your heirs at a price significatnly higher than what you paid for it, so that they 1. won't pay the capital gains tax & 2. can begin whatever depreciation there may be available at the point in time all over again from the new basis on which they may have paid inheritance taxes.

We need duration & the ability to improve the property (story about large gain on sale of realty).

Now, having decided we want a property with durability & fixability, the next thing we must decide in the acquisition process is 3. what mix we want between land and stucture with a reasonable life of either 31 1/2 yrs for commercial or 27 1/2 yrs for residential property. How much do we want to put into personal praoperty, having a useful life of 3, 5 or 10 yrs? The more we can allocate towards the personal property the more quickly we can provide shelter for taxable income we get from the property. Obviously some properties lend themselves more to that formula than others, e.g. a run-down apt. bldg. which we can refurbish & refurnish & provide new applicances for will be a more attractive blend of opportunities, than, e.g., a commercial shell bldg. in which there is no personal property & which doesn't land itself to any *enhancement* & isn't as well located as the older bldg.

The acquisition process has to anticipate how we are going to present the bldg in terms of several different issues: 1. what class of structure do we want to talk about? There are 5 classes: a. single-family residential, b. farm & extraction properties, c. residential, d. commercial & e. subsidized. For example, if we buy a single-family home, we will want to make it our legal residence so as we pass 55 we can take all the gain as an exception to gains tax & then we will want to rent it. If we are 47 yrs old & rent our house & establish a new residency, then we just blew all our shelter in that house.

Or, for example, say we buy a farm or extraction property. For a while "hobby farms" were popular, where you raised a couple o fhorses & ran up the net losses to deduct against income. You can't do that anymore. Rather, you have to make money 3 out of 5 yrs. If we lease the farm we have rents (passive incomeI, but if we have a joint venture with a farmer (i.e. each ows 50% of the cattle, equipment, etc.), then it's operational income. As a joint venture it's more liability, but 1. it can be owned as a subchapter-S corp. to limit liability and 2. it's not rental income so it doesn't run afoul of the restraint on rental income for subchapter-S corp. formats.

So the 1st thing to know is what category it's in. Is it a farm? How do I prove it? (story about orchard Chief bought)

How much gravel do I have to take off the property before I have an extraction property? Do I really want to be in that category bad enough to prove it? I better lay down my audit trail so that everything is supportive of that. (story about farm he bought with Robbins)

"Residential" isn't too hard, but you have to have at least 80% of the property in residential use, according to the FHA rule, you weren't entitled to FHA insurance unless 80% of the income & 90% of the space was in residential use, rather than commerical. Of you fell below that you had to split the bldg to remain in that category.

Finally, we're down to subsidized properties. There are a variety of subsidies: 1. Section 8's, which are direct rental subsidies, 2. those properties financed with below-market loans, by SBA, FHA, etc. The gov't is strict on "double dipping", so if you have one of those loans the investment tax credit is reduced from 9% to 4% on e.g. new residential property for low income qualified tenants.

So, #1, you have to know what category you're in. The 2nd thing you have to know in your acquisition process is: for what purpose am I acquiring the property? There are 3 categories here: 1. for use in a business - has slightly more generous write-off terms & you're entitled to take the ordinary losses on sale of that property against other income (this is true even if it's a proprietorship). 2. for investment and appreciation, or 3. dealer status (i.e. the property is on the inventory, available for sale like any other trade goods).

The real estate can be any 1 of all 3 of these categories, or the property can be 2 of these, e.g. you can buy the bldg to house your operations as a real estate broker & developer (for business use) and split the property in 2 and have the office for business use & the balance as an investment for income & appreciation (to qualify for captial gains under the old law). If you bought it as a dealer you could never get capital gains tax, e.g. a subdivider of lots is a dealer & it used to be taht he wasn't entitled to capital gains, with 2 exceptions: 1. if the business acquired the land for another business purpose that became obsolete or unnecessary, they could dispose of the land & take a capital gain, & 2. where you inherit the land & then subdivide it to dispose of it - your basis is the value when you get it & any gain is capital gain.

It is suggested that one way ot move real estate income out of the passive category into the earnings category is to be a dealer. It used to be you didn't want to be a dealer but now it can be good.

In addition to these categories, the next thing we need to know in the acquisition strategy is (#3) when to anticipate when we plan to acquire, when we plan to dispose & where we want the profits to fall. We need to structure our acquisition to accomplish whatever purposes those may be, e.g. if I want the income only on retirement I might decide to acquire the real estate through my pension fund in my corporate shell. The income would go to amortize the mortgage but none of it would be available to me now, but when I brought it out of the pension fund it would be subject to a tax. If I wanted to give it to my kids & this was a wealth transfer device I might use a tax-freeze holding device such as a family corp. with 2 classes of stock, preferred & common. I then give my kids the common & the preferred is exactly equal to the purchase price. Gradually I call the preferred & any appreciation on the property all goes to the benefit of the common, & when I die the only thing in my estate is the common stock, automatically valued at the call price, & all the wealth increment would have been transferred to my children without benefit of the gift tax or inheritancea tax and no charge in terms of administration of my estate.

If on the other hand the play is to give me leverage so I can trade up, what do I want to trade? Mayhbe I want to trade stock for stock? Maybe I have to acquire it through a corp. so the basis is in the corp. If if acquire it in my own name & then put it in a corp. later, the only basis the corp. gets is the basis I had when I bought it.

So I need to know when to acquire it, when do I dispose of it & where do I want the net profit to land. Corps. do this all the time, i.e. deciding how to show it for their own particular corporate purposes of earnings per share in a certain quarter, getting it out of the corp. & hiding it as a submerged asset, in some cases they want it to appeara as a big bonanza, & sometimes they don't want it to appear at all. The less people know about a corp's net real worth the less likely they are to raid. Corps. are sensitive to that - if people figure there's a lot of real estate they'll have a leveraged buyout; they may want to "spin off" some of the "crown jewels" & bury them here & there so it's not so obvious what the real estate position is.

Given these considerations, the acquisition of a piece of real estate gets to be a sophisticatged play, even for something as basic as a 4 unit or an 8 unit or a small commerical property with a triple-net lease on it.

A further element in the acquisition formula is to refine the kinds of assets acquired. What class do I want them to fall under in the IRS code, e.g. 3-5-10 yr. category? What evidence can I ahve to allocate the purchase praice to those categoreis of personal property that will withstand IRS scrutiny? Do you need a bill of sale for equipment & furnishings? Do I need a statement as to what the land was purchased for as vacant? To what degre is the assessment ratio of land vs bldg applicable? The IRS isn't necessarily bound by it. One comfort you have as a small investor is that it may not be worth the effort by the IRS to pursue you, so you want to push it as far as you can. It's the holler theory of tax allocation, i.e. you allocate it the most favorable way until the IRS hollers & thaen you holler back, and then you decide if they're going to make an issue out of it & whether it's worth it. You arrive at some small compromise which allows them to indicate that they collected some additional tax on you.

Real estate 850
Feb. 10, 1988 Lecture
Outline by Evan Harrison

Beginning of class: Prudential has 2-3 openings in Atlanta. They just placed Frank Lohas from Chicago to Atlanta, so you will have to get the phone # out of Atlanta information. We also posted some full time jobs on the job board.

Mark Eppli has just completed a tax theory course in the law school and has paid taxes himself several times. He has agreed to take the pressure off my lungs, and pick up on investment tax credits.

Case study questions: Contract rents are the rents stated on the contract. If it says $12/ft/yr, that would be your contract rent. Effective rent is contract rent less free rent, so if you have say, 2 mos/yr free rent, you would have an effective rent of $10.

A squeeze down is a joint venture agreement in which both parties agree to provide a certain amount of equity capital initially, then if the project doesn't run according to expectations, one party puts in the additional needed funds, and the other party goes from a 50% position to a 25% position, and if still more funds are needed because, say the project isn't marketing very well, then he's out altogether, with a 0 position in the joint venture, or sometimes gets reduced to a slow-pay subordinated note. As we'll talk about later, courts will generally not support a total wipeout of your equity position, feeling it too harsh a remedy for failing to meet the call for additional capital, but will allow you to change your position from a joint venture partner to a limited partner or change your position to a slow-pay note with interest at 5% which accumulates toward a payment 10 years down the road, so you can't say they cheated you out of it, but it will be a long time before you see it.

Free rent is now generally given as two months at the beginning of each year to avoid tenants who get six months then leave and claim you somehow did something to breach the contract.

Assume today's depreciation rates. Even if you'd cut the deal in '86, you would not be entitled to dep. until '87, and would be under the new law anyway.

Eppli:
DEDUCTIONS AND CREDITS:
Deductions as in depreciation are subtracted from the gross income to reduce taxable income, and is worth 28% if you are in that bracket. A credit, is in rehab tax credit, is a dollar for dollar reduction in tax liability. A $ credit is a $ tax savings.

DEPRECIATION: For commercial and industrial property it is 31.5 years, for residential 27.5 years. Personal property is mainly 7 year porperty, but could be 3, 5, 15, or 20. There are other non-statutory ways to take depreciation. For example, the Hertz Corp., takes > actual dep. on vehicles than allowed per statutes, so they used what they've proven over the years, so they use something greater than that. In R.E. that comes in with tenant improvements and leasing commissions. That would be improvements specifically for the rental of the space, and wouldn't improve the life of the building or be a capital improvement, and can be depreciated over the life of the lease.

Chief: When McDonalds changed their marketing strategy to include seating in house, they were able to show that the rate of obsolescence in fast food was perhaps 7-8 years, so they can use an 8 year life. If you keep historical records, and can demonstrate that the historical life is less than allowed by the code, you can establish your own useful life.

The next thing on the outline is section 179 - RAPID EXPENSING. That was expanded per the '86 tax law, and is used mainly by small business. You are able to take sec. 38 preperty -tangible personal property used in a trade or business - and expense up to 10,000. If you bought a computer and printer for 12,000, you can expense 10,000 of it. If you bought more than $200,000 of such property, you start to lose this benefit, so it is mainly for the benefit of smaller businesses. If it is . $10,000 you might buy in Dec. and make 2 payments out of it and get 2 credits.

CREDITS: The ITC was repealed retroactive to 12-31-'85. Don't be surprised by retroactive changes. It pays to stay tuned with proposed changes. The ITC has mainly been used to stimulate the economy. The Rehab credit. The old law gave a 25% credit if you were on the Nat'l Register of Historic Places, and you only had to reduce your basis by half that amount. There was then a 20% credit for buildings over 40 years and a 15% credit for buildings over 30 years. In the new law, you get 20% for structures on the national register, and a 10% credit for buildings built before 1936. So you have a building that is 52 years old. Your total rehab costs have to be greater than the adjusted basis of the puchase price, which means that if you are negotiating a building for rehab purposes, you want to negotiate the lowest price possible, and if necessary compensate the seller through other means so you are not forced into a rehab budget which exceeds what the property needs or can carry. There is now a 100% REDUCTION IN BASIS FOR EVERY $ TAKEN IN REHAB CREDITS.

PASSIVE LOSSES: The three types of income are COMPENSATION, which is wages, salaries, and tips, and PORTFOLIO INCOME, which is stocks, bonds, and securities, and PASSIVE INCOME,which is limited partnerships. You cannot offset passive losses with other types of income such as compensation income. The only person this doesn't apply to is those who materially participate in the deal. You almost have to be a dealer in real estate to be a material participant or a general partner. In many instances, a G.P. is not deemed to be a material participant. In order to keep the classification of active income you have to participate in the management, and then you lose the protection of a L.P. and are classified as a G.P. Chief: limited partners are permitted only three areas of discretion: sell, refinance, or get rid of an incompetent G.P. They've had cases where one of the L.P.'s commissioned someone to plow the drives after a snowstorm and signed a receipt for the snowplow and lost his status. That blew his cover. Passive income is virtually any kind of rental income, whether you are a limited partner or not. The form of ownership isn't the critical thing, it's the source.

Ans. to ?'S: You can be both a G.P. and an L.P. up to 20%. If you are managing you own property in your own name, that's still passive income. Brief discussion of $25,000 exemption "for the little guy" where husband and wife both work and have a couple of duplexes. Today that's covering the blue collar family. It phases out 50 cents on the $ between $100,000 and $150,000. You also have must own at least 25% of the deal and be an active participant in the deal.

Examples on chalkboard. One taxpayer in two partnerships, one with $20,000 gain and one with $50,000 loss. Net loss is $30,000 annually.

	Year 1	Year 2
Taxable income	$100,000	$120,000
Maximum passive loss write off	($25,000)	($15,000)
TAXABLE INCOME	$75,000	$105,000
Carryover	$5,000	$15,000
Accumulated carryforward	$5,000	$20,000

On sale:

	Example 1	Example 2
Selling price	$180,000	$120,000
Adjusted basis	$100,000	$100,000
Gain	$80,000	$20,000
Less Accum. carryforward	($60,000)	($60,000)
TAXABLE GAIN	$20,000	($40,000)

The $40,000 of net passive loss at time of sale in example 2 can be applied at that time to offset other types of income. Upon sale, the $25,000 limit does not apply.

Chief: Notice that in the acquisition process, one of the things you have to think about is "What do I want to acquire, the tax entity or the real estate?" If this was a RE entity that was set up in 1985 and enjoyed the tax law that was in place at that time, you might want to buy the the stock or the whole partnership and continue forward on the accounting entity that was in place at that time, and continue forward under the old rules. By the same token, let's assume the RE has a substantial suspended carry-forward. You might want to buy the corporate or business entity in order to have that carry-forward available some time in the future. The seller might have reasons to do that too, or he might want to trade stock for this corporate entity and go forward in that manner. It becomes valuable to sell the suspended entity. Do I want to buy the entity, or the RE itself?

Eppli: You can take credits for passive loss purposes also, where one $1000 credit is worth $1000/0.28 = $3,570. The passive loss deductions are always used up first, then the credits second.
Chief: The passive loss deduction does not apply to corporations at all. You're talking only about individually owned properties and single conduit tax entities. I was talking about tax investment credits and unused depreciation under pre 1986 rules above when I said you sometimes want to buy the corporate entity instead of the RE.

Eppli (Ans. ?) If you have $20,000 in passive losses and $10,000 in credits, you can only write off the $25,000 limit, and you have ($10,000/.28-$5000)*.28 of credits to carry forward.

Chief: It works out that anything you earn over $100,400 is taxed at 28%. You are charged a higher tax rate which is offset by the partial deduction of passive losses.

Eppli: If you earn 0 - $17,850, your tax is 15%.
If you earn between $17,850 and $43,000 you pay $2677 plus 28% on anything over $17,850. $43,150 to $100,480 there is actually a 33% rate. What is being done here is to recapture the 13% you saved on the first $17,850. In addition, you have a personal exemption of $1900. So it works out that every dollar you earn when you make over $100,480 is taxed at 28% and your marginal rate is equal to your average rate.

NO COMPETE CLAUSE: If a developer is selling a shopping center for $2,000,000, the buyer has to depreciate it over 31.5 years. But if I buy the center for $1,700,000 and pay $300,000 for a three year non-compete clause, you can depreciate the $300,000 over the three years. Both sides of the transaction have to match. The developer can't take that $300,000 as capital gain. It is ordinary income.

Chief: You can also have a consulting fee to help him take over the management and leasing commissions on the remaining income from leases already in place, and in fact being purchased and assigned with the property acquisition. All of that allows you to accelerate depreciation on that portion of the investment, and the total dollars paid still adds up to what you were going to pay for the shopping center. There is a great deal of creative accounting as to whether I bought a tangible asset or an intangible asset in the form of leasing services and non-compete clause and consulting services and whatever. The more inventive you could get, the lower the real estate price appeared to be. From the seller's standpoint, he might be able to shelter the ordinary income another way and give the buyer his write off so the limited partners coming into the partnership over three years were getting enough write off to simply pay for the investment with their tax savings on other income. Now uncle has tended to spike those as rapidly as he can.

Eppli. 3 TYPES OF SYNDICATION COSTS. The first type is to organize the partnerships. You can amortize those costs off over 60 months or more. The second is the costs incurred to acquire the RE which is added to the basis in the real estate.

Chief: Costs which are for loan purposes are written off over the life of the loan and the others over the life of the real estate. So the appraisal would be written off over the ten year, say, loan life, while the engineering fees would be over the life of the property.

Eppli: the third category is the costs of marketing the limited partnership. Those you can't write off at all. You simply add them to the sales price, but there's no deduction as you go along.

The last category I have here is Master Limited Partnerships. For all pratical purposes at this point they are dead in the water. Originally, master limited partnerships were set up to be passive income generators to offset passive losses on limited partnerships which many people bought, but in Dec., '87, regulations, MLP income was considered to be portfolio income, since they are traded on stock exchanges. Starting in 1988, they will deemed a corporation. As corps., they will be double taxed entities, which doesn't work too well for real estate.

Graaskamp:.. If the tax status isn't quite clear (as with Master Limited Partnerships) and a klutz doesn't read the prospectus, that's his problem. Eppli (answering a question): Let's say you have limited partnership shares at $50,000 apiece and Merrill Lynch or whoever is selling them will sell them at a commission rate of 6 to 9 per cent. Say 6. It will cost $3,000 to sell this particular limited partnership share. this $3000 is not deductible as an expense, and you cannot amortize it. The only time it comes into play is when the partnership is finally liquidated, it can be subtracted from the sales price it determining gain. Graaskamp: It's part of your basis going in.

Graaskamp: In looking at the acquisition of any property there are two tax considerations to keep in mind: how to structure for the seller and how to set it up for the buyer. Which works out best for both? As we argued often in 856, the price is ultimately engineered to lesen the impact on the seller and maximize the benefits for the buyer.

For example. The seller may have some interesting problems. Let's say you're buying a one-day medical-surgical center type facility, where the state of Wisconsin until very recently would only allow one of those per community. That's a franchise, and not a strictly real estate enterprise. Franchises are never entitled to a capital gain. they're always taxed on sale as ordinary income. It's pretty important to load the price of that particular kind of business into the real estate, so the seller can take his profit as capital gain and pay as little as possible on the sale of the business, which is always ordinary income. On the other hand, if you were buying an industrial plant with inventory, machinery, etc., it would be advantageous to load as much as possible of the purchase price into the inventory and purchase of existing contracts and retainers that were in place for that kind of firm, so in effect you could write off as much as possible of the purchase price against sales as a reduction of inventory as opposed to depreciating the real estate over 31.5 years. Obviously you can't be absurd, but there are a lot of judgment calls, a lot of room for erring on one side or the other depending on the deal and then daring the IRS to find it and then fight about it. The parties need to find out what their purposes are.

