

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

III. REAL ESTATE DEPARTMENT ADMINISTRATION

M. Shidler Award

Selected Correspondence, and Kevin Dretzka's Winning
Essay (Appeared in Real Estate Review, Fall, 1984)

~~Alumni News~~

University of Wisconsin Madison



School of Business

1155 Observatory Drive
Madison, Wisconsin 53706
Telephone: 608/262-1555

Graduate School of Business

Office of Associate Dean

April 9, 1985

Mr. Robert J. Korslin
269 North Thompson
Madison, WI 53714

Dear Bob:

Congratulations on winning The Shidler Grant 1984/1985 with your paper on real estate entrepreneurship in the year 2000! It is always a pleasure for us to know that our students compete well in national scholarship competitions.

Sincerely,

E. J. Blakely

E. J. Blakely
Acting Dean

rg

xc: James Graaskamp ✓

THE SHIDLER GROUP
HONOLULU • SAN FRANCISCO • LOS ANGELES • NEW YORK • CHICAGO

, May 21, 1986

Jim
For You
Jim

Dean E. J. Blakely
University of Wisconsin
Commerce Building, Room 102
1155 Observatory Drive
Madison, Wisconsin 53706

Dear Dean Blakely:

Thank you very much for your help in letting students know about The Shidler Grant. The winners have been chosen, and I'm happy to say one is from the University of Wisconsin.

First place (\$10,000) went to Peter Kelley from UCLA and second place (\$5,000) went to Ralph Cram from Wisconsin. Susan Thomas from Wisconsin was also a close contender.

I am enclosing copies of the two winning papers for your use. Press releases will be sent to your local newspapers, as well as to national publications.

Again, thanks for promoting this competition at Wisconsin.

Sincerely,

Pam Woodard

Pam Woodard

Enclosures

THE SHIDLER GROUP
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November 7, 1986

Dr. James A. Graaskamp
Landmark Research, Inc.
Pyare Square Building
4610 University Avenue
Suite 105
Madison, Wisconsin 53705

Dear Dr. Graaskamp:

The time of year for The Shidler Group real estate essay competition is rolling around again.

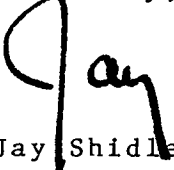
I appreciated very much your participation as a judge for the 1986 competition. We are hoping to put together largely the same group of distinguished judges for the 1987 competition. I am writing to see if you would be available to join our judging panel again this year.

As you know, the judging process involves reading about 20 to 30 short essays and picking your favorites. Judging for the 1987 essay competition will be in mid-April.

Last year, we awarded \$10,000 to the first place winner and \$5,000 to the second place winner. This year, we will be keeping the first and second place prizes of \$10,000 and \$5,000 respectively, and we will be adding 5 third place prizes of \$1,000 each to reward those students who wrote good essays but did not attain the number one or two spot.

Dr. Graaskamp, could you join us as a judge again this year? I have asked Pam Woodard, the essay competition coordinator, to follow up with you next week. Thanks.