For example, the deal of the year for the SIR a couple of years ago was when Gordie Rice bought the old Gisshold-Johnson plant. Johnson had been absorbed by Giddings and Lewis who had moved all of their operation except for the foundry - up to Oshkosh or wherever their headquarters was. Now they've got a plant on their books which had a book value higher than the market value. Giddings and Lewis didn't want to take a one-time write down because the securities analysts would be on top of that immediately, so they said "You buy it from us for our book value, or to give you a small profit, and we'll lease it back from you. So the losses on the empty building were being feathered out against years in which they had taxable income, and they were converting a capital loss into an ordinary loss in the form of rental expense. They had a release clause that said when Gordie began collecting rents, they would be released from their obligation, so it gave Gordie a positive cash flow on a vacant building the day he took it over, and he could offer prospective tenants several months free rent because he didn't have to take a credit against the rent he was getting paid by Giddings and Lewis until the tenants started to pay hard dollars. It isn't hard to make a deal work on that kind of basis. Giddings and Lewis got what they wanted, too. They were allowed to extricate themselves from a surplus industrial facility where Gordie Rice took over the operating costs, they did not have to take a hit on the surplus and alarm the securities analysts, they were allowed to write off the loss as an ordinary loss against future income, and for that matter, they were allowed to use the foundry for another nine or ten years. So both sides were looking at the tax consequences and structuring the deal in such a way as to optimize on either side of the equation. With the cash flow from the project, Gordie was able to borrow enough money to make tenant improvements and turn the facility into a multi-tenant operation.

Most deals are structured in that way. What does the seller need? What does the buyer need? How does FASB accounting treat that?

Dick Sheidler will be here later this Spring. That's really his whole game - understanding the corporate culture and FASB accounting rules sufficiently to understand when there is a buy point when he can buy the property at a price lower than market price, while making it appear that the seller took a profit. So let's say you have an industrial building that was bought on a sale-lease back with a 25-30

year term. A lot of these deals were acquired around '67-'72. The accounting rules at that time required that you take the present value of the rent payments, and treat them as though they were an amortized level-payment mortgage and put that on the liability side of your ledger. Prior to that time, you didn't have to recognize more than one year's rent. At the same time to offset that, you put on the asset side the true value of the facility. Since you were allowed to depreciate the asset as though you had bought it, you ran the asset side of your ledger down very quickly, but the liability side was being run down just like an amortized mortgage with the large principal payments not occuring until later. So in effect you were understating your surplus, because your liabilities were out of kilter with respect to your assets. Furthermore, you had to do that, if you had a lease longer than three years. So if you had a corporation which had a little downturn in its earnings for a particular year, he could go in and say "hey, I'll tell you what I'm gonna do," I'll buy that leasehold position from you for x dollars, and lease it back to you for 23 months or 36 months or whatever, and give you the option to renew that to wht would have been the end of your thirty year term. Since that takes the asset off the asset side and the liability off the liability side, and the liability is significantly larger than the asset, it drops right into surplus as earnings. Now Sheidler is sitting in the position of a sandwich lease, and he is making the payments to whoever made the sale-leaseback in the first place. The tenant in the property in the first place is now making rent payments to Mr. Sheidler. Those rent payments, in a deal cut in '68 -'70 are significantly below the market rent for the space today. the only risk is if the tenant doesn't renew, but all he has to worry about is releasing the property for something more than it was rented for in the early days, and then he is home free and his cash flow is more than it was before. Now he turns around and looks at the guy who owns the building and there's fifteen years to run on the lease at 7.5%, which was not a bad deal in '68, and he says, gee, the leasehold value in this building is substantial, let's say it's a 5 million dollar warehouse, and currently given the present value of the rent stream to you to the end of the term, even assuming a resale price which is fairly favorable, is 3.5 million, and I've got a leasehold value of 1.5 million, so I'll pay you 4 million for the property. You can reinvest the four million at current rates, and I'm buying the building by reassembling the fee at a million dollars less than market. In most cases the seller would go through with that. He hasn't been able to extricate himself, because the hit would have been too great, but chances are, he has already depreciated the property below the 4 million mark, so he's going to register a profit, too. So the fee holder comes out with a capital gain less than he would have liked, but at least he has his money back to reinvest at current rates which are more opportune. The tenant's out from under, he's just taken a little hit in the surplus to improve his earnings, he's happy, and what's more, he's improved his corporate flexibility, because he now has a series of three year leases, so any time he wants to pick up and move he can do that.
Mr. Sheidler in the meantime bought the leasehold at less than it's value and the fee at less than its value, and he's assembled an asset

he can flip for a substantial piece of change. Given the credit, let's say, a national credit of the tenant, and given that he bought the asset at less than market, he can in fact finance out on the whole deal, and never have a nickel of his own money in it. Notice that he is playing the FASB rules on the one side, and the fact that the asset manager on the other side looks bad because he's got an asset that is generating a rather miserable cash on cash yield, and investors, say in pension funds, want more cash on cash, and if they realize there's no upside left in the property for them, they're happy to get their cash out and reinvest it at the current yield. Even though he's given away possible capital gains ten or fifteen years from now, everybody wins - a totally engineered deal. Now some poor appraiser will go down and say "this sold for 4 million, so that's the market value." Baloney.

So you have to look at the acquisition. How do I want to set it up for tax purposes? How do I want to set it up on the seller's books? And notice if the seller doesn't work consistently with you, as Mark pointed out, uncle Sam smells a rat, they'll go back and unwrap the transaction on both sides and say "here you treated it as a capital gain and you treated it as a fee, what goes on here. Obviously it must have been a capital gain, so you can't write it off over three years, you're going to have to write it off over 27.5 years." You really have to make sure that doesn't occur.

One of the classic leaseback cases involved 3M leasing a warehouse in Minneapolis, and the developer came in and wanted 100% financing from the bank, which said we'll make that a triple net lease with 3M, and you assign us 100% of the income until the financing on the warehouse has been amortized. If you want to step in and buy down the mortgage, we'll restructure the deal and you can save some of the cash flow. Now, the nominal owner of the building depreciated the whole thing and took his payments from 3M as rental income and and deducted all of his payments to the lender as interest. The IRS said the lender who has title to the property as security for his loan didn't have any operating risk at all- it's a 3-net deal, the guy in the middle made all his profit up front in the construction fee, etc., and the lender says in effect that while he has title, you can have the property back any time you want to give him x dollars and make it an 80% loan again. Your deal with the lender really isn't rent to the lender at all. IT DOESN'T MATCH UP. The lender has no ownership risk. Therefore, the lender isn't the owner, therefore the payments to the lender aren't rent. And indeed, the lender's books showed it as a mortgage loan. It didn't matter that they were holding the deed, as far as they were concerned it was a straight mortagage deal, interest and principal. The developer had been deducting all of his payments to the lender as rent. that didn't match up with their documentation as far as their in-house accounting was concerned. The deal was off, and the (sic) lender had to go back and pay taxes on the principal payments he had been making to amortize the loan.

So you have to be confident in an acquisition that the seller is going to treat all the various dollars received the same way you are acknowledging them for your tax purposes as outlays, and that is part of the negotiation leading to the final closing- how each party will handle this element.

The second thing you are going to be concerned with is **timing**. One element of timing which has changed slightly is that depreciation works on a half year rule and a quarter year rule. If you buy real estate in the seventh month, you are allowed to depreciate only six months of that year. If you buy in the first month of the year, you are allowed twelve months of depreciation on it. You buy it in the last three months of the year, you are allowed only 25% of a year. That's a change, because in the old days, you could buy it in December and depreciate it for the full fiscal year. So they chopped down on that. So now if you need a little extra kick early on, you may want to close part of the deal on Dec. 28 at the end of one calendar and fiscal year, and close the other part of the deal in the next fiscal year. So if you are limited to 25,000 of tax losses, you can get that to fall in 2 different tax years, and you can time your closing accordingly. By the same token, if you need to take the expenditures for certain elective items, you make sure you get them to fall in the tax year which has income. One of the advantages of the so-called convertible loan, is that if a pension fund comes along and funds that loan, while technically they may be willing to come in as a joint venture partner, and put up 90% of the money and own it, their depreciation is going to get burned right up the chimney because they are not taxable. So by making it a convertible loan, the interest payments made to the lender, which may be all the net income in the property, are totally deductible for the developer, and the depreciation and other tax credits as they may be, may all go to the developer or his other equity partner. Then 7-8 years later, the lender has the right to call on the property and take a 75% ownership position and forgive the debt or I want my money back. It didn't turn out as well as you guys said, you're going to have to refinance it, and so forth. But notice that they've structured it by this deferred ownership position, so that the tax benefits are going in one direction and the other benefits are going in another direction.

Another way to do that is to split the land and the building. One party which doesn't need shelter owns the land and takes land rent plus a participation. The other party owns the building, and is able to take depreciation relative to his entity. There is very little income during the depreciable phase of the project. There are different ways to carve up the interest to provide ONE, allocation of the tax and income and capital gain benifits, and TWO, modify the timing as to when each party receives it.

For example, if foreign capital is structured right, there may be no capital gain tax at all if you dissolve the total entity. Sell off the total thing and take your money home. As a result, they may structure their deal largely as debt, with a kicker of participation in the resale. They in effect simply liquidate the whole enterprise and take their profit home in the form of a one lump liquidation dividend.

In the old days it was also possible for the American entity to have a single 30-day liquidation and pay no douple tax coming out of the corporate structure, but that is no longer possible.

So again, the timing and character of the distribution is something you want to build in up front.

That's it for today, we'll see you on Monday.

Mr Clifford Case
-use the MRCAP program, it was designed to do that originally; put all of the land in 1 account, the land for each of his identified properties, seperately in terms of its basis; & then you can have 1 line for each of his investments & you'll have to work out what the basis is going in, & in several cases there will be no basis, he will have utilized all his depreciation; & then the valuaiton method is suggested in the case so each year you know what the going value of his real estate is, simply use a NIM so you will produce a resale price; the resale price against the lower basis will have some substantial capital gains characteristics to it which are part of your problem; do you sell now or wait for Mr. Clifford to die & what will it cost him to die? the stock & bond fund can then be put in the initial reserve account of MRCAP which is also permitted to earn interest; if you'll recall, interest rate earned net after taxses is reported in the case so that you can in effect run his other investments along on that basis; so you can come up with an at least crude estimate of how his estate will accumulate from 1988 forward, what his tax bite would be if he sold & what his gross estate would be if things accumulate as they have.

-you'll have to make some of your own assumptions as to what you think will happen to his real estate portfolio; you can pretty much take the assumpitons made for the stock & bond portfolio; & you may havea to run individual analyses of 1 or more of the properties as you decide how you would advise him in terms of organization, disposition, planning for the day when he's no longer there; there's lots of loose ends flapping in the breeze in this case; therefore you are expected to find the loose ends & tie them down; don't come running to me "do we have to do this w/such & such?" - the answer is if you think it's important you better do something about it; anyway I think you'll find it an interesting problem; the problem is slightly different than it has been in the past because the progressive income tax rate isn't as serious as it once was; on the other hand the capital gains rate is no blessing; so this year we'll come w/different answers than we did in the past; if you have notes from the past, roll them out, since most of the variables that were true then ain't true no more - so have at it; have this in the Wed. after Spring break ...

Marital Deduction/$600,000 Exemption
-OK, so lets talk a little more about estate planning, since that seems to be the topic of the moment; 1st of all a little bit abaout recent changes in the tax law which have changed the traditional formulas for estate planning; for a long time the basic marital deduction trust was $250,000 or 50% of the estate, whichever was more, & in effect postponed payment of any estate or inheritance tax on that portion which fell in the marital deduction trust; the kicker on the marital deduction trust, however, was that the wife had to have general powers of appointment, that it was really her funds to do with as she wished, to give it to a new boyfriend ... or whatever else she was welcome to do that; & that if hubby was the 1st to go he was relinguishing control of 50% of the assets; now that's out of sync w/current marital law & the equivalent rights of the lady of the household & so the estate tax law now permits all the money to go to the spouse on a marital deduction basis, so you can postpone for a time the heavy hit of estate taxes; you may or may not wish to do so, but you can for a time, & the progressive rate would then hit the total estate some time in the future; because of the fact that the spouse may want all the benefits to go to the surviving spouse, but may not want to relinguish total control after that, they developed the QTIP trust, the qualified termination trust, so tht the surviving spouse can have the benefit of the income & partial principal liquidations if necessary then the testator can direct that the corpus be distributed on to his children, whatever, some other

beneficiary, & he doesn't have to give up general power of control to the survivor; so you have several types of trusts: 1. you have the classic marital deduction trust which gives general powers of appointment to the widow or widower, & 2. you then have a limited powers of appointment trust which is essentially a life estate to the beneficiary and then the funds are distributed under whatever conditions the testator may wish; the old format used to be 50% went into a marital deduction trust to eliminate any estate taxes on that portion immediately, the other 50% went into a limited powers trust in which the income went to the surviving spouse for as long as they needed it, & in addition the corpus remaining would then be distributed however they wanted to do w/it, e.g. children prorata, grandchildren, etc.; further more to maximize the marital deduction trust the taxes that were due & payable, the administrative costs, the expenses of last illness, etc., were typically paid out of the 2nd turst; so the marital deduction turst represented a gross 50% of the availablea esatte &^ the 2nd limited powers trust represented a residual after everything else was paid for, so the amounts of the 2 trusts were not equal; 3. now w/the newer format you can postpone all of the costs of administration, etc., etc., & it will fall on the survivors under the QTIP survivors & partially on those hwo benefit from the general powers of appointment trust to the will; there's much more flexibility in how you structure that then there once was.

-in addition the tax rate has baeen reduced, the amount is $600,000 before you pay any estate tax ...; the estate planning process depends more on protecting the asset from waste during administrations & protecting the asset from waste during administration & protecting the asset from prolonged litigation which will drain the estate through legal costs or poor management, & it's not unusual for an estate to be tied up for 20 yrs as they fight about it ... (story about the Wells Estate).

Gross Estate
-now, what constitutes the gross estate? (Question: How can you avoid problems like that? Answer: Keep it nice & clean, don't have too complex an estate, keep it simple & straightforward (story about a shopping center) ... anyway, building the gross estate:
-1. 1st is property owned at death.
-2. 2nd is property passing to spouse by elective share - most wills will say surviving spouse & children can choose $15,000 personal property from the estate as a little momento ... & most wills provide to various children, relative, etc. come in & choose soem momento of that sort - the value of those elements are included in the value of the gross estate ...
-3. next one: certain transfers w/in 3 yrs of death; part of that is due to the fact that the gift taxes might be slightly less than the estate tax, part of that is the gifts were given sequentially so they were below the taxable amount in any event; there is a reule that if the individual had reason to believe he was going to die & he was doing it for tax avoidance purposes they can include that in the gross estate, e.g. if dad has 12 kids & gives them $10,000/yr, there's $360,000 he's gotten out of the taxabale estate, the IRS is likely to challenge that, i.e. say dad knew he had a terminal disease ... it isn't often employed & it's been slightly softened in the current law ... the rule used to be that the presumption was any gift w/in 3 yrs of death was in contemplation of death - now they're reversed it & the burden of proof is on the IRS.
-4. tax transfers w/a retained life estate or w/retained control; so if you give the farm to the kids but give mom the right to stay in the house for life, that's still w/in the estate.
-5. reversionary transfers requiring survivorship.
-6. revocable transfers - let's say you were the beneficiary of a limited powers trust but you died before anybody could renig on the fact that it had been given to you - at that point it's locked in & it moves forward - if you're the beneficiary of the trust & you have certain powers that could determine what to do w/the trust after you die, then that's part of your

estate - you might not have done anything w/it, but you had the option & therefore it was under your control & it's your property.
-7. annuities & employee benefits - close out sum on pension, PV settlement on your remaining pension program & so forth.
-8. property passing by right of survivorship - in other words even though you & your wife own the house jointly & you die, 1st of all your 50% of the house is in your estate even though technically title automatically passed to the survivor on your death, & what's worse is if the wife can't prove that she paid for her half then 100% of the value of the property is in the estate of the deceased; so it's really important that when you buy a house that husband & wife each write out a check for 50% of the down payment, that you each write out the checks for the monthly payments & establish an audit trail; there are certain limitations on that, you can get around some of that arguing the annual amount is less tahn the gift that would have to be unreported - but as soon as you get an amount of money which would have to be a reportable gift you either have to report it as a gift & pay a gift tax on the transfer to the wife or she doesn't technically have 50% ownership of her half; (Question) is a joint checking acc't adequate for establishing that? (Answer) only if she can prove she put 50% in it in the 1st place, i.e. establish her paycheck as well as yours went in it - that's one of the joys of communal property, establishing that in fact both contributed to it; (Question) so if the wife stays home & tends the children ou need to pay her a salary? (Answer) that's about what it amounts to, or make her technically a gift every month of the house payment; yes (Inaudible Question) ... the question is how much is in the estate of the deceased, 50% of the house or 100% (regarding contributions by the surviving spouse); yes ... $600,000 is the minimum estate before the fed. gov't has an estate tax; the marital deduction could be 100% of the estate, all you've done is postpone the impact of the tax law until the spouse dies; distinguish the 2 things - if you have an adjusted gross estate of less than $600,000 you don't have a fed. estate tax; (Inaudible Question) ... 1 type of marital deduction trust is a QTIP trust - in a QTIP trust the testator can maintain control voer where the principal goes on the death of the beneficiary; in a straight marital deduction trust the wife has power of appointment & she can change the will if she wants & have the money go to whoever she wants; (Inaudible Question) ... well what it means is that her marital trust will not have to pay any estate tax in the future as long as they pay out all the income, & since they've postposed the tax & they only put $600,000 in the 1st place, assuming everything is paid out, then there's no fed. estate tax the 2nd time around when the widow dies.
-9. general powers of appointment property - if your dad left you a trust & you have general powers of appointment then the control factor is such that it was your property, you could have done whatever you wanted w/it, even if you only took the income from the other turst, the fact that you had the right to decide who was going to get the benefits when you die includes it in your estate.
-10. life insurance proceeds are subject to the estate tax if they're payable to the estate; here's of course the great temptation to make the life insurance payable to some other individual, but again you have the power of control problem - there are 3 incidents of ownership of a life insurance policy & you must have given up all of them or the proceeds will be in your estate even though it was payable to another individual: 1. the right to decide who the beneficiary will be - you must give that up irrevocably; 2. the right to take advantage of the loan powers in the policy; 3. the right to take advantage of the prepayment powers of the policy - any life insurance policy has a set of standard agreements & for example if you got tired of paying for the life insurance you could step it back to a prepaid basis, you could require that the dividends were used to buy additions, or for that matter you could require that the policy be terminated & any cash values be returned to you; all of those elements represent incidents of ownership - unless you've given up all of those to the life insurance you own the policy technically, it's like having powers of appointment & therefore the proceeds are included in the estate even though they were paid to somebody else - which

is very dangerous if you have a big life insurance policy of $1M & not much else & it all goes to somebody else, you may have a taxable estate even though you don't have any resources w/which to pay the tax; yes (Inaudible Question) ... then the life insurance proceeds are not included in measuring the gross estate; (Inaudible Question) ... but if at the instant before you die if you have any of the indicents of ownership & control of the life insurance policy it will be included in your estate constructively even though the proceeds have been paid to somebody else; (Question) how do you get around it? (Answer) what yuou have to do is file a form w/the life insurance company indicating that all the incidents of ownership hve been transferred to the beneficiary; you may continue to pay the premium & that's your privilege; (Question) you have the right to change the beneficiary? (Answer) that's right you have the right to change the beneficiary, cash out the policy, make loans against the policy, or make any decisions about the use of dividends (Inaudible Question) ... (Answer) irrevocable (Question) do you do that when you take the oplocy out or when? (Answer) You can do that any time you want up to when you file an irrevocabel statement; so far so good? (Question) does the person that you give the incidents of ownership to, to they hve the right to transfer them back to you? (Answer) No, the question is who has the control the moment you die, if he gives it back to you then you have control then it's in your estate; (Question) right, but my question is, does he have the right to transfer incidents back to you? (Answer) sure, it's theirs, their interest or their benefits, which you may not want floating around ... "choice of benfiaciaries" - give it to some Italian fellow w/a short neck & a gruff voice & you're in trouble.
-11. next transfers for partial consideration are included in the estate - essentially that's a kind of gift - let's say you sell the business to one of the kids for less than full vlaue, the balance of that is still in your estate - you can't automatically diminish your estate by moving the asset out at a nominal price & argue it's a sale - so it's a valuation issue - what was it worth when you sold it & did you get full value?
-12. & finally property on which the marital deduction was allowed under the QTIP trust - so if you have property coming in as the survivor interest in a QTIP trust where the marital deduction applied, that becomes part of your estate & is now subject to tax - if you pay nothing on your spouse's estate for the 1st $600,000, now the spouse has died & you will be the beneficiary of that QTIP, that becomes part of your assets as well.

Adjusted Gross Estate
-all of these things added up represents the gross estate; the gross estate is adjusted downward to what is called the adjusted gross estate, w/2 things: 1. deductions for all administration expenses, debts, funeral expenses & what is called "the last illenss expense" and 2. any deductions for casualty losses (fire, theft) - that gives you an adjusted gross estate.

Tentative Estate Tax
-from the adjusted gross estate there are 2 major deductions: 1. the charitable deduction & 2. the marital deduction - & that then gives you the taxable estate; the taxable estate has a small adjustment for taxable gifts you've made since 1976, and you come down to what's called the tentative estate tax base; multiply that times the rate & you have the tentative estate tax; (Inaudible Question) ... an adjustment for taxable gifts made since 1976 when they unified estate & gift taxes; and that gives you the tentative estate tax base, times the estate tax rate & that gives you the tentative estate tax; and then from the tentative estate tax you would deduct any gift taxes you have paid from earlier years; you also get a credit for state death taxes - you get a credit for foreign death taxes & you get a deduction for any unified estate tax credit that's still due - as you recall there's a flat deduction representing the gift taxes you might have made but didn't because you made

gifts in small enough amounts to not count; and when you're all done w/that you end up w/the fed. estate tax; relative to Mr. Clifford you don't have to worry about any of that stuff about gift taxes, get down to taxable estate & assume that's it - being an old skinflint he didn't give away a nickle while he was alive.

-notice that's a fairly detailed process, a long-term accounting process, & it presumes that during your lifetime you have kept adequate records so that you have a way of supporting lots of that, & by and large most people don't keep adequate records to support all of that, so that simply prolongs the difficulties & justifications of your program once you reach the probate court and once you start dealing w/the IRS, which begins w/the premise that you're all gonna cheat them ... (Question) in the gross estate ... if a spouse dies & the surviving spouse uses the marital deduction & he remarries, you're saying it's not available again? (Answer) that's right - so it's a charge onto the estate, gets added back, but it gets added back & then it can be deducted, in other words he adds it back to determine the gross estate, the previous credit that he took, & then after you get down to your adjusted gross estate you can subtract the marital deduction from this time around, which may have gone up, more net worth the 1st time around.

-Any questions on taxable real estate or tentative estate tax base? ... you should be aware that that becomes a major terminal point where the success of your investments & your ability to pass throu;gh the principal accumulated is going to depend.

Structuring
-let's talk a little further on structuring; a number of the more common ways of those w/property handling that property - maybe to set up:
-1. an administrative trust, what's called an inter vivos trust - you set it up while you're alive & you retain equal management or trusteeship powers w/a corporate trustee - many business executives do this because they're so engrossed in what ther career may be that they don't have time to manage their own assets to their best advantage or do the detail work that's involved, so they turn it over to the bank trust dept. to manage their resources for them, and the trust may be given certain instructions, that you want to go for capital gains for 15 yrs & then you want to be able to start changing that into an income stream, you may have other beneficiaries, identifying each child when he reaches college agto to get a certain stipend each month w/which to go to school or whatever; it's not unknown that some of the older trusts (not very well drafted) suggested athat Charles get $1,000/month as long as he remain in college & we've had a number of students here that remained in college for at least 20 yrs, never quite finished ...; there may also be what's called a spendthrift clause in it & the income distributions to the beneficiaries can be terminated at the will of the corporate trustee at any tiem so that there is no vested interest in the beneficiary on which he could borrow or which could be attached by creditors or which could be attached for settlement of a judgment, which may be an important feature in protecting one's children, brothers, alcoholic relatives from themselves; inter vivos trust - sets up contingent plans so that at the death of the initial donor it then in effect goes into phase 2 which involves distribution to children, widows, other beneficiaries of the donor; there are no administrative charges on it, but notice because he has retained general powers of control during his lifetime the total value of the trust is included in the estate for tax purposes, definition of the estate tax, but it is not part of the estate for administrative purposes, so it does provide for a smooth transfer of management & controlof the distribution funciton - it avoids the erosion of administrative costs, in general it avoids litigation since the ambiguities have been defined, if any, & in the mean time it provides on-going money management services by professional money managers in the accumulation process for a doctor or an executive or someone else of relatively high income, intensive concern of one thing or another; many career diplomats & others that

began w/at least some modest degree of wealth in their family often use this intervivos trust as a way of having their property at home in continual management & monitoring while they're wandering around over seas ... the inter vivos trust; to the degree that there is going to be a tax laibility, the donor must maintian seperately from the trust funds suitable for the payment of the estimated estate tax - life insurance proceeds, perhaps some other emergency cushion or resources; you can provide that as the donor passes away that his spouse or eldest son or whoever else he wants as an overall overseer of the trust be appointed co-trustee w/the corporate trust, so that the family's wishes are equally represented w/the financial skills of the corporate trustee; both of them are also referred to as "sprinkle trusts", meaning that the 2 trustees can alter the amount of monies going to the various beneficiaries according to some priority schedule, so that if 1 of 3 children gets himself into medical difficulties the majority of resources can be focused on that or if the surviving spouse has an illness & needs nursing home care the principal can be liquidated to sustain them in the style & comfort to which they are accustomed; they have a great deal of discretion to optimize what they perceiuve as the priorities & interests of the deceased & do it on a common sense, a necessary, basis, so it doesn't have the rididity of a will which says this is the way it will go & everybody gets 1/3 & that's the end of it, because once it's written down you can't change that; ... no matter how unreasonable the will may have been or perhaps incompatible w/circumstances as they evolved, there's no way to do that w/out breaking the will; and doing that is an unlikely task ...; so the inter vivos trust is a very useful device.

-2. the 2nd way of handling the problem is to incorporate - the incorporation provides the opportunity to freeze values in preferred stock & may also provide a device for providing continuity in management; particularly important in real estate is where you want the property manager to be skilled, familiar in the porperty, perhaps trained by the testator himself, & you want to assure yourself of their loyalty & continuity of employment & you can give them a partial interest in the corporate entity ... (end of side 1 of tape) ... you look at the fact that either you give 20% of the money to him w/life insurance or he's simply allowed to escape & the property loses 20% of its value for bad management & lack of continuty, well you're better off just to give it away to assure stability of vested interest of ownership on the part of the survivors.

-3. a 3rd way of handling that is to set up a 2-tiered entity, the general assets of the family go pretty much as we have looked at it before, in terms of the marital trust or life estate trust & so forth, but the major asset, let's say it's a corp. that owns a building business or a large real estate portfolio or a large farm, goes into a seperate trust, sometimes called a foundation, & a principal objective of that foundation will be perhaps to provide charitable contributions; often it's a way of neutralizing the possibility of a raid, lets say we have 2 classes of stock, a voting class A, a non-voting class B, most of the assets are represented by the non-voting class B, the class A goes to the survivors & stays under the lets say the $5M mark where estate taxes begin to be confiscatory, something like 60%, and the non-voting stock goes into a charitable trust & the income from that can then be used to support charitable purposes of the trust; the IRS says that's OK as long as the following conditions are met: 1. it doesn't represent total control of an operating business, in which case the foundation would be required to dispose of the stock in it, 2. that you disperse at least 5% of the value of the securities per yr to the charitable beneficiaries, so if you put $10M in there at the very least you have to put $500,000 out in cash benefits to whoever it's designed to support; if you meet those 2 criteria you can retain total voting control of the parent-family corp. & at the same time eliminate a majority of the tax, because the largest part of the asset is now a charitable donation & is a reduction against your gross estate; so you have the leverage of the assets taht are represented - they are earning money from the voting stock & at the same time you retain control of the limited number of voting shares and spin off the rest into whatever daddy's charitable objectives were; this is popularized by the Ford Foundation & the Rockefeller

Foundation & a number of others, but it's done quite commonly even at the small, local level in which the estate of the deceased is set up in that way; because you can hire your own children to run the trust it doesn't mean that they don't get any benefits out of it; I know a number of major trusts where while the primary objective is to invest in medical research & so forth the daughter & son-in-law & brother & sister-in-law are each employed as trustees at $100,000/yr to overview the estate & continue to make their contributions, so it's not a total loss to the survivors, so it's a great thing to do if you've got a son-in-law who is inacpable of doing much but spend your daughter's money ...
-4. the 4th method of management of at least the major resources of the businessman is to have worked out a long-term buy-sell arrangement w/a partnership or business entity which represents the largest part of the resources, e.g. a 3 generation family has owned a resort; the 1st thing in structuring the resort has been in yrs past a twin stock freeze, the resort has then gone into joint venture w/other money partners to expand the resort; now you have g-dad & g-mom having given the common stock to their kids, now their kids are coming along & running the resort (3rd generation), how do you extricate the middle generation? one of the things is that g-dad & g-mom can leave the remaining callable preferred to their g-children so it would skip a generation, that would be one way of doing it; another way of doing it would simply be to create a buyout arrangement whereby any one of the partners that dies in the venture, either the outside family interests or inside family interests, would have say a 10-yr buyout period in which they would just receive 10% of the net operating income & 10% of the capital assets sold during that period of time; it's attempting to recognize that the momentum created by many yrs of service & input by those people must be rewarded by successive returns out of business rather than simply a 1-shot settlement; the hope is that the asset will be continued as well by the survivors & will continue tc appreciate as they receive the money, which is in essence a partial liquidation over a 10-11 yr time period, they will get more money than if they simply got the present value of the estate right now, which may be at a point where if they had just gone into straight debt the net worth is pledged to secure the loan, were they to have to cash out one of the partners at that time it would be relatively stressful & a technically insolvent kind of situation, so you design a long-term buyout of the deceased partner's interest from the income of the partnership; part of that requires soem evaluation of how well the partnership will survive, what kind of momentum it has, ovviously if there are only 2 partners & 1 dies his estate doesn't his estate doesn't want to wait too long for the payoff because partner #2 may also die and "the goose will stop laying the golden egg altogether", but on the other hand if it's a hard asset kind of busienss that has 25-30 yrs of momentum going & an executive-management force in place, you can take a much longer term to amortize 1 of the originator's interests out of the property; there are a good many major businesses today that are still in the process of amortizing the estate value of one of the early partner-originators of the program; that's also useful where the deceased contributed certain patents or other kinds of resources of that sort which have a longer-term payoff, rather than having a royalty agreement directly w/them because at that point the value of the royalties & the patents contributed to the corp. have to be paid for over time by a long-term contract.

-those kinds of arrangements, any one of the 4, are most significant where the estate consists of assets likely to appreciate if well managed or likely to be wasted quickly if not managed well, which certainly characterizes real estate; for the real estate investor in the past one of his real problems was finding corporate trustees who were willing & able to provide that entrepreneurship that was presumed by his real estate investors; a banker said last summer at the banking school "we're trained to paint & sell it, that's all we want to do w/real estate", it's not as easy to handle as bonds & stocks; we never know how we're doing & there's no place to look & every time we do look something horrendous is about to happen; so since then some banks have developed very good real estate skills & charge for their services w/a whole listing of things they can do for you for a certain price; and it's really critical to draft a will that picks in advance who the corporate trustee is going to be & who w/in their staff is going to be responsible for the assets, & them giving them the power under the will to do what needs to be done for the real estate, exempting them from liability for loss & providing incentive returns where they succeed; the old trust fee of 1% or 1 1/4 %/yr is being replaced by a series of incentive fees that look at acquisition management & disposition, minimum rates of return in terms of cash income or bonuses; if they exceed that then look at overall rates of return after 10-15 yrs when the properties are sold or reappraised, & to the degree that you ahve an average annual return in excess of a real rate of say 6% & in inflation rate, the trustee gets a percentage of that; this has been a long time in coming and there's a great deal of resistence still in many of the trust circles to having incentive fees for fear that that will be an incentive to take riskier positions w/other people's money & perhaps to churn a little but to earn the higher disposition or acquisition fee & so on; that remains to be seen, but the Comptroller of the Currency & ERISA have both modified the position over the last couple of yrs to permit that type of incentive contract where you have enterpreneurial assets like real estate to manage; several of our major building & landowning firms are now in the hands of bank trust depts who find someone they feel has the skills appropriate & appoint them the chairman of the board & they become the overseer of the operation, which then goes on for yrs w/out public recognition that technically the control & managerial power is a corporate trust division of a bank.

Vehicles

-OK, for structuring we talked about the vehicles for the trust, the creation of it begins in 1 of several ways; these are not mutually exclusive, probably all of these instruments will exist at one point or another.

-1. 1st is the will - the will will be a very detailed plan for establishing administrators, the probate processes, the assets' ultimate disposition & most importantly for providing the powers necessary for those who survive to execute the plan; the presumption of the statutes is that you have no powers to go forward w/a continuing business & in the abasense of anything to the contrary you turn it to cash & distribute the cash under the terms of the will (not the assets, the cast) so throughout the will is being designed not only to provide positive instructions to those who are expected to carry out the plan, but at the same time to frustrate the way in which the statutes work to acheive something entirely undesireable or unsuitable relative to your plan; if you die intestate the way the statutes work essentially if you have a spouse & child each gets 50%; if you have a spouse & 2 children the surviving spouse gets 1/3 & the children get the balance prorate between them; if you have 3 kids, mom gets 1/3 & the kids each get a 1/3 of the 2/3rds; if 1 of the kids have died & he has 2 kids they would each get 1/2 of what that original child would have had & so forth; that may mean if they're all under age each one has to have his own guardian, which is an expensive proposition, greatly complicates the operation, & it may mean the working control of the business is gone; a friend of mine, his father died intestate, he was the controlling interest in a major corp. in Milwauke; by the time it got divided up among the wife & 3 children, 2 of the guardians named for the children were unfriendly to the existing management of the corp. - they had a Donnybrook - ultimately he had to quit college & take over running the busienss jsut to sort out the family feuds that were going on; so the 1st instrument is the will & it has to be a very carefully drafted statement of intent as well as a statement nullifying the operating of the local statutes that govern inheritance.

-2. the 2nd element is going to be cross-purchase arrangements w/business

associates for 2 reasons: 1. teh estate of the deceased needs cash & 2. your associates don't want to be in business w/your relatives; you were dandy as far as they were concerned but they don't want anything to do w/your relatives, they want to go their own way; so you need a mechanism for disengaging at the same time that you create liquidity.
-3. a 3rd element than needs to be drafted & at least ready to go into place if not already operational are the trust instruments which will control the ongoing objectives of the will.
-4. the 4th major piece of work will be an ongoing inventory of assets, other property rights (e.g. teh survivorship irghts in a life estate of somebody else, life insurance), all the various things that make up a gross estate maintained at a reasonably current level, w/the documentation for all that at a central point protected against destruction & violations of privacy ...

-(Inaudible Question)... yes, the trust instrument probably would be drafted, even a marital deduction trust or a QTIP trust, the wording of that would be in place even though it doesn't become operational until the funds are actually transferred to the trust, but you as the testator want something to say about how that's going to be done so now's the time to do it.

-finally,it would be good for he donor or testator w/considerable means to provide some sort of further direction as to his intentions, priorities, charitable objectives, etc.; too often those are either cryptic or impossible to recall by the survivors after the fact, & yet they're sincerly interested in carrying out whatever the wishes of the testator were, & therefore some sort of essay that is non-binding but directional can be extremely useful; & it's amazing how many people don't do that; it also goes w/out saying that both spouses in a married couple or all partners in a given business should have executed something in a similar fashion.