Sincerely,


Jay Shidler

JS:ik

Reply sent 11/12

Real Estate Review

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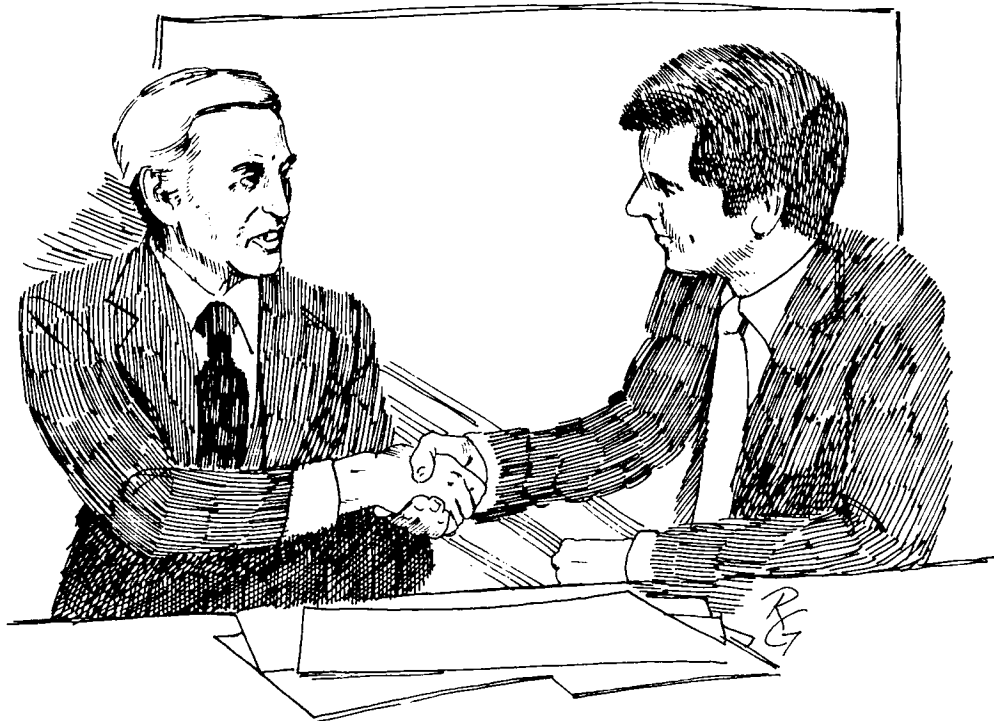
- STANGER SYNDICATION SALES DATA
- TAX SHELTER TOPICS, *David A. Smith*
- LEGAL OPINION, *Richard Harris*
- TAX REFORM ACT OF 1984 ELIMINATES MANY REAL ESTATE BENEFITS, *Sheldon Schwartz*
- FOREIGN INVESTORS IN THE UNITED STATES: A SYMPOSIUM *Henry A.A. Regeling, C.J. Bartram, and Takahide Moribe*
- INTEREST ACCRUALS UNDER THE RULE OF 78s: A POSTMORTEM, *Leslie H. Lofgren and Sanford C. Presant*
- A PROPOSED STRUCTURE FOR A SYNDICATION/PENSION FUND JOINT VENTURE, *Kevin Dretzka*
- SELLING LEASEHOLD POSITIONS: A NEW SYNDICATION AND FINANCING OPPORTUNITY, *Sidney B. Rosenberg*
- THE EXPLOSION IN LEVERAGED SALE-LEASEBACKS, *Chip Conley*
- HOW TO READ A SYNDICATION PROSPECTUS, *Allen Cymrot*
- THE LIMITED PARTNERS' REPRESENTATIVE, *Frederic Tisch*
- PEOPLE AND PROPERTY: INSURANCE CLAUSES REVISITED—PART II, *Emanuel B. Halper*
- THE DEDUCTIBILITY OF THE CONTINGENT INTEREST PAYMENT IN A SHARED-APPRECIATION MORTGAGE, *Michael A. Granson and Michael N. Silver*
- LESSENING THE RISK OF "TURNAROUND" PROPERTIES, *Mark R. Adams and Brian K. Purcell*
- STANDARD ANALYTICAL TECHNIQUES GIVE INCONSISTENT ANSWERS ABOUT COMMERCIAL PROPERTY DEPRECIATION, *Dennis Eisen*
- THE BATTLE OF THE JUNIORS: SECOND MORTGAGE VS. WRAPAROUND FINANCING, *John Oharenko*
- ACCOUNTING FOR CERTAIN MORTGAGE BANKING ACTIVITIES, *Robert M. Kozub and James P. Trebby*

The Real Estate Institute of New York University **WG**
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An A/B structure that yields higher than normal potential returns to each class of partner.

A Proposed Structure for a Syndication/Pension Fund Joint Venture

Kevin Dretzka



THE TWO FASTEST-GROWING money sources in the 1980s have been pension funds and real estate syndicators. However, differing goals have motivated pension and syndication real estate investment growth. Pensions invest for cash flow, appreciation, and portfolio diversification while syndicators invest to maximize tax shelter for limited partners.

Since pension funds are tax-exempt and as such cannot benefit from ACRS deductions, joint pension/syndicator real estate ownership appears to be a logical relationship to maximize returns from a venture. How-

ever, unresolved legal issues concerning the separation and allocation of tax benefits and income have hindered joint ownership by tax-paying and tax-exempt entities. Convertible mortgages are the most common vehicle used to separate depreciation deductions from cash flow and appreciation, but risks of equity clogging and

Kevin Dretzka is an analyst at the Los Angeles office of Kenneth Laventhol & Co. and a candidate for the Master of Science in Real Estate at the University of Wisconsin in Madison. This article is an edited version of Mr. Dretzka's winning entry in an essay competition sponsored by the Shidler Group of Honolulu.

of being classified as a general partner have prevented wide institutional use of such instruments.¹