-since the marital deduction is such a significant factor many wills contain what's called a survivorship clause which is a presumption of survivorship; the marital deduction may be an extremely desireable device in terms of cutting taxes & getting the assets passed through to children, trustees, guardians & so on, so where there's a "common disaster" (sometimes it's called a common disaster clause), there's a presumption that one party or the other, husband or wife, died 1st, depending on which serves their estate purposes best; therefore if ther's an airplane crash & though the husband survives the spouse by several hrs., the will can reverse that back over a period of I think 24 hrs., & treat the whole process as though the wife died 1st & therefore the contingency clause comes directly into operation; or you can presume the husband died 1st & a marital deduction moved to the widow for a matter of moments before it then gets distributed, thereby salvaging the property tax interest that might have been there.

-so there are a variety of details that must be atteanded to in the structuring of the plan, & real estate makes it particularly important taht you do so, & at the same time gives you more diversity of planning techniques because of its joint survivorship, because of the way in which you peel off different interests in the real estate, the land going to 1 party, the bldg going to another party & perhaps life estates going to the occupant, residual estates going to those who are going to inherit the farm; the amount of flexibility in real estate is perhaps greater than any of the other investment media, therefore real estate creates its own estate problems but at the same time it provides more opportunities to solve estate problems than virtually any other asset.

Real Estate 850
3-7-1988
Transcribed by Evan Harrison

Discussion of Returned Problem Assignment: In looking at any RE investment, as in any kind of analysis, the 1st thing you should do is set up a time line and lay out some points on the time line and ask "where the hell are we?" What has already transpired that can't be undone? Where am I coming in on the life cycle of this investment? Two of the tenants in the case got rent concessions. But that is in the past - it doesn't matter to you. By the time you're coming in on the scene, they're paying the face amount of rent. From an accrual accounting basis you would take the ave. dollars paid per year. This is one of the major problems RE has with accrual accounting. If you are buying an investment on the cash flow, then match when you get the money to what periods you're talking about. It is very useful for any kind of analysis to block out a time line.

Critical flaw #2, is that a lot of you had a problem w/ rent stops and what that does to the cash flow. You were quite right saying that the market was quite strong and assuming that land costs & const. costs had risen, you should flow up to a more normal occupancy. Some of you not only bumped the rent, but eliminated the stop. The tenants are paying whatever is above the stop. Some of you dropped the stop to $4.00. You had a little problem in terminology. Some of you went to no vacancy.

Some of you had a problem with the venture capital firm, saying it was high risk. Not so. Venture capital firms are very liquid organizations. They make loans to other start-up companies, and have lots of capital of their own. You talked of a guarantee - from whom? The tenant is already in there. The developer is going to take the same approach and refuse to guarantee what is essentially a national credit, or if he must, want $1,000,000 more for his building.

Most of you are pretty conservative. A few were very aggressive. I can tell the brokers right away from the former auditors for the FDIC. You now have the Clifford case to chew on, and we're going to hand out the fourth case soon. It will be due on the last Mon. of class, and Jim Huffman will be here from Eastdill to go through that with you.

Q. on Clifford Case. A: that should be 300,000 life ins. on the next to last page.

Q. On RE 769. A: Schedule is in place and we have an all star cast of thousands. (Discussed indiv. presenters)

GROUP INVESTMENT AND GROUP RISK

By way of introduction to the next phase of the course, which has to do with portfolio structures for RE. The Phoenicians were the first to develop the group investment concept as a way of handling risk. They sent their ships out on trading expeditions with underwriting shares. The term underwriting comes from that. They would put out an agreement and you would sign for a percentage of it below the agreement. That was picked up in marine insurance in terms of the way Lloyd's of London, etc. operate.. The concept essentially was don't risk more in a single venture than you can afford to lose assuming total loss of your entire investment in that enterprise. If you then made enough investments, then that ship which did return or RE investment which did survive would provide sufficient return to:

1. Recapture your capital, and
2. Provide a return on the total amount of money at risk.

TYPES OF GROUP INVESTMENT

All of the various forms of group investment grow out of that philosophy: diversification by buying a small divisible investment which is of no greater size than you can afford to lose. In RE that breaks down into the following kinds of investments:

1. The **General Partnership**. The problem is that the General Partnership with its full liability really doesn't break the investment down into small enough units. You can conceivably be liable for the total project even though you are only a partial investor in it.

2. The second more likely way of doing that is obviously the **limited partnership.**

3. The third way is the **corporation**. As you've already learned, there are essentially two types of corporations, but there can be as many as three which can be utilized.
One is the subchapter S, with very limited applications to RE, except for land dev., resort hotels, and restaurants.
Number two would be the standard corporation.
Number three would be the incorporated trust, REIT if you will.

4. Then there are two additional **trust forms** for investment in Real Estate.
The first is the classic REIT, Massachusetts Investment Trust, which is non-incorporated.
And two, the land trust, which is available in maybe a dozen states or so, such as Illinois, which will define a series of beneficiaries and their appropriate shares in whatever is owned by the trust.

5. Recently we have begun to see three new **institutional formats**.
One is the so-called open end commingled fund, which is a general trust form of ownership, essentially, in which the investors receive certificates of beneficial interest. Generally associated with pension funds, but it doesn't have to be. It could be associated with endowments and other forms of non-profits.
The second type of collective pool is the closed end trust. It essentially has a finite life - nobody gets in past a certain date and nobody gets out until all the assets are liquidated and there is

a distribution to the beneficiaries.

The third type of collective investment is a whole variety of so called loan participations.

Notice we did not talk about a REMIC. A REMIC is not a form of organization. It is any one of these organizations which is managed to qualify as a REMIC in the tax law. A REMIC is a critter of the tax law, and has nothing to do with its legal of organization. It could be a corporation, it could be a trust, it could be an REIT, it could be a limited partnership. All of them, if operated a certain way and if meeting certain requirements, could be a REMIC. So do not confuse REMIC with a legal organization. It is a tax qualification.

CHARACTERISTICS OF THE GROUP INVESTMENT

Each of the different formats have to address very specifically the following items:

1. Liability of the investor for losses beyond the original investment.
2. Allocation of managerial control.
3. The time window for purchase.
4. the time window for liquidation.
5. The frequency of reporting.
6. Who is eligible to invest.
7. Investment policy.
8. Regulatory policy.

For example, an REIT that is traded on the open market, the **time window** to get in and to get out is generally continuous. With an open ended commingled fund it is generally quarterly. The management of the fund can decide whether to accept your investment or not, and moreover, put you on call as to whether they will pay you off or not. A decidedly different window of investment and window of liquidation. On a closed end fund, you can get in before a certain period, and after that, bang, it's closed, no further investments accepted, thank you. It will generally be marketed to say, "the minimum we are going to go for is $100 million, and we will accept investments up to $150 million. If by that certain date, we only have 90 million, you get your money back, and there's no deal. Once we hit $150 million and its oversubscribed, everyone gets to invest a proportionate share, so if it goes to $200 million and you put in $10 million, your share would be 3/4 of that, or 7.5 million, instead." You don't get out until the liquidation of the fund, and that window is generally very broad, they say "We will liquidate the tenth year, or up to the thirteenth year." So they aren't stuck with having to liquidate when the market is at its low point, or some other condition suggests they can't do that, or some building takes too long to sell. So they have a very wide window for exit, even though there's maybe only a month wide window to subscribe and fish or cut bait.

Q. Do they load any risk factor into that for the fact that you can't get out when you want to.

A. That is the subject of considerable debate, as we shall see as to which is riskier, the open end or the closed end fund.

Next thing we need to decide is the **frequency of reporting**. If it is a bank managed fund, technically, it must report monthly. By convention, REITs, etc. generally report quarterly, but they don't have to, they can go 6 months. Almost all of them report annually. But once you go to a closed end fund, they may not have to report changes in the capital value, as opposed to operating statements of revenue and expenses, more than every three years, arguing that there is no way to take the temperature of the real estate every year and have an accurate sense of what values may be and so forth. So they get to establish the game.

Next, **who is eligible to invest**. This is going to reflect a number of things. The minimum size of a unit, obviously. Second, the category of the investor. What do we mean by category of the investor? Well, we have investors that are subject to ERISSA. ERISSA has distinct rules as to what they can do and can't do, and the tax laws have some things to say about when you qualify and when you don't. However, a public employee retirement fund has much more liberal rules about what they can and can't invest in. Public employee funds can invest in everything ERISSA funds can invest in, but ERISSA funds can't invest in everything public funds can. Play with that one for a while. On the other hand, endowment funds of eleemosynary institutions can't invest in what public funds invest in, because they're under a different section of the code which is somewhat more stringent, particularly relative to leverage and relative to the at-risk rules which could make them subject to taxation. Then, of course, we have private individuals and consortiums of private individuals. As you saw in the REIT rules, we saw that 5 people can't 50% of the deal, and there have to be at least 100 investors. So suddenly you get locked into a position where if you get 1 more from a family, under the attrition rules, bang, you just blew it, because then 5 families have 51% of the deal and you just blew your trust cover. So there are a variety of qualifications as to who is eligible to invest.

All of this precedes what the investor really asks about: "What is it that we are going to invest in?" Some of these rules you can make up for yourself. "This fund will only invest in office buildings that are less than ten years old." Or, "We will not invest in buildings which are under development, which is defined as any building with less than 80% occupancy." Those are arbitrary, but they reflect the **investment policy** of whoever is running the fund.

There may be other controls. For example, in the pension area, you could not invest in something in which the parties in control had a vested interest. If they are an interested party in the transaction, it would be regarded as an illegal transaction. If you make an illegal transaction, several serious things happen: 1. There is a tax on the gain which is totally confiscatory, so if you sold your 1 million dollar building to the pension fund in which you were also one of the investment managers for 2 million dollars, you had a 1 million dollar gain, the federal gov't would take the entire gain. And 2., if the board lost any money for having engaged in a prohibited transaction, the board personally would make up the difference.

So we have some things which are a matter of investment policy and some things which are a matter of **regulatory policy** which begin to define what we can invest in and for whom.

Those regulations can come from multiple sources:

1. Federal rules controlling pension fund investments.
2. IRS rules controlling tax exempt investments.
3. Enabling legislation controlling public investments.

The city of Milwaukee says their pension fund cannot invest outside the continental United States. That's their rule. Maybe good, maybe bad, but it's their rule. They cannot invest in development properties. They will invest 5% of their assets in Milwaukee. They're legislated, but singular to a particular turf. One of the big rhubarbs you hear about currently is 'should a pension fund be a social investor and a development bank for its own state, etc. You have that continual tension between legislators who would like to serve their own purposes and investment managers who say that's a lousy idea, because you lose risk management control, and we're watching that happen in Wisconsin right now between the investment board and the legislators. The legislators would look pretty silly if the Investment Board had knuckled under and done what they wanted and put $200 million into the Chrysler plant of teacher retirement funds. If they had succeeded on that one, the idea of social investment would died right there. It might have been worthwhile.

THE LIMITED PARTNERSHIP

Let's ignore for the moment the general partnership, and treat it as a special exception to the problems of the limited partnership. After all, no one wants general liability on the project, let alone for whatever their partners do, unless there is some overriding compelling reason which makes that exposure more attractive than the next alternative which is the limited partnership. So let's talk about limited partnerships.

PUBLIC DISCLOSURE RULES

Limited partnerships have been around for a long time. They are a product of the statutes. The basic bones of the statutes in all states, although each state differs slightly from the **uniform partnership acts** which have been promulgated to standardize the process are:

1. The limited partnership must be registered at the register of deeds office under the misc. category in any county in which it does business or owns property. The purpose of that is to put creditors on notice that, 'while there are a lot of folks involved in this deal, here is the exposure of each of the limiteds, and here are the generals to whom you must look for general credit support, and here is the current roster of general partners and limited partners in the project. The partnership then must file its partnership agreement, which identifies the gen. partners and their address, etc., and then lists the limited partners, and their address, etc., and the % of their relative participations. The generals have 5% each, let's say, and the other 85% is the limited partners, and how many of them are involved in each one. Why is that important? Well, one thing that terminates a limited partnership is if 51% of the limited partners die. If you have 1 limited partner with 51% interest, you'd better watch him closely, because if he dies, poof, the whole thing is in dissolution. The only way out of a L.P. is for someone to have his name removed from the public roster. You may do that, even though you don't get any money back. You may see the whole thing going down the pike in another year or two, having a negative basis, foreclosure on the mortgage causing you a disaster, etc. You may abandon the partnership simply by going to the G.P. and asking, requesting, and demanding that he remove your name from the public roster. At that

point you are no longer a L. P., you have no claim on the partnership, you get nothing if it is dissolved, but on the other hand you don't get bit in the tail of it goes into foreclosure, either. The only other way out, as John Ridass (?) puts it so delicately, is to put it in your wife's name and get a divorce.

Q. If there is limited liability, why would you want to get out of it?
A. There may be limited liability as far as the investment is concerned, but not with IRS.

Q. If there were periodic cash calls and you wanted out before all of them were due, what would be your liability to pay?

A. You can get out of the L.P., but you would still have to pay. You cannot avoid the subscription price. Now what you would have to do is attack the organizers of the partnership on the grounds that there was securities fraud or it was misrepresented or there was mismanagement of one form or another. That is happening all over the country. Some people really had to make that decisions. In many cases their attorney advised them to go fight it - to attack the G.P. or the securities underwriter on the grounds that there had been some sort of breach in the execution of the partnership, and in essence extort a release from your restriction, because in general the G.P. would have to decide whether they would want to be in public being accused of securities fraud or just buy you off and hope you go away. Just raising the spectre of a public spitting match about that may be enough to get the people to give you the money back and let you off the hook. With the change in the tax law, there was a good deal of that going on.

Now, the other elements that would be involved in that agreement would be the <u>subscription agreement</u>. How would the L.P. and G.P. fund their requirements. In many cases they could go as long as five years to collect all the money, and the hope would be that the tax savings on other income would be sufficient to fund the subscription, so you weren't really using real money after the first draw.

One of the problems, is what kind of sanctions (and this would be part of the subscription clause) there would be against a partner who does not meet his subscription. There were two major answers to this.

One, there are some companies who will guarantee the timely payment of the subscription. MGIC had a partnership group that did that, Continental Casualty, Travelers Insurance, a number of others are providing, more cautiously now than before, in effect a credit enhancement which says in effect "no matter what this limited does, we will pay and then we will go and extract it from him." The creditors get the feeling therefore that the money will be there when it is needed by the project, not because Joe Smorgasborg says so, but because Continental Casualty says so. And that's a AAA credit, etc.

The second alternative is to simply convert the L.P.'s position to subordinated debt to a long time fuse. The courts will generally not allow you to simply confiscate the partners interest, general or limited, because he didn't meet his next obligation in funding. He subscribed for $50,000, he's got $20,000 in it and thinks he made a mistake and he doesn't want to make the last 3 $10,000 payments. They say, O.K., Charlie, in suing you for breach of contract for getting into a spitting match about that, in the meantime, your $20,000 no longer makes you a limited partner. You lose all rights as a L. P. and we're going to give you a $20,000 subordinated 3rd position note which pays 5% interest per year and is payable in 15 years. Then you've got a pretty worthless piece of money. But the creditor feels better, because he knows that whatever money was in is going to stay in. So those are the two methodologies for meeting unpaid subscriptions.

The last major area is <u>dissolution</u>, and that can be subdivided into three categories:

1. Voluntary dissolution. L.P.'s under the IRS rules and the Limited Partnership Act have only three decisions in which they can participate:

1. Refinance
2. Replace the Limited Partner because he is incompetent
3. Dissolve the partnership. That's voluntary. If they vote to dissolve, the G. P. has to follow through on that and go into a dissolution mode.

Q. Does it have to be a 100% vote?

A. No, generally it is on a sliding scale. Say 100% to replace the G. P., since he drafts this thing and he wants to make it very difficult to replace him, 75% to dissolve, and 65% to refinance. In other words a different percentage.

Dissolve may also include merger. We'll roll up our partnership into a Master Limited Partnership or a corporation or something like that. That would technically be a dissolution.

2. Second kind of dissolution. The General Partner says "I don't want to play anymore." Nobody can be forced to be a G.P. against his will. So the G.P., generally w/ some kinds of contractual limitations like he has to stick with it three years or five years, or he has to complete construction, but with some prequalifications with respect to the fact that he must finish now that he has started the job, he can go out at any point in time. He may have several qualifications for that. He may 1. buy out all the limiteds according to some pre-set appraisal formula, or 2. he can just say, enough of this, we're going to dissolve it, or 3. he dies. Now this may make his investment unmarketable if it is is too vulnerable. In order to make it a marketable L.P. in which other folks want to invest, they need some stability - they don't want a surprise dissolution which may hit them at a very vulnerable time relative to the tax law. They've taken all of the investment tax credits for the personal property and they've used accelerated depreciation, and they've just taken a big chunk of tax savings because they've donated the facade of the building for historical restoration, and now the G.P. says "hold it." All of a sudden they have to pay ordinary income tax in year 2 on all of the stuff they've just taken a deduction in year 1. Obviously that's not a good thing to do, so obviously they want control of it. Well if it's wide open on the part of the G. P. to take a (?) powder, obviously that's not a good thing to do. So typically you try to put some constraint on his mortality. So typically the G.P. puts 5% in his own name and 95% in a corporate name, so if he dies, the corporation still lives and can keeps the partnership going. You'd be surprised how often locally in the earlier days a G.P. put his interest only in his own name and then suddenly died, immediately, thoughtlessly and inconsiderately to his investors. That's a mess.

3. The third kind of dissolution is when 51% of the Limited Partners die. Otherwise, if only one dies, representing, say 10% interest, there is an automatic restructuring of the partnership, as

we talked about in estate planning earlier, or 2. the estate gets a note for the value of the share or 3. the L. P. is assignable to the estate or heir of the deceased, while it would not be marketable. Notice that there is a difference there. Most L.P.s have a very limited marketability initially, but an assignment to an heir would not be a marketable instrument. So it could be turned over to the estate, even though the estate couldn't sell it to somebody else.

Q. Would the rights go along w/ the assignment.

A. Yes, it would survive as a full L.P. interest, including voting rights.

The above are the basic kinds of information which have to be in the public disclosure. You follow that and you now have a Limited Partnership.

INTERNAL REVENUE SERVICE RULES

The Internal Revenue Service has a couple of requirements of their own, however, which are not part of the Limited Partnership act, but which represent significant constraints on it.

1. To be a single tax conduit, and a non-corporation as defined by the IRS, you cannot have more than two of the following four attributes. (Technically 6 attributes if you include that there have to be 2 or more investors and they have to be in it for a profit. Obviously there will be 2 or more investors, the G.P. and the L.P. They cannot be the same person, although the G.P. can invest up to 10% in the limited partner. So you've got to have 2. So the first 2 criteria are kind of a given.)

1. Centralized management
2. Limited liability.
3. Marketability of shares.
4. Immortality or continuity.

Notice that a corporation with marketable shares has all four attributes. The board of directors elects somebody to run it; he's called the president - centralized management. The shares are marketable, there's limited liability since the shareholder can only lose what he's paid for his share, and presumably can market his share indefinitely, and the corporation doesn't die even if all of the shareholders do.

Those are all of the attributes that everybody would like to have, but don't want them so badly that there would be double taxation. So the trick is, how do I creep up on every one of those four, without crossing this rather vague line as to when a group of us become a corporation or an association taxed as a corporation.

Looking at the Limited Partnership, what do we have? Well, the first thing we have almost by definition, is <u>centralized management</u>. The general partner is a centralized manager, and the L.P.'s are not even permitted to manage, or they lose their status as L.P.'s. So we have centralized management, and there is nothing we can do about that one.

What can we do something about? Well, one is <u>immortality or continuity</u>. Almost all Limited Partnerships have a clause in them which is a sunset feature which says if we don't dissolve before then, we will dissolve on April 7, 2007, or whatever, and poof, you are now not immortal. How far you can push that out is obviously a big rhubarb with the IRS.

The next one is limited liability. The rule is that everyone has to be equally liable. That means that either nobody is liable or everybody is relative to the capital debts of the organization. For example, if we write a non-recourse mortgage, so the only remedy of the lender is to take back the property, then everybody is equally non-liable relative to that debt. The general partner is always liable for the trade credit. But what if he gets a second mortgage on the property and the G.P. has to sign on the second mortgage as a condition of getting it, but the L.P.'s don't. At that point we no longer have equal liability, because all of them are non-recourse on the first, but the G.P. is full recourse on the second. At that point the IRS says you drop back to the at-risk rules and the L.P.s only enjoy tax deductibility for interest and depreciation only to an amount equal to their actual investment at risk. They are trying to discourage a situation where everybody says, we're all non-recourse officer, none of us were driving, we were all in the back seat. But recognizing that the G.P. would try to avoid that exposure by creating a corporate shell in which there are no assets in the corporate shell, the next rule is called the safe-harbor rule, and this is what puts the clinker in the general partnership.

The Safe Harbor Rule says that the G.P. must have liquid cash resources equal to 15% of the cash raised for the equity side available to the partnership. So there is real substance to the fact that the G.P. in essence is liable for something and can stand to lose something. Otherwise everybody has limited liability. The limiteds haven't signed on the mortgage, it is a non-recourse mortgage. If the general doesn't have anything in the shell corporation, he can't in fact lose anything. You now now have limited liability for everybody, and that's a corporate attribute. Again, with that third corporate attribute, you're a corporation, and if you're a corporation, you get taxed like one.

Finally you have to have marketability to be a corporation. So most partnership units have very circumscribed marketability. Many of them say "I'm sorry, but you can't sell at all for 5 years or 10 years, or something like that." Others state that in order to sell your share, you first have to offer it to the general partner, and he can buy on some scale, so if you offer it in year 1, you get 75% of what you invested, in year 2, maybe 82.5%, in year 3, 87.5%, etc. And the general isn't obliged to buy it if he doesn't want it. Assuming he doesn't want it, the next condition says you have to offer it to all of the other limiteds so they can maintain their pro-rata position. If they turn it down, then you can go and offer it to the general public. So it's a real restriction on marketability. If you don't have that, then it's a corporate attribute to be able to sell your unit, and you're going to be double taxed.

So the IRS has created a significant number of limitations on what you could do with a limited partnership but you can't if you want to maintain the single tax conduit element.

SECURITIES REGULATIONS

The securities folks have gone even further to provide additional limitations on the Limited Partnership. A limited partnership is a security. **A security is defined as any fractional investment in an enterprise run by a third party for the profit of**

all. That clearly covers a limited partnership. Therefore you are presumed to be a security unless you can meet certain exemptions under the security act. But those exemptions must be applied for and determined explicitly. The failure to do so means the G.P. or whoever structured it - generally the G.P. - is guilty of securities fraud and the investors are entitled to their money back with interest at any time they so determine that such a fraud has occurred. Furthermore, if they don't get their money back, you get to go to jail and think about it some more. By and large the SEC attorneys are very good, and most of the people who violate this rule do in fact go to jail and have a chance to think about it some more. So as a result you don't want to cross either the state blue sky laws or the federal blue sky folks at the SEC.

Now part of their requirements are who is eligible to invest. We'll talk about schedule D, etc., later.

THE GENERAL PARTNERSHIP

Now the limited partnership begins with some very real constraints on those who would use it and apply it. At that point the general partnership doesn't look so bad. The general partnership has everybody involved in management, and is therefore not a security. It is not an assignment of fractional interest to be managed by a third party. All of the parties at least theoretically have equal say in the management of the enterprise. Second of all, because it is mortal, there is no limit of liability, and there is no centralized management, and the G.P. can't sell his interest to somebody else, because the remaining G.P.'s can't be forced to be a G.P. with somebody they don't want, it can never be a corporation, and will never be subject to a double tax. The third major advantage to a G.P. is that because it is not a security and doesn't have all of these technical rules, you can start it instantly. You and I can decide we are going to have a general partnership, open a bank account, each put in $5, and we are in the real estate business. We don't have to know what we are doing, we don't have to know what the budget is, we don't have to make anybody any promises as to the general area we are going to invest in. If the following morning we wake up with a hangover, and want to reorganize it, You're going to do all of the work and I'm going to go along for the ride and only critique on the management, etc., and you get 80% of the profits and I'll take 20%,. you can do that. You didn't promise anybody anything, therefore there is no paperwork to change, etc. So for that reason the G.P. looks good relative to the L.P., but you'd better know who you are in business with, because you're liable for his mistakes as well as yours. By the very nature of the G.P., the creditors can come after both of you, or they can come after you because you have $100,000 and he doesn't. How you collect from the G.P. his 50% of the mistake, that's between you and the G.P., not between you and the rest of the world. So with that little exception, general partners are really fun to work with, but I don't know very many people I would want to be a General Partner with.

NOTES 850: Monday, March 21, 1988
Prepared by Chris Quinn

I Limited Partnerships: until recently, very popular in structuring single tax conduit entities.

- A. need two persons: a General Partner and a Lim. Partner
- B. Must register with Register of Deeds in county of principal place of bus.
  1. Certificate must have a summary of all agreements
  2. (great prospecting device for syndicators to find out who's making what deals and who's investing
  3. If additional shares are sold, an ammended certificate must be filed. Primary purpose - to put creditors on notice, for liabilities and debts
  4. Must include:
     1 Name of partnership
     2 Character of the business (farm, oil, cattle).
     3 Location of the business
     4 Name and residence of every GP and LP.
     5 Term of the partnership
     6 Cash & or properties contributed by each partner. ($, land, skills etc..)
     7 Any further contributions which might be called for (assessments and maybe penalties for non-payment. All this helps creditors get a better picture of the deal)
     8 Time frame that the contribution of LP has to be returned (if any).
     9 Terms of profit distribution: % of what?
     10 Provision for "assignment" of limited partnership. Typically no sale provisions due to non marketability feature of all lmt'd partnerships. Possible sale to other members but usually with penalties
     11 Any rights to include additional Lp's
     12 Terms of priority of contribution and compensation of Lp's and GPs.
     13 Do Lp's have right to receive other property besides cash (paid "in kind"

Generally, an amendment must be filed when a change of purpose, partners, financial relationship between the partners, occurs.

- C. LP's have 3 possible decisions to make:
  1 to dissolve the p-ship
  2 to refinance the p-ship
  3 to get rid of GP - malfeasance or incompetence etc..
- D. The GP is a fiduciary and as such exposes him to litigation from LP's. This is a major risk
  He acts and reports as a fiduciary
  Second major risk for GP is that a LP'ship is an investment security. The question is: Must it abide by security rules?
  Answer: Yes, unless it has an explicit exemption from it, vis-a-vis certain technicalities of inter or intra state cps.

None the less the GP must apply for and receive the exemption

(D.) In the past many GP's didn't understand their obligations and ended up in costly litigation.

E. The need for complete information about the project compiled for prospective investors means that the GP must have everything accomplished before writing the prospectus; appraisals, accountant info, financing etc., all of which is very expensive. So: **sunk costs are high**

sellers had long waits (6 - 9 mos.) for their $ and charged more for that time value

<u>Third big risk</u> to GP

This means they couldn't move quickly on an acquisition, implying that the properties weren't always top notch.

F. In order to pay for all the upfront expenses, the syndicator (GP) had to charge a variety of fees allowing for a first year write off. He also could structure financing with a false mortgage constant (from 12% down to 9%) and pay
he defines in, he could double dip on that basis. If he
he defines in, he could double dip on that basis. If he
the balance due after,say, 5 yrs. Obviously , he was hoping that the project would appreciate in value which occasionally didn't occur. More often than not the LP's weren't told about all this. If the project failed to meet the debt, and the LP's found out about the false constant tactic, the GP was really screwed!

II. Concept of profit sharing: % of what?

** The definition of return is the critical element of the prospectus. E.G.: a LP getting 5% of taxable income isn't the same as getting 5% of net profits.

A. Whereas a GP doesn't have such a large interest in the future value of the building and would rather "milk it" and get his piece of cash
available for distribution <u>before</u> returns, while the LP's have a vested interest in the resale value of the property, and are also the ones who pay to refurbish and renovate, so they want the GP to take his 5% <u>after</u> distribution for reserves. But now the GP has to postpone getting his cash, so he'll want some other participation elsewhere.

B. "What if he (GP) gets a part of cash avail. for dist. before res. plus the amount of that years principal pmt. on the mortgage debt? Is that a good deal? See, net profit is before you pay debt service and the GP would love to share on a net profit basis, then the mortg. comes out on the Limited's side and there's nothing left for distribution. The GP has taken his share up front and the LP's take all the risk that they'll ever get the principal back. So, 95% of nuttin is still less than 5% of something." (Dr. G.)

C. People often didn't read the prospectus which the GP wrote, and therefore didn't see that his profit share was based on something different than theirs.

D. GP's also often own the leasing, general contracting and land syndicate companies, so they are taking those profits too. Now if he takes 5% of gross income which he already got that in property management fees, the excesses get a little blatant.

E. "How bout cash avail. for dist. after allowance for reserves , plus the tax liability for shelter benefits of the taxable income calculated on a specific tax bracket? The GP says "you guys (LP's) are getting 95% of the tax shelter, we really ought to add that back in. So if everybody is in a 50% bracket, then we'll take that cash after reserves, which is fair enough, but now in addition relative to the LP's we'll add back the tax benefits you're getting and then I'll (GP) get 5% of that because I'm not getting the tax benefits that you're getting."

F. "Ultimately what you're really interested in is cash after reserves, (which is fair, you've paid off the loan and set aside money to involve the property) plus the tax liability or shelter benefits of taxable income calculated for a specific bracket, plus the amount of principal on that years mortg. debt. Is this a good deal for the GP or the LP? Isn't the GP at that point already getting his share of resale price? The net proceeds on the resale include the pay down on the mortgage, but he's getting it up front already - 5% while they own it. Now if we look at what our sales proceeds that he defines in, he could double dip on that basis. If he now gets the cash left after the repayment of the mortgage on the back side, he's double dipping, he got 5% on the mortgage pmt. in aid, while they were making mortgage pmts. and now he gets 5% of the net worth on the back side after the loan is paid."

Who gets paid when is the critical element of the profit distribution plan. A 95/5% split , alone, tells you nothing unless you know from what accounting line it comes from.

III. Sales Proceeds

A. Should the GP participate in gross sales? The LP's won't ~~want~~ want him to since there will be a number of charges taken out downstream such as closing costs, and sales commissions.

B. Some GP's might get a piece of Net Sales price

C. Or they might get the above minus the beginning mortgage balance.

D. Or he might get paid for performance. ie: Net sales price minus the purchase price, and therefore the capital enhancement of the deal will be shared. But then the GP complains that that isn't a 5% deal since he's only participating on the upside, and therefore he should get 25% of the difference The philosophy: You get to name the base, and I get to name the percentage!

E. Another possible base is all cash received on sale after pmt. of the mortg. balance at the time of sale, including a refund of working capital and unused working reserves and unallocated reserves, to the LP. That would be fair since the reserves were withheld from the LP"s as well as the working capital.

F. Still another is where the GP gets 1% of the original value of the assets=s (why the original value? This keeps the GP from

being too aggressive on annual appraisal values thereby increasing his take). Then the investors would get , say, a 7% fixed return plus an annual CPI loading (e.g.:7% plus a 4%
(F) CPI = 11%). After all investors had gotten their real return of 7%, then you subtract it all from the total sales proceeds and any surplus goes to the GP/LP on a 25/75% basis respectively.

The idea is to know what accounting line you're on and how you define the base and what the "wiggle room" is in that. Don't end up paying twice by giving a cut of operations and another cut of sales proceeds. E.G.: "Don't reward the GP for making mortgage payments which he was supposed to do anyway and then give him a reward in addition to the build up in the equity position as a result of pmt. on the mortg.. That doesn't make any sense at all." (Dr. G.)

IV. The LP'ship has other quirks.

A. The investor wants single conduit but he also wants to resemble a corporation as much as possible, and he wants as much liquidity as possible. Some forms of the P'ship created a battle with the IRS. These forms are:

1. Create a GP'ship that was a corporation in which there were no assets.
   This way they were essentially judgment proof.

   Uncle Sam said NO. Must have assets equal to 15% of the equity raised up to the first million and some scaled
   *** down % after that. This was called the <u>SAFE HARBOR RULE</u> the GP must be able to demonstrate that he has real assets to be able to meet real liabilities.

2. Relative liability of the GP & LP's
   Equally liable (by inference, equally not liable)
   (E.G.: FHA insured, non recourse mortgage - neither GP or LP are liable and is therefore suitable.

3. The third problem has to do with liquidity. What if a LP wants out? Some alternatives:
   a) Internal solution - set up an escrow acct. to buy out the LP
   b) sell shares on the secondary market at a discount

4. The law of LP'ship has been evolving quickly. Great deal of litigation occurring mostly from **conflict of interest** Developers and property mgr's having overlapping multiple interests. For example: A developer who also owns the prop. mgmt. co,, and steals a tenant from one of his buildings to fill another; or, a developer building 2 or more bldg's of the same type in the same vicinity, effectively over-building the market.

5. The laws have boiled out that after the GP has stated his other activities, and if the LP's are dumb enough to go along with him, they lose. Unless there is a blatant fiduciary violation.

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The Limited Partnership (cont'd.)

The limited partnership of the early 80's was a somwewhat different critter than the one that we see today. Many of the problems of being a syndicator, and structuring a limited partnership remain, although the facets may have shifted to a different syllable because the tax laws are no longer what they once were.

The first issue for a limited partnership is whether it is going to be a specified or unspecified property fund. Unspecified property funds are often referred to as blind pools. It is attempting to address the reality that we were referring to the other day that there is a long time period between the time at which you might tie up or control a property and you finally got through the whole legal process of being able to issue publicly shares in the partnership. The idea of the blind pool is to raise the money first, with an investment specification or strategy maybe, and then be able to bargain more effectively, as you can go for a quick closing on available properties, you have the cash, get a better going in price. The fund can raise more money with the same effort. For example, it is not that much more difficult to raise twenty million dollars up front than it is to raise five million dollars. You are better off raising additional money in one fell swoop, and then look for opportunities to buy for cash, getting better selection, better pricing -- a portfolio effect if you will, rather than funding one property at a time with individual syndications.

The problem is that many people are suspect of the blind pool, as they are not quite sure if they want to buy a pig in a poke. Many states, such as Wisconsin, probably would not permit you to register a blind pool, simply feeling that it is a license to steal and that in the absence of any evidence to the contrary, the organizer/general partner will simply buy whatever there is to buy in order to earn the fees, and there is no ability by the investor to analyze and be aware of what it is that he is purchasing before the fact. Some states permit the blind pool, other states make it much more of a hassle with rather strict specifications as to what kinds of property can be acquired, and other states like Wisconsin will kill it altogether if they can.

Due diligence, while not performed before receiving the money, is still required by the general partner as a fiduciary, but he does not have to go through the processing with a series of folks in advance.

The second element is whether it is an open or a closed end fund, whether the acquisition or pool is a one-shot deal, or whether they could sell a property and buy another property and continue forward in the future, do they have to distribute the proceeds to the investor when they sell the property. The open end funds allows them to trade, move in and out of various properties, and continue down the path until they have reached the stated temination date for the limited partnership.

The third area of concern is sponsor compensation. There are an infinte variety of ways for sponsors to compensate themselves, but they break themselves down into three (or four) major sections. The first is the fees on acquisition and marketing. The second is the property management, with two aspects. The first aspect is managing the property itself, and the second is managing the partnership, which is a separate function and for which he can also be compnesated. The accounting, the filing of reports, keeping the investors informed, etc., are functions of managing the partnership and not the property. This separate fee could include rent on an office building, secretarial services, accounting and legal services, plus some nominal fee for the time involved of the genaral partner. The third area is the back end load as it is called. What does he get at the time that the partnership is terminated and the various commitments have been met? There are obviously several levels of participation.

One is simply the fee for finding a buyer and disposing of the property, and typically the general partner has an exclusive brokerage commission in which the commission fee is stated as part of the partnership agreement. Second, there could be an incentive fee in which if he meets certain goals with reagrd to minimum rates of return, prices in execss of certain floor, etc., he would get an extra kicker. Third, there may be a flip-flop clause that after distributions have reached a certain amount the residual would go entirely to him or at least 50-50 to him, sometimes more.

The degree of sponsor competition, and when he receives it, is such that the sponsor would like to get as much up front as possible, but quite often that is not possible to make the numbers work. This up-front amount is often referred to as the "hog factor". The National Security Dealers Association typically puts a limit at 18% of the capital raised as being the maximum that the dealer can take out on the front end. That 18% would cover sales commissions on the sale of the partnership units, finders fees, advising fees, all of the other fees that he can dream up. Mangement fees relative to the operation of the property, probably about 5%, must be close to the norm that a third-party professional peoperty management firm would charge. Most general partners would try to come in below the typical market rate to avoid controversy.

The back end load is where they kill you. The back end load of course first involves his normal participation, e.g. if he is a 5% partner he gets 5%. It is very important to know how the 5% is defined. If he is careful, he will define his 5% on a very high number (e.g., net sales proceeds less first mortgage balance). After taking out other expenses and a stated rate of return for the limiteds, he might then get 40% of any of the remaining profits. Quite often he reserves the right to particiapte in any new partnerships that are formed after the sale, and can start the process all over again. He can control where the property is sold as long as it goes for a fair markert price and he hasn't chintzed on the existing partnership. That ability to control the resale gets a lot of general partners in trouble, because if the limiteds feel that they did not get top dollar, they sue, charging a conspiracy. Because general partners can own up to 20% of the old partnership as a limited partner, they can move from that position to a general position in a new partnership without being guilty of churning.

If they go from general to general, Uncle Sam may accuse them of churning.

There is nothing to prevent the general partner from diverting the insurance premium to his insurance agency, the property management fee to his management company, repairs, etc. The idea of controlling the enterprise as the general partner is to create as many profit centers as possible. Certainly, many developers over the long run have discovered that the real profits have proven to be these various fees. Once you get up to a point where you have 2500 to 3000 apartments to manage, the cash flow from the fees becomes substantial, and can be used for a variety of purposes. Leasing commissions on commercial properites can average 7% of gross, in addition to management fees. Mucho bucks involved even if the real estate goes nowhere, and only the investors go down the pipe. The National Securities Dealers Association does provide some benchmarks as to maximums (more on this next week). Depending on how clever the general is in setting up the financing, most of the front end money from the limiteds may not have to go into the project at all. The NSDA has tried to constrain this. The amount that is taken out by the general contrator escapes the NSDA limitations. It is therefore not a surprise that many syndications have been done by those who could build the deal as well, creating a significant profit margin for their general contractiong arm that had nothing to do with the syndication profits. (Much soft money can be drained out of the project.)

The prospectus must define reasonably well the investment objectives. These are also tied to what is perceived to be the target investor for the syndication unit. The security rules are fairly specific as to the difference between a qualified investor and an investor. A qualified has a certain net worth, has a presumption of a certain education level and a familiarity with business practices. The net worth does not include the house, car, personal property, etc., and if that is the group that one is trying to reach, one might want to set up a minimum unit of $100,000, $200,000, up to one million a shot. If that is your target market, that makes for a different type of investment objective as to what that type of investor would be willing to look at as opposed to the guy with only $5,000.

The investment objectives can relate to a number of different things. The partnership can create value by developing a piece of land, taking a relatively long term view. It can purchase and enhance the cash throw of a property that needs renovation and repositioning. It might want to exploit government programs such as Section 8 or FHA, whatever. It might be to create capital gains at the expense of current dividends. It might be to provide maximum tax shelter, and once the maximum shelter had been obtained, the property would be traded into a REIT, etc., and the investor would move forward through a successive series of rollups in the investment. For example, merging one or more limited partnerships that had exhausted depreciation and interest write-offs being combined with an entity with large carry-forward losses to provide additional shelter. This type of manouver ought to be at least broadly sketched out in the prospectus so that the investor has some idea of what will happen in the future. The general partner will of course try to keep things as vague as possible so that if things don't go as planned he will have an out.

A number of other issues that the limited partnership tries to deal with include the role of disproportionate allocation. At a time when tax shelter was a significant portion of the real estate investment game it was often desirable that some people receive tax shelter, while other people receive cash flow. Some people would receive a faster payback on their capital than others, depending on the nature of their investment. To accomplish this, quite often two classes of partnership shares are created. One of the legitimate economic reasons for disproportionate allocation might be payback. If share A put in $8.00 per unit, and share B put in $2.00 per unit, share A would get all of the shelter until the tax savings equalled $6.00 per unit. At that point each has the net at risk of $2.00 per share, and now you would go forward and share proportionally. Other ways to do it would be to split the investment between land and building, with the land in one partnership, the trust conduit would own the building, and then when you got down to the point where they were relatively equal merge the interests again. There was in the past a considerable effort made to give the investor the type of compensation that he desired. This, of course, is not as important as it once was since the changes in the tax laws.

A second element of investment strategy would be to define for the investor what stage of the life cycle the fund was expecting to participate in. Were they going to buy land and build new, or were they going to buy existing property and renovate, were they going to buy existing properties with no need for repair that could continue forward to produce income. And they generally provided some type of timetable as to the exit from the investment. When to get in, when to get out. what are the implications with regrad to the duration of the investment. Where are we on the time cycle?

The next elements are some constraints and parameters with regard to leverage. How much debt will the partnership be allowed to carry? This is cause for mixed emotions. To some extent the investor would like, to the extent that he forsees inflation, to carry a relatively high ratio of debt, but by the same token he does not want any personal accountability. Therefore, an FHA insured project allows a high ratio of debt since they would go to 90-92% of value, at the same time if it is a Section 8 deal he is guaranteed the cash flows even with the high leverage. Quite often, and for quite some time, syndications were priced as a per cent of the mortgage, because the mortgage seemed to be a good proxy for the value of the depreciable asset. If you had a 90% loan on an FHA project, you could sell that for 30-35% of the amount of the loan. That meant a lot of cash up front for the syndicator, in addition to his other fees. This is no longer as lucrative a situation. The more the price of the deal was hiked by funny money financing, the more depreciable assets you got, the more you could sell the partnership for, and it was a neat litle money machine.

The qualified or accredited investor, who was the primary target that all of the syndicators were pursuing, had to have the following kinds of characterisitics. An individual had to have a net worth of at least one million, an income of at least $200,000 in the past two years with a future expectation that it will continue, and it also included entities that were owned by such individuals, they could set up a corporate holding company if they wanted to, and included tax exempt organizations with assets greater than five million, i.e., pension plans, endowments, etc., and individuals who would invest a minimum of $150,000 in that particular project within five years so long as the commitment was not more than 20% of their net worth. The premise was, of course, that these wealthy investors had access to legal and accounting advice, had business experience of their own, and therefore were operating knowledgeably, and therefore did not have to be protected by federal and state blue sky laws. This was a fairly major premise considering the kind of crap that they bought.

The type of partnership that would appeal to that type of group was typically involving a small number of investors, such as five of them each going in for $200,000 over a period of three years, which would, with leverage, allow you to have a five miilion dollar piece of real estate with only five limited partners and a general partner who put in nothing but his expertise. You didn't advertise the units, the cost of issuance was small, and as further protection from the SEC, if all of the investors knew each other then you could be exempt from misrepresentation. This is not too different from the new accounting rules that say that an accountant can provide a forecast based on empirical data if he he not going to be there to explain it, but on the other hand you can use a projection based on any what-if that you want as long as you are going to be there to explain it individually. The premise was that with a small group of investors there was nothing floating around with the public at all.

Because many of these so-called wealthy investors were looking at the real estate from a tax shelter standpoint, the result was that the general partner/sponsor was able to do things that made no sense at all as long as it made a tax deduction for the limited partners in the early years of the project. Hence, they became very creative in inventing a variety of fees which were presumably for services, and they could in fact deduct them in the year in which the syndication was formed as a cost of doing business, and therefore accelerate the write-offs in the early years. Starting with about 1979, Uncle Sam started to spike those types of things, but each time the tax law identified more of these, more creative ways were found to get around the limitations. Private tax law attorneys are paid much more money than are government lawyers. Many of the best government lawyers are often hired away by private firms who want their expertise.

The limited partnership creates a number of problems for the general partner, and for the limiteds as well. It is really not what you sell, but how you sell it, that ultimately represented the major risk to the general partner. He could protect himself reasonably well against liability for the partnership, although not entirely so. Incidentally, it was popular during that time to give a young, driving project manager a piece of the deal, as opposed to a bonus or salary. This would leave him with nothing in case of problems, as well as liability. In the case of bankruptcy, if a bank chose not to forclose, the forgiveness of debt was construed as a form of income, upon which you would have to pay income taxes. Take your compensation up front!

There are several remedies for the limited investor against the general partner. First, anyone who offers or sells securities in violation of the registration rules or prospectus requirements has absolute liability to any purchaser who may have bought it, plus damages, plus interest on the money. Section 12, Part 2 of the securities laws gives the right of recision to the investor and damages against any of those who offer or sell by a prospectus or by oral communication which has materially untrue statements. Section 11 under the securities laws gives damages to those whose registration statements contain untrue statements or ommissions. Those who are liable for the prospectus include the sponsor, all who sign the registration statement, including the appraiser, the accountant, any directors, any general partners, any advisors, any underwriters, who can only escape if they indicate that they did in fact provide due diligence. This is why law firms hire our graduates to research the real estate aspects of the project, because as the law firm advising the general partner, they are equally liable with the accountant, the appraiser, etc. That is why as an appraiser you have a hold harmless clause that states that the appraisal cannot be used in conjunction with a prospectus without the permission of the appraiser, and without the appraiser approving exact language in which the results will be reported. These various professionals are very unhappy about this situation. The idea is that none of them will be inclined to be part of a conspiracy if they might have to take the consequences.

Section 15 imposes contingent liability on those who control the persons who are liable under Sections 11 and 12. "I knew it was illegal but my boss made me do it." Good, you are both liable. Section 17-A prohibits fraud and gives a private remedy to the purchaser and applies to all partnerships whether they are exempt or not. (Fraud implies intent, which is not always easy to prove.). Finally, Rule 10-B implies that a private right of action for sins of omission and commission are quite permissible. If you fail to disclose something that you should have disclosed, then the limited partner who is now disgruntled because the investment is now worth less than he expected chooses to sue on that basis, fine. Therefore, in the prospectus, you always put in more information than you think is necessary, even if that is likely to kill the deal, or make it difficult to market. This would include any past legal actions against the general partner, and even any personal problem

that he has had which might give a limited partner a clue toward his true character. Many have chosen not to become general partners as a result.

Much of Sections 11 and 12 are based on discovery rather than when the sin occurred, so if you don't find out until 8 years later what in fact transpired, you still have an additional three years beyond that to bring suit. Given the poor economics of many projects, the investor can elect prima facia that he was defrauded, and the courts have been very receptive to that with the exception that any tax benefits that the investor received despite the fact that he never got any money back as the result of the investment would be a credit against the damages. So, just the fact that it didn't work the way it was supposed to have worked may be grounds for fraud. The SEC can place an injunction as well as criminal penalties for specific violations, and the burden of proof is on the plaintiff initially, but the defendant has the burden of defending any exemptions from registration or use of statutory defenses on (unintelligible).

Syndicators can pursue two relevant exemptions. First, the private offering exemption under Section 4, and the intrastate exemption, which is called Regulation D. The other major exemption initially included issuers such as banks, placements to pension funds and other similar institutions, or business promotions by the founders, where there was an identity of interest between those selling the security and the management of the company. In that case they did not have to be securities dealers as long as that individual was not hired primarily to market the security.

In March of 1982, the Real Estate Board lobbied very hard and successfully to create a three-tiered structure of exemptions, and bring a lot of real estate out from under the SEC. Interestingly enough, the SEC at this time was run by Bill Casey, the later head of the CIA, and one of Reagan's long-time advisors and confidants. Casey wanted to bring real estate in all of its aspects under the securities laws, and the R. E. Board was able to successfully fight back, and to carve out some big exemptions, as we shall see in a moment, to keep R. E. in the hands of the brokers, rather than requiring a securities license for sale, as most real estate brokers weren't bright enough to pass the securities licensing exams. Futhermore, one couldn't be both a R. E. broker and a securities person, because the N. A. S. D. wouldn't permit it. You had to set up a separate entity for each.

The three tiers are essentially labeled rule 501 through 506 (he seems to mix and match these numbers, and it would be advisable to look at the actual regulations for an accurate accounting of the numbers.) the first one that you need to be aware of is Rule 503, which involves offerings of equity up to $500,000. The second limitation is offerings up to 5 million dollars in equity to a limited number of accredited investors, as defined earlier, which is Rule 505. The third level is offerings to an unlimited amount of securities to a limited number of suitable persons. A suitable person would be a pension fund, a bank, and similar types of investment organizations, who presumably are knowledgeable in the selection of their investments. In each of these cases, you could sell up to a maximum of 35 non-accredited investors, but you could sell to an unlimited number of accredited investors or suitable investors.

The small investment, less than $500,000, does not have to register with the SEC, but probably does have to register with the state. Regulation D investments are probably the primary hole in the SEC act, which simply exempted the small investment from further concern, as well as providing for this new type of investor called the accredited investor. The six rules, 501, 502 and 503, (see what I mean?) simply contain definitions and requirements that are applicable to the balance of the rules, 504, 505, and 506. The real gist of the readings would be to look at the last three rules, 504,505, and 506.

For the small sales not exceeding $500,000 total equity, you simply have to disclose that you are going to organize and submit your investment plan and demonstrate to the SEC that the entire offering is made within and in compliance with the state for that particular investment. It is only the state that need be aware of the project. In Wisconsin, anyone who is a syndicator would have to file a plan no matter how small the investment, but you are allowed one deal before you are defined as a syndicator. So, if you do a small deal, and get four or five of your friends into it as a limited partnership, you are allowed one free bite. After that, anything that you do using a securities format would have to be filed with the state and obviously with the SEC if you have to. The great majority of local broker deals fall under this exemption. The marketing of any one of these is extremely constrained as far as what you can advertise, what kinds of information you can present to the investor, and how you qualify yourself to do that. At one point, a great many of the national syndicators would hold schools, and they would nominally teach you real estate investment. There was one group called Keystone that was particularly sly. When the computers first came out, they would analyze your investment portfolio from the standpoint of how much real estate that you could hold. All that you had to do was fill in a questionnaire in which you identified your net worth, assets, real estate holdings, etc., and they punched this into the machine and would come back to you and say you need so many dollars in each of a number of investments. The catch was that they would now have a picture of your holdings, which would make you a target for their sales force, who would show up soon after to sell you shares in their projects. Many of these were run by professors, or people that presumably had some knowledge about real estate, and so they tried to take the credibility of the speaker regarding his subject and impute that to the quality of the real estate being offered for sale. Finally, in a court case, they ruled that all forms of markerting in that form were illegal, and attempted to misrepresent the credibility of the source. The presentation of the prospectus with cash flow format has gone back and forth. Until very recently, a syndicator was not allowed to present a cash flow statement about the property, other than past years for which there was a known history. He could not promise great things. Casey changed all of that, saying that R. E. is a futures investment, and that a forecast was needed in terms of increased expenses, income, resale price, etc. California tried to provide very tight constraints on how you could make projections, with maximum rates of increase in rents, expenses, etc. Most other states and the SEC have not gone along with the prospectus rules adopted in California, and thus you will see a wide variety of types. There are now a series of court cases that indicate that a real estate broker or syndicator is liable where the property falls gravely short of the projections that were represented. The debate continues on this subject.

April 6, 1988

Corporate structure for Real Estate

Advantages (Overview):

1. Limited liability
2. Ability to tier voting control
3. Structure preferential returns
   in terms of 2 classes of stock or 3 classes of stock or can have prefered dividends or voting stock and nonvoting stock

Major advantages, in a little more detail:
1. Limited liability
2. Gives clear dichotomy between individual investor and the real estate, so literally can keep 2 sets of books. Can have fiscal year that is in sync with your own personal fiscal year, which allows you to move income into one year or another (can't do with Sub-S or LP) Often quite useful - - can declare bonuses month after their taxes filed which allows them to defer payment, or you can play a variety of other games to mitigate your taxable income.
3. Small corporations (sales less than $1,000,000) are allowed to use cash accounting basis and cash acctng also very useful device in that you don't have to book receivables until they're collected (you may not even bill your receivables until the fiscal year is completed if it will move you out of av advantageous position). So there is some ability to better time the impact of your taxable income in the corporate framework than there would be otherwise.
4. Abikity to share ownership with executives or staff on a limited basis - - can provide either (1) stock options to encourage their longevity of employment or (2) provide the right to buy stock in the company with a specific buy-back provision if they leave the company so the appreciation in net worth the co. during the time can go to the employee Certainly not the only way to do so - - providing psychic benefit to the employee - - by providing (1) ownership position and (2) feeling they have something to say about the operation of the co. Generally the agreement of our graduates that equity ownership position is not all it's cracked up to be and if had option in future they would rather have cash bonus now in which could put in something safe like US Treasuries. There certainly is something to be said about not having your name on the note. Corporate stock allows to share the upside without any personal liability, which you would get as owner via a share of the general partner interest in the partnership format.
5. Not required to classify income as passive or portfolio or personal and, thus, able to use earnings from RE to shelter other income. So if running a little appraisal company, your're better to run the company as a corp. and shelter the income you don't pay out with your ownership of a couple of rental properties with appreciation that's still available under the tax law - - can mix and match under the corp. framework that not allowed to do as an individual.
6. Can take 25% of taxable income and put it in various forms of profit sharing - - that profit-sharing program itself is not

taxable. Ex. Owners of corp. name themselves as trustees of the profit-sharing trust and then can invest that money as they see appropriate. with long-term liquidation at preferred tax rates when retire - - kind of like having own private IRA or Keough that you can then utilize to, say, buy a ground lease that has no tax shelter to it but provides favorable income that would not be taxable Put site in pension fund profit sharing account and run your ground rent into that which is not taxable and keep the appreciation of the building in the corp. and gives degree of flexibility that can't do with single conduit structure. Corp.s, therfore, provide great deal of shelter income, but not necessarily in the traditional format.
7. Ease with which can be subdivided within the estate, particularly where have multiple classes of stock and the partner that survives gets the controlling interest even though may not want to give the entire interest it may make the ability to buy out your voting shares more feasible. given the life insurance is available to back up a cross-purchase agreement and at the same time leave the future value of the assets to your heirs that don't necessarily have voting priviledges with their class b shares or can go the other way and use the preferred shares to freeze the value on generation 1 and allow to skip to generation 2 (nonvoting).

Great deal of flexibility in terms of how its divided up, either as part of the estate plan or compensation for other associates in the venture or etc....

Also can alter the timing either in terms of the fiscal year or the timing of the profit-sharing for management that may postpone tax till 30 years downstream.

Cash acctng also allows you to fine tune tax advantages.

This all explains why the IRS continues to tinker with the tax law - - if there seems to be some weird regulation in the laws you can bet that it is meant to cover a loophole that existed prior to the revision.
8. More flexibility in terms of exit from the RE.

a.Trade stock with REIT or other stock entity - - move up from local entity to entity with natl standing or listing status or maybe trade on one of the over the counter exchanges - - a share for share stock exchange is certainly cleaner and simpler than trying to find a match for each property in your portfolio.

b. Single tax liquidation has been somewhat curtailed by the '86 tax law - - at one point one of THE big loopholes in the tax law - - if sold all assets within 30 days or 12 months avoided all capital gains tax at the corp level. In 30 day case could have buyer in hand before the Board of D made thier decision and in 12 month case the Board had to make a policy decision they would liquidate and then could go out and seek the ultimate buyer of the assets. As said has been sharply curtailed but still possibility of doing so. The distribution doesn't have to be entirely in cash - - can roll-up assets into the corp. as nontaxable event and can also distribute assets of corp. on prorata basis to shareholders as a nontax event...EX. Corp. did sub-division and su-div. now substantially complete in lang. of the IRS and you still have 12 lots to sell and have 3 shareholders could spin off 4 lots apiece and they wouldn't have to pay tax until sold their lots. Basis would be whatever they paid for the shares in the first place. EX. If your doing a 40 acre plat, zoned for multi-family or commercial, may break into 3 pieces and spin off to shareholders and allow them to groundlease to someone that actually built the buildings (maybe your own corp.) and grounlease income move thru the corp. as an expense to SHs that now own the land and then have no taxable event except for income received anyways till sold the groundlease (capital gains at that time) Great deal of flexibility in terms of how move assets and income in and out, and the timing of the income - -therefore corp. form can be very attractive medium for RE investment (contrary to popular mythology that single-tax conduit always better). Currently the little guy (less than 100,000) has some advantage in that can take 25,000 of tax shelter so that if at that lower level single conduit may be more attractive but if filing joint return people can be moving into 60000 area pretty quickly and it wouldn't take much of a piece of RE to put them near the 100000 mark so little guy has to be very little indeed to take advantage of the 25% shelter.

Additional advantages:
1. Raise successive capital more cleanly LPs have difficult time expanding unless allowed for that upfront. Can sell additional stock with minimal effort and even if have to register a stock prospectus it is easier to do so than a new fancy LPs etc..
2. Essier to raise Large amounts of additional capital.

Once get into really large corp. now have whole new realm of capital sources - - bonds, commercial paper, qualify for venture capital loans in which provide stock option to source of the venture capital.

By + large corps have the greater flexibility to grow (raise K) with least amount of reorganization. Probably the one thing that does modify as raise more K or decide to go public or semi-public is the accounting Become more concerned with accural accounting etc.. so that again the flexibility of deciding when to take profits and when to record them becomes way of est. 3-4 yrs before the actual issuance of a new stock issur a track record of gradually increasing earnings etc.. so that the investor will look at this as a growth opportunity. As corp. moves out of cash acctng little business phase gives all kinds of opportunitys to bamboozle on the basis of your past record and perhaps confuse the investor by his tendency to look at stock measures (P/E ratios) vs. the underlying assets. This was something Carley did so beautifully - - statrting with Public Facilities Associates.

So much for that - - have reading on that as well.

Oh no, it's that darn Chris Quinn asking another question and making my typeup longer. This better be an inteligent question Quinn or else....
Chris: Chief, a REIT is a single tax conduit right?
Chief: But it is also a corporation.
Chris: Well, it can also be a trust or a-
Chief: Yes, the old ones were Massachusetts Investment Trust but today the majority of them today are going to a straight corporate entity.

Chris: So they are double taxed?
Chief: No! The REIT remember is a critter of the IRS law not of the corporate law You can be a corp. and be a REIT or a Mass. Trust and be a REIT or be a partnership and be a REIT.
Chris: (Some guys never give up) But the corp. is double taxed and the REIT is single taxed I don't understand ...
Chief: Because the IRS says that if the REIT follows certain rules, 95% of their taxable income is distributed, they have at least 100 shareholders, don't have more than 50% of the control in less than 6 individuals, etc... if you meet all of those than you will be treated as a REIT by the IRS. Now have 3 months to correct errors from those guidelines. Like the REMIC, the REIT is a creature of the tax laws.
Chris: A REIT could be a way for a real estate corporation in real estate to avoid double taxation?
Chief: Yes. REITs have got themselves into deep trouble, didn't know what to do with their tax shelter and didn' have anything to pay out and so forth. went back to being a corp. and as a result all of the losses they had been taking markable as tax loss carry-forwards. which they couldn't have done as a REIT. Now after 5 years of they got back on their feet and now could decide whether wanted to go forward as RE holding company or become a REIT again, which they did by applying the then rules of REIT status. Not allowed to flip more than once every 5 years.

(Well, I think Chris has been satisfied, so we can move right along with the lectu- - OH NO, not another "friend" asking a question).
Charles: I haven't been keeping up with the tax laws but I remember (probably an acid flashback) it used to be that when the tax rates were different there were a lot of penalty taxes on corps that didn't distribute their dividends/income in that the game was to keep the $ in the corp. and try to reinvest it and get taxed at the lower rate. All those laws are still in effect even with the changed tax rates?
Chief: Yes, much of the rate differential has been lost. In the past the corps would do a whole bunch of wild assed things to justify their retention of earnings. So yes that was always haunting them. The other thing that was haunting was to be labled a family holding company (which is confiscatory). So important to maintain what appears to be an operating company. Therefore certain types of buildings became popular (hotel, restaurant,) by def. operating businesses that happened to use RE. So if generate large gross from an operating business avided the holding co. classification. Eventually the IRS caught on and changed the rules.

Now have looked at some of the idiosyncriaces of structuring, etc... In this course trying to sensitize you to the broad array of issues and why need accountants and lawyers to help with tax aspects as create entity for RE venture.

Shift ground for balance of semester to more investment strategy and away from the more technical aspects of the tax laws, structuring, etc....
RE investments come in 2 sizes

1. Individual property or
2. Portfolio (2 or more properties)

Literature has predominantly been on the port. side currently. for several basic and perhaps obvious reasons.

1. Big $ in RE invst from group investors who are inter for PFs or invstmnt groups or for dissaitsfied Am. stockholders. Amount of $ is such that many times it takes more than 1 property to use all the $ available so that automatically in port. status.

2. Shifting percepton of the fiduciary

ERISA in effect, upgraded the prudent man rule to the professional prudent man rule. Anyone exercising discretion in the selection of a pension investment, is personally accountable for negligence in that selection process, not ot mention for deceit, negligence, and being an all-around bad guy. The crime is always with you and there are obviously retributions for that. The real issue is: What represents negligence? and growing out of that are a # of aspectes have already run into.

1. ERISA placed greater emphasis on diversification to disperse risk, but never defined diversification. This is 1 of the most heated subjects in RE right now. Once assumption was that if bought 1 of each, had a retail center an apartment building and an industrial place, that was diversification. But if bought all 3 in Houston, no way. Not going to come up with a hard and fast answer but getting good bead on where going.

2. What is due diligence?

a. What should we buy strategically?

b. What can we close on tactically?

How careful do we have to be? Which surprises couldn't have been anticipated and which could have been known if they had been thought about? Ex. How do you view a thermal scan on the roof of a ind building to see if it has bubbles that suggest it will deterioate in a relatively short period of time? It only costs about 10 cents/sq. ft.. But if don't do it and have to replace at 3.00/sq. ft. are they liable? Soon will find out if courts feel so because Northwestern Mutual is suing the hell out of somebody because they have that problem.

3. What represents performance?

How know the trustees, having avoided the pitfalls of 1 and 2 above and having operated for 5 years to establish a track record, maxed out on the property? Could they have done better? Could they have had a better return if, for ex., they had pursued tenants better in terms of rent collection? Is performance positioning yourself for maximum return or protecting yourself from unexpected inflation? Can you measure the performance of a manager on the basis of current earnings if his/her major function is to protect against unexpected inflation?

Stocks and bond measurements are wonderfully precise and incredibly precise - - remember the Crash. Basic defense is that if in with the group then you are no worse than the next guy - - better to stand separately than to hang together. RE doesn't lend itself to that type of psedo-precision. Must have a range (unless you're a traditional appraiser who can value accurately to the penny). So have problem of trying to measure performance in an industyr that has terrible time doing so, but know have to do better than in the past.

Need to look at all of those elements as begin to build a portfolio investment theory or strategy.

1. What type of property and where?

2. Ensuring the decision maker (whose usually remote) in an industry where data is scarce, where ineffiency exists and therfore the advantage goes to those with data, how much $ can I spend on diligence in implementing my what and where policy? Hopefully there will also be correlation between downside risk and the amount of $ spent up front on research. To the degree that the institutional invstr wants to avoid liability how much can shift by assigning discretion in the what, where, and information search and how much retain control of the the decisions? Good deal of conversation between the discretionary asset manager and the nondiscretionary asset manager. Where does the liability fall for a mistake? What kind of protection can you count on?

Have real problem in industry right now, coming to grips with this management problem and structuring some kind of balanced relationship between them that have the $ to invest (institutions) and them that provide the services to invest the $ in such a way that they can solve these 3 related issues: (1) the what and where, (2) due diligence, and (3) performance. We'll pick up on those on Monday.

Real estate 850
April 4, 1988
transcribed
by
Evan D. Harrison

Mr. Eppli would like to say a few words.

Eppli: Case study #3:
All month-month leases that are in your case as m-m, assume a lease start date of 1-1-'87. No costs, no free rent, also no concessions. That is only true of m-m leases. No leasing commissions or tenant improvement costs. All leases expiring prior to 1-1-87, assume they re-rent, no costs also. A good example is the second lease, you see it on the second page, you see it expires 8-31-'85, assume it rolls over onto 9-1-'85 for a three year term. Acc. 201 has an assignment due one day after this case is due, so things are going to get really busy next week, so start early.

We want to touch on three subjects today. Finish up on trusts, talk about master limited partnerships, and get started with REMICS.

A good example of a trust with some of the fance accounting that they do new, neverless with the openness that the new trusts have, is one called EQK, which is essential Equitable and Krafko. the properties came out of Equitable's portfolio and the property management group is Krafko. It has only three properties in it. It is a finite trust. And because shopping centers and office parks don't cash flow well enough to attract investors, a large part of this was financed with a 44 million zero coupon bond back to Equitable, the original seller. A lot of these trusts, as well as REMICS, will be a result of major institutional lenders adjusting their portfolio and retailing properties which were at one time only institutional properties and allowing them to reposition into what they percieve as stronger properties or growth markets. This particular property the trust was capitalized with 45 million of zero coupon notes which will have a face value of 94.7 million at maturity in 1992, and an effective interest cost of 10.9%. Obviously a very strong manipulation of the cash throw to attract investors. There are only three properties in it. The first is a commercial office park of 1.2 million sq. ft. in Indianapolis. It was appraised at 77.5 million. If you work that out, that's a fairly modest cost per sq. ft. of leasable area. It represents about 37% of the total value of the trust, but had a 9.8% vacancy going into this year. The second is a high class office building called the Peachtree Dunwoody Pavillion in Atlanta. 673,000 sq. ft. appraised at 76 million with a vacancy of 9.9%. Finally the jewel of the package. That's the way most of these are put together. There is one tomato you would love to have and a couple that are marginal all in the same celophane. Like sentries you have to take the 2 marginal ones along with the Roman beauty. This is Harrisburg East Mall, 898,000 leaseable, appraised at 52.4 million, with a 1% vacancy. The reviewer looks at each of the three properties and their obviously different markets. Indianapolis is a slow steady growth market, Atlanta has been explosive, but inclined to overbuilding - spinning off into the NW 1 corner, where this property is located, so it's in the right place. Harrisburg Pa. is going nowhere with the W. half of Pa. Not a growth area, which is why they decided to get out of it.

Now they look also at the lease mix. The comm. park is almost all short term leases, so several thousand sq. ft. are rolling every year. They expect 73% of the tenants to renew, & for the balance they are neg. on 80,000 sq. ft, which leaves only 98,000 sq. ft. exposed to the market. At the Dunwoody Complex, things are messier. Tremendous free rent and standard tenant concessions down there. It has an occupancy now of 89.6%, so they are losing ground. What's worse, their key tenant, DEC, will be moving out in 20 months. The shopping mall is just humming along. The variety store is being converted to a food court, and they have 100,000 sq, ft, rolling to market rate in 1989 and 1990.

They are making about $1.66 dividend, of which 1.09 was from earnings and .16 was from extinguising a part of the shopping center debt. That puts the yield at 13.8%, which is attractive except for the 0 coupon debt. You have to anticipate that your equity is going to go down when the 0 coupon explodes on you in 1992 which isn't all that far away. If you start reserving for that, your yield drops to earnings of $1.04 and an 8.5% yield. There is virtually no dividend growth expected before the 1990's for the reasons mentioned earlier. The shares are selling at a 26% discount to the value of the underlying assets - at $16.5 per share. In other words they are looking at the underlying values, which in the old days got sort of submerged and forgotten. So if you want to take the gamble that runaway inflation will bail out the investment causing the shopping center to perform well and cutting off new construction for indianapolis and Atlanta, it is an interesting speculation. As of Jan. 1 of '87, the price was at 12. Notice there are only three properties in this one. Zero coupon debt is the favorite form of structuring in this type of deal. The yield on this was 8.39% for '87. Not too impressive.

the ones who are doing well are Krafco, who have the property management, and Equitable the asset manager, which gets probably 150 basis points for setting this up - that's 3 million up front. They probably get 75 - 90 basis points for running it, and a 100 basis point kicker on the back end. Because these are figured on the total asset and not the equity, they are doing very handsomely also. Since shareholder's equity is only 101 million on a 171 million capital base, the fees are leveraged almost 2/1, so the fees are almost more than the return to the investors. This is really why the insurance Co. will go into these kinds of deals.

One critter that appeared initially in the oil industry, then in R. E., is the **Master Limited Partnership**. The MLP differs from the corporation in several ways. Of course, in the corp. form, liability is limited to your net assets. MLP's are organized around two types of partners: limited partners, who have no more liability than they would in a corporate share, and general partners who are individually liable for the debts and possible cliams, i.e. damage claims against the MLP. Corps. have an indefinite life, and MLP's have a finite life. In addition, the nomenclature is a little different. In a corp., the investor owns shares and receives dividends. In a MLP, the investor holds a partnership share and receives distributions. It is a single tax conduit, and therefore those distributions may include, actual taxable income, capital gains, and simple distributions of capital. Unlike other limited partnerships, MLPs are traded securities, and can be bought and sold on the securities market.

To compare the corporation to the MLP is probably more instructive than to compare it with a standard limited partnership. At the entity level, there is a tax on corps. at corp. rates, while the MLP has no tax. At the investor level, anything coming from the corp. is taxed as income unless it is called a partial liquidation, which is frowned on by the IRS. With the MLP, the distributions are not taxable, unless the investors tax base has been reduced to zero. The income may qualify as passive income. One of the major problems with the MLP is the expense of the accounting. If you are not into accounting, you won't like MLP's and you won't like the annual report that you get and have to transfer to your report. Gains on unit sales are taxable for the MLP as ordinary income, where with the corp., after 6 mos., the gain on a share of stock is taxable as capital gain. The investor tax basis in the corp. is what you paid originally, minus any unlikely partial liquidation distribution. For the MLP, you start with the original purchase price, then you add back the taxable income he has received, the non-recourse debt, then he subtracts actual cash distribution, the tax losses he took on his form, and his debt repayments. Again, an accounting nightmare.

Now the IRS hates LPs, and especially they hate MLPs, and they got a law which says the MLP will be taxed as a corporation **except** where 90% or more of the income is received from real estate or from extraction. Obviously the IRS got beat hands down by the real estate lobby and the oil lobby. While you will probably hear that the MLP is a dead dodo, you probably won't hear that if 90% or more is in real estate, everything goes on as before. A classic case of Wash. D. C., where those who want reform get reform, and those who want an exemption get an exemption by paying off the right committee members, so everybody's happy - except a few of us, who would like to see them put the whole thing to bed. In the oil industry where you had a number of individual partnership wells, it was helpful to market the oil effectively, to roll those up into a single revenue base, and also tended to stabilize the revenue where each well had quotas established, etc.

There are basically three reasons why the MLP is popular in corporate finance. One, it converts a double tax entity to an operating corporation which is a single tax conduit. It eliminates the corporate tax, and therefore increases shareholder values with the cash flows which would have gone to pay income tax. It comes as no surprise that some of the recent MLP conversions are Perkins Stanley Restaurants, which is an operating entity, but has sig. R. E. write off, Andy Homes, a home builder, Motel 6, Newhall Land and Farming Co., which is essentially a residential developer. All are listed on the N. Y. stock exchange. Obviously you kick the dividends up if you don't have to leave 34% behind in a corporation.

The second thing it does is avoid unfriendly takeover, because it is much harder to remove a general partner than it is to unseat a corporate manager.

It also allows you to emphasize for your investor cash flow rather than earnings per share. You obviously have far more cash than earnings, because of a high degree of depreciation and amortization of debt and a variety of other non-cash expenses, so the investor feels he is doing better as a result.

The second reason is for corporate asset disposition. Typically the corporation sells its asset to a passive MLP entity and leases them back in a friendly not-so-arms length arrangement so you might have a series of three year renewal options - an off balance sheet kind of financing. You can sidestep FASB and not have to carry the assets on one side and on the back side as a liability. I'm sure Shidler will be talking to us considerably about this on Friday. The corp. that does this gets a considerable hype to its surplus in the year they take that deal. Let's say they have an industrial plant under a 35-40 year lease and they've used accelerated depreciation to write down the asset, but accounting requires they write off the 35 year liability of the lease as if it were a 35 year fixed interest loan. So what you have is a very significant imbalance. So if you sell the asset, you get cash for the asset, but glory worsky the liability disappears, and that's a fairly large number. So the assets stay the same or go up by the cash you sold it for, and the liability comes off, so you get a large boost to your earnings per share. They get both the resale profit and clean up the balance sheet.

So lo and behold, all the Burger King restaurants are leased back to Burger King. The La Quenta Motor Inns were sold to their MLP then leased back to La Quenta. The nursing homes leased to Beverly Enterprises and Angel Care, Inc. Again, a way of corp. refinancing off the balance sheet - getting the fixed assets off, getting the cash flow in and allowing them to do a different thing or improving their working capital position relative to the service component of their business. This type of MLP is really an income vehicle. The potential for capital gain on highly specialized Burger King restaurants is really limited given the high rate of aging in styles of fast food stores. You can make an argument that you can write those off in about 15 years because of the modus operandi and the facade will change every 15 years, and they'll have to go into a rebuilding program. So it gives you a fairly rapid write off, and an income that's well sheltered.

The third is a way of buying assets for a corporation as an alternative to the REIT. they go out and buy properties which are currently in a limited partnership status, where the tax shelter has been exhausted, and they have a negative basis, and if they were to sell they would get hit with quite an income tax on their negative basis. The properties have appreciated, so we can go back and get non-recourse debt for a good part of the purchase, and notice that what you paid for it plus the non-recourse debt is part of your new basis. So the MLP can re-hype the depreciation game that the limited partnerships were playing before they got rolled up into the master.

Again, dep. on their structure, there may be tax deferred returns dep. on the financing they use. U. S. Realty Partners is a good example, EQK has an MLP called Green Acres, not related to the previous EQK property, which has a shopping mall and some other properties all rolled up into one MLP, providing much of the same character as an REIT, but with a little more basis. The REIT share owner's basis would be what he paid for the share, just like a corp. share owner, where the owner of the MLP share gets the kicker provided by the non-recourse financing, as he writes down distributions as capital dividend distributions. So the much heralded demise of the MLP has yet to occur, probably because Congressmen bought a good many of these and need to gradually disinvest before they change the law.

Q. Is the CEO of the selling corp. the Gen. Part. of the MLP?

A. Not if he's smart. He should set a corporate general partner - something which meets the safe harbor rule of 15% net worth. Maybe the parent corp. could be the GP. Notice in a lot of these cases, the management co. and the institution were joint venture partners, as with Krafco and Equitable.

Q. Please review the difference between asset management and property management.

A. Property management brings you down to the net income line as "under current contract." Asset management is concerned with tomorrow's income. How much should we pay for tomorrow's income. Should we invest in asset enhancement? Should we buy out tenants that are not a credit to the entity. The asset manager is always out ahead of current operations. The prop. manager is always executing on current operations, and the financial manager is obviously concerned with how do you capitalize that structure now and into the long run.

Q. Re. termination date.

A. they would sell off and liquidate. One suspects that there is or already has been good communication among the inst. investors, so if we both have ones terminating, we would make a deal so this year I'll sell you mine and next year you sell me yours. We haven't made it so apparent that its churning, but we haven't really lost control of the property either. The Coldwell banker finite Trust was the first one to come to the end. They liquidated and sold off the property to a number of institutional investors at good profits - it worked beautifully and was really a hype to all the other finite trusts. Gee, it worked - look at all the money they made.

Typically they make the window with a good deal of flexibility - with a termination maybe ten years out and 2-3 years to complete the liquidation. There is a provision that 70% of the shareholders can extend it on a year-to-year basis, so if that window shows up right at a trough in the market, you have a way of postponing it without a forced sale. It's kind of a forced sale that's not. The IRS wants to be really firm - maybe.

Q. Rel. to spin-off shareholders.

A. They may be one and the same person. So if a corp. is spinning off its assets, each shareholders would get a pro-rata # of units in the LP. They now have both shares of stock and LP interests, and they can sell or keep both or either. That is a distribution in kind and not a taxable event. It is like a contigent sale - pretty hard to tax when you can't find a hard number from which to subtract your basis in order to come up with your gain. You get a piece paper which says you now own 6 shares of EQK, that is kind of a mooshy return. Now when you sell it, you have a historical accounting record - so many dollars - so you pay the tax. At one moment you had 100 million of RE in the corp., and you owned nothing other than your share. One moment later you had 100 million of Real estate, and you still own your corporate share. It is really not quite clear what happened to market value. Where you go out and acquire other properties, and you roll it up, and say "your apt. project is worth 6 million with 4 million of debt, so you get 2 million in the new partnership which assumes the debt." Here market value is critical, so that kind of roll-up requires a precise appraisal, and that is where there can be trouble with IRS because a precise value is established. There is a tendency to undervalue so they can show a good profit on their assets once they put it all together. So a **roll up** is much more dependent on appraisal than a roll out. A **roll out** is where all the shareholders get their pro-rata share. Note that the corp. doesn't sell its asset on the rollout, but simply says instead of one piece of paper, now you have two pieces of paper, but your proportional share of ownership in both entities will be the same as before. If the corp. sold to another MLP, that would be a taxable transaction.

The final will be on Wed., May 4. The 857 final will be May 6.

Another critter not unlike the REIT is called the REMIC. Real Estate Mortgage Investment Conduit. Like the REIT, it is not a specific form of organization, but a set of qualifications which make you a REMIC or not. A trust, a corp. or even an MLP could be a REMIC. It exists in the mind of the IRS, not of state statutes. The REMIC grew out of the CMO - collateralized mortgage obligation. The CMO grew out of the idea that different investors are of a different degree of receptivity to getting their money back, and would like some protection against call. The original mortgage obligation was a complete pass thru. You never knew how much you were going to get or when you were going to get it. If interest rates rose, there was a tendency to get your money a little slower as prepayments slowed, and if rates fell, there was a tendency to get your money earlier as people tended to refinance. Just when you wanted the higher rate you thought you had locked in earlier, you got your money in the mail and had to reinvest it at the lower rate. To solve that problem, they created an investment which provided for different tranches of priority. A tranche is a cross section of the mortgage portfolio. What they said was "we'll have 5 tranches, and the first tranche will be paid off before tranches 2-5 get anything. This 1st trance was a short term investment of 20-22 months credit enhanced by all of the other tranches. That is just about as good as U.S. Treasury money. It's like a zero coupon, when tranche 1 gets pd off, we start paying tranche 2, & GO THRU THE SAME PROCESS. Tranche 2 is guaranteed by the money in the other 3 tranches, etc. Holders of tranche 2 were guaranteed they wouldn't have a call until the end of the 21st month or later. They had a defined term of invewstment. So depending on what you wanted - short term highly liquid and credit enhanced - or longer term, you could get it. That greatly enhanced the market for mortgages. What they said was, mortgages really represent a series of investments along the interest curve. As Mike Feiner put it, mortgage finance was shifted from the long term curve to the Treasury curve. The weighted average rate of interest on the tranches was considerably less than the contract interest on the mortgages. There was a tremendous amount of spread there.

The last tranche was what they called the residual tranche, and you can only have one of those. There are several sources of residuals. One is the fact that there may be some short time lag between the receipt of the interest or principal payment or the prepayment, and the coupon date on which it has to be paid out. Hence there is a reinvestment possibility. As reinvestment rates rise, the residual rates rise. Not only does the residual rate rise, but you enjoy a longer period of time of spread between the rate you are paying on the short term tranche and the mortgage rate, because there is less tendency for the home owner borrower to repay. A double kicker. Second of all, it has to do with costs to administer the portfolio. If interest rates rise too much, you obviously have more delinquencies and losses and foreclosures in the portfolio. Generally you over collateralize. You sell a hundred million of CMOs and you have 101 or 102 million of mortgages in the pot. So you have a little extra falling in the last tranche if foreclosures or administrative costs are lower than you forecast. So this tranche becomes a way of speculating on the loss experience of the portfolio involved. It really is almost a futures market kind of thing - based on the indirect consequences of the interest rate rising or falling relative to the volatility of the underlying mortgage. Recognizing you could never get an exact match between the mortgage revenues and your CMO coupon obligations, the last account is the clean-up account. If you own the last account, you can do very well. That was the executive perk to the officers at Salamon, etc., because of its great potential for profit. That's a REMIC.

Q. Is there a minimum size for those. A. It's pretty much a Wall Street operation -150-200 million because of the high fixed legal and underwriting costs. A. (to Q. on rates.) They go for about 25 basis points above Treasury for the first tranche up to about 75 basis points for the fourth. There is really no way to price the residual, which is the catchall - a high spec. kind of investment. It is the clean up account - the residual.

Why did the REMIC come into be. Under the previous tax law, if different classes of investors were taking their returns in different priorities, you were subject to tax as a corporation, and to avoid that it was necessary that the debtor keep the debt on his books. So if you were a homebuilding co., and you had 50 million in sales which you financed for all of your buyers, you had to keep that on your books even though you sold it into this fund, because it was a contingent liability on the part of the originator and issuer. A somewhat uncomfortable position if you were kicking out a large # of mortgages. Further, if you had more than one tranche, uncle Sam wanted to tax as a corp. unless all tranches were equal in amount, etc. The REMIC allows the issuer to have a complete sale of the mortgages so they are off his books, and they are no longer his liability and further allows the issuer to have more than one class with different coupon rates. Tranche A might be $900 principal/unit with an 8% coupon. Class B might be a $100 principal with an 11% coupon, because you were willing to wait and subordinate to class A. Then you have a residual class which says in essence after A and B are paid off, anything left goes into your class. The REMIC was simply intended to tidy up the bookeeping, and get around the IRS technical interpretation of what determined a corp. and was subject to the double tax.

Originally the REMIC was intended to deal w/ residential mortgages - insured res. mortgages. If you are buying into a Wall Street security, you have no intention of looking into the houses in the pool or the credit of the borrower, you are buying a straight financial transaction. Theefore the two traditional sources of protection, the borrower and the property, just drop out of the mentality of the investor altogether. What is he looking for? He is looking for some form of credit enhancement. The old form of credit enhancement was the FHA. You didn't care about the borrower or the house, you looked to the FHA to get your cash, backed by the full faith and credit of the U.S. govt. In addition you are credit enhanced by the fact that if you are the first tranche, you are backed by all of the other tranches who have all subordinated their claims to yours. What could be more fair? You could care less about the real estate. We have detached the whole issue of the RE and the borrower from the generation of capital for the residential market.

Now along comes Salamon and Goldman Sachs and says this is terrific - great ability to arbitrage and make fees. Let's say the portfolio is largely southern California and we expect a higher delinquency rate there so we want to get out of it and buy one that is mostly Indiana and Ohio- not a bunch of newcomers who might get in the car and drive away at night and forget the mortgage. As a result the yields very subtly shift as people percieve the delinquency rate and default rate and price levels of the underlying assets shifting in different parts of the country. There is a great market in trading residential mortgages from different parts of the country. One third of the profits of Salamon Brothers in 1986 came from trading in CMO's of all kinds.

Now somebody gets the bright idea as they did in the old days of the mortgage trust, that worked so well for single famililly home loans guaranteed by the FHA and PMI business, what would happen if we did it with commercial loans. Terrific. Now they're putting together CMOs with commercial loans. But you can get to 300 million really fast with commercial loans. Now the problem is the Uncle Sam doesn't guarantee that, and there is some question whether the private mortgage insurance industry should be insuring anything right now with VEREX and TICOR closed and a number of others not accepting new business. So they said gee, what we need is the blessing of the rating agencies: Moody's, Standard and Poors, and Phelps Dodge. The rating agencies are not selling out very quickly. Moodys has set up a whole set of standards as to the kinds of income proprties they will look at. They have developed a model which analyzes the probability that the whole thing will go belly up and not be able to pay and the underlying real estate will not be adequate to cover the mortgage. So as a result the CMO applied to commercial mortgages is moving much more slowly. They don't have the credit enhancement, even though the investor has learned to expect that and two, once you get to wall street, there is no correlation between what you paid for the security interest and the real estate. Nobody is looking to the real estate. They are all looking to the credit enhancement. A number of insurance companies have stepped up -it remains to be seen how Travelers and Continental and a number of others do to privide guarantees on commercial loans. Everybody who has tried that in the past has come to regret it. They may too, but it provides additional fee income in the interim. The interest cost on a credit enhanced commercial loan is generally another 200 basis points above the rate. The only place it really works not too badly is where you are using tax exempt municipals, and even there it begins to move the interest rate well above what it should be. Watch a number of major housing projects in Madison and Milwaukee that were financed with tax exempt housing authority bonds. No provision is made in those bonds to call them and refinance them because interest rates fell. So what they are planning to do is default on the bonds, because when they default the tax exempt bond authority has the right to call all the bonds and refinance. When they do so, it will be at a much lower rate than those babies carry, and the cost of the credit enhancement will also come down, so the overall costs will be something the projects can carry, which they can't presently. So the commercial mortgage REMIC is kind of tottering along at the moment. The most successful one to date is (although a straight CMO - it was prior to the change in the law) was Provident Insurance in Philadelphia who had about a 600 million portfolio of commercial loans. They culled that and got rid of 200 million because they wanted to reposition their portfolio. They were able to CMO that mortgage pool. It remains to be seen what the REMIC will do in commercial real estate.

Okay. You should be able to compare the formats on control, liability, tax status, proceeds, ease of selling the security and raising money, the other elements that we talked about the other day, and you can add the finite REIT, the MLP, and the REMIC to that list. One other element and we'll call it a day: There are obviously a great many structurings that one can make for a real estate enterprise, in order to enjoy a tax law feature or a product liability feature or insure your despot control of the enterprise, and quite often you se real estate investment entities bent all out of shape to accomplish one or more of those objectives. Ultimately they get themselves into some form of difficulty where the incentive for choosing that form of organization is no longer true, such as we saw in the recent change in the tax law and then comes the realization that the accounting costs more than the benefits. By and large we are getting back to really basics: Corporate ownership straight away double taxation, or two, a non-taxable institutional entity, which could be a closed or open end fund for pensions, an REIT, a REMIC, in which the draftsmanship is relatively simple and the adaption to changing times and changes in the tax law is relatively easy and the perils of inadvertently making a misstep relative to IRS rules, FASB rules, SEC rules, or public reporting requirements are minimized. All of the tax savings of being exceedingly clever can be lost from one stockpayer suit, even if the stockpayer loses.

The legal profession isn't necessarily rational on that. We are involved in a case currently where the damages, if the worst case were proven, which it can't be, would be $530,000. But the irate shareholder, which happens to be the Marshall Field Trust which has 400 million in assets, has already spent a million dollars in legal costs, because they say "we will not be flim-flammed, and we will proceed at all costs against those who try to flim-flam the Marshall Field Trust." But the biggest flim-flammers of all are their attorneys, who have somehow not related back to the trust that they have now spent a million dollars, and are no nearer a settlement than they were when they began. There is no point to wandering into that morass of security, fiduciary, and shareholder law if you can avoid it.

Despite all the elegance of 47 ways to skin the IRS or the SEC, ultimately we get down to basics. We run into the simple one or two class share corporation, or into some institutional conduit which leaves the tax issue with the ultimate investor on a pass through basis, and all of the other nuances drop out.

Evan D. Harrison

The REMIC Rules

from Mortgaged Backed Securities, by Kenneth Love
Reading C for April 11, 1988, pp. 1220-1252

The REMIC is purely a creature of the IRS code. It represents a successful cooperation between the Congress and the private secondary market, and is the culmination of 7 years of secondary market developments. A REMIC may be a trust, corporation, partnership, or even a segregated pool within an entity. It permits the issuer to sell mortgages outright rather than hold them as collateral for CMO's, thus getting the asset and liability off its books and passing all tax through to the purchase of the mortgage backed securities.

FASB rule 77 and Technical Bulletin 85-2 govern, and permit issuance of REMICS to be considered a sale of the mortgages if certain conditions are met.

STRUCTURES

A REMIC may be a fixed investment trust which issues ownership certificates of pro-rata entitlement to all items of income and expense of the trust.

A REMIC may be an issuance of CMO's (collateralized mortgage obligations) by a corporation, where the CMO's are debt obligations of the corp. secured by mortgage assets of that corporation.

A REMIC may be an "owner's trust" used to issue multiple class securities. Certificate holders are lenders to the trust and receivew distributions of the trust assets that secure the loan.

REMIC Impact: Holders of regular interests in the REMIC will be treated as holding debt obligations and holders of the residual interests will be taxed on the taxable income of the REMIC.

REMIC Requirements:

1. An election must be made on 1st year return to treat the entity as a REMIC. There are provisions to restore inadvertently lost REMIC status thru appeal to Sec. of Treas.

2. All interests must be either regular interests (specified principal and proportional-to-market fixed or objectively indexed variable rate interest, with timing, but not amount contingent on prepayments and investment income, all terms fixed on startup day. Treated as debt for taxes, but may take any form. May be issued in fast/slow pay, senior/subordinate classes like CMO tranches) or residual interests (one and only one class allocated pro-rata to a single class of investors, who receive diff. bet. actual investment income and payments at the assumed rate).

3. Substantially all **assets must be** qualified mortgages (can include mortgages, reg. interests in another REMIC, GNMA, FNMA, FHLMC pass throughs - just about anything secured by R.E.) and permitted investments (short term reinvestment of cash flow only until next regular payment date, reasonable reserves, and foreclosure property).

4. It must have a calendar year taxable year.

A REMIC must be a self liquidating pool of mortgages. Prepayments must be distributed. After the first three months, the REMIC cannot purchase or (except for disqualified mortgages during the first two years) replace mortgages.

Non REMIC multi-class CMOs can be issued until 1992, but the issuer must retain a residual interest, keep the collateral and debt liability on its books, be adequately capitalized and have debt payment intervals which do not correspond to receipt intervals.

If **payments to goods and service providers** are not deemed reasonable, they can be recharacterized as residual interests, which disqualifies the REMIC since it can have only one residual class.

The **transfer of mortgages to a REMIC is tax free** and the basis carries over, with pro-rata allocation to reg. and resid. interests. Either mortgage acquisition or issuance of interests can come first.

Costs of acquiring interests are capitalized, added to basis, which is fair market val. at transfer of assets acquired by REMIC. Diff. between basis and initial issue price of interests is taxable.

The REMIC must pay a <u>penalty tax of 100%</u> on the net income (gross income - allowable deductions which are directly related to transaction.) from <u>prohibited transactions</u>, which are 1. disposing of a mortgage except for qualified replacement, foreclosure, bankruptcy or insolvency of the pool, or qualified liquidation of the REMIC; 2. receipt of income not from a qualified mortgage or permitted investment; 3. receipt by the mortgage pool of any fee for services; 4. gain from disposition of any cash flow investment except upon <u>qualified liquidation</u> whereupon the REMIC will recognize neither gain nor loss on asset disposition if: (i) it adopts a complete liquidation plan, (ii) w/in 90 days sells all its assets and distributes proceeds to regular and residual interest holders, less assets retained to meet claims. Any reason for liquidating is O.K.