Formation of a partnership with special allocation of depreciation and income between tax-paying and tax-exempt partners is clouded by uncertainty. Proposed regulations² state that special allocations must have economic effect; that is, that the partner to whom a special allocation is made must bear the economic burden of such allocation.³ The tax basis on which specially allocated deductions would be taken is composed primarily of nonrecourse debt, hence the uncertainty: allocations of deductions attributable to nonrecourse debt may be viewed as never having economic effect because the creditor bears any economic risk of loss.⁴

AN A/B PARTNERSHIP STRUCTURE

This article outlines a hybrid A/B partnership structure. An A/B partnership has two classes of investor: one who invests for the depreciation and tax benefits and one who invests for ordinary income. This partnership structure uses the leverage of limited partner and pension capital and allows a general partner with acquisition authority to maintain control of the real estate. In addition to placing management responsibility in the hands of the general partner, the partnership has six other design goals:

- To provide return potential to the limited partners that exceeds the public syndication industry after-tax return goal of 18 percent.
- To provide return potential to the pension fund that exceeds the return it otherwise might have received from an all-cash purchase.
- To allow the pension fund some degree of control while limiting its exposure to liability.
- To enhance return potential for both limited partners and the pension fund with minor reliance on inflation.
- To base general partner compensation and contingent interests on performance.
- To comply with ERISA, the Internal Revenue Code, and state and federal regulations.

Partnership Design Background

Preliminary sensitivity analysis indicated that straight-line ACRS deductions from property, for which the ratio of depreciable basis to value is 90 percent, provide after-tax internal rates of return that range from 20-25 percent when the only returns to a 50 percent marginal tax bracket investor who contributed 10 percent of property purchase price are tax savings. (This computation is Exhibit 1.) To provide a tax basis for the limited partners, who will contribute the partnership equity and be the "A" or tax-paying partners in this A/B partnership, the pension capital contribution must be that of a nonrecourse lender. The pension fund (i.e., the tax-exempt "B" partner) derives its income from cash flow and appreciation. The problem is how to give the pension fund a degree of control while retaining its status of a liability-free nonrecourse lender.

EXHIBIT 1

AFTER-TAX IRR CALCULATION (ATIRR)

Assumptions: 50% marginal tax bracket; \$1,000 property purchase price; \$900 depreciable basis \times .067 straight-line ACRS factor = \$60.03 annual ACRS deduction. Tax savings from deduction recognized end of year incurred.

	1/85	12/85	12/86	12/87	12/88	12/89
Investment	\$100					
ACRS deduction	—	60	60	60	60	60
\times tax bracket		$\times 50\%$	$\times 50\%$	$\times 50\%$	$\times 50\%$	$\times 50\%$
Tax savings		30	30	30	30	30
Property sold 1/1990 (no appreciation)						
Return of investment						100
Losses taken					(300)	
Capital account					(200)	
Capital gain tax $(300 \times .2)$						(60)
Cash proceeds (1/1990)						40

IRR = 22.28%

IRR variation (20-25%) is due to changes in holding period.

To arrive at the proposed partnership structure, sensitivity analysis was performed on the following property simulation model:

Property type: commercial
Purchase price: \$1,000
Depreciable basis: \$900
Annual depreciation: \$60 (straight line)
Initial net operating income (NOI): \$90 (9%)
Sales price: based on 9% capitalization

Incurred income and tax savings were recognized at year-end.

The model was tested by varying the following factors:

¹ Jerome Siegman and Richard C. Liquanti, "The Convertible, Participating Mortgage: Planning Opportunities and Legal Pitfalls in Structuring the Transaction," *University of Colorado Law Review* 54(3): 295, 1983; Jack M. Feder, "Either a Partner or a Lender Be: Emerging Tax Issues in Real Estate Finance," *Tax Lawyer* 36(2):191, 1983; Norton L. Steuben, "The Convertible, Participating Mortgage: Federal Income Tax Considerations," *University of Colorado Law Review* 54(2):237, 1983; *Humble Oil & Refining v. Doerr*, 303 A.2d 898 (1973).

² Regulations interpreting Tax Reform Act of 1976 § 704(b).

³ Reg. § 1.704(b)(2)(ii).

⁴ David R. Bower and John W. Larson, "The Proposed Regulations Under Section 704(b)," *Tax Notes* 19(8):667, May 23, 1983.

A Proposed Structure for a Syndication/Pension Fund Joint Venture

- Appreciation and cash flow participation;
- NOI growth;
- Holding period; and
- Debt/equity structure.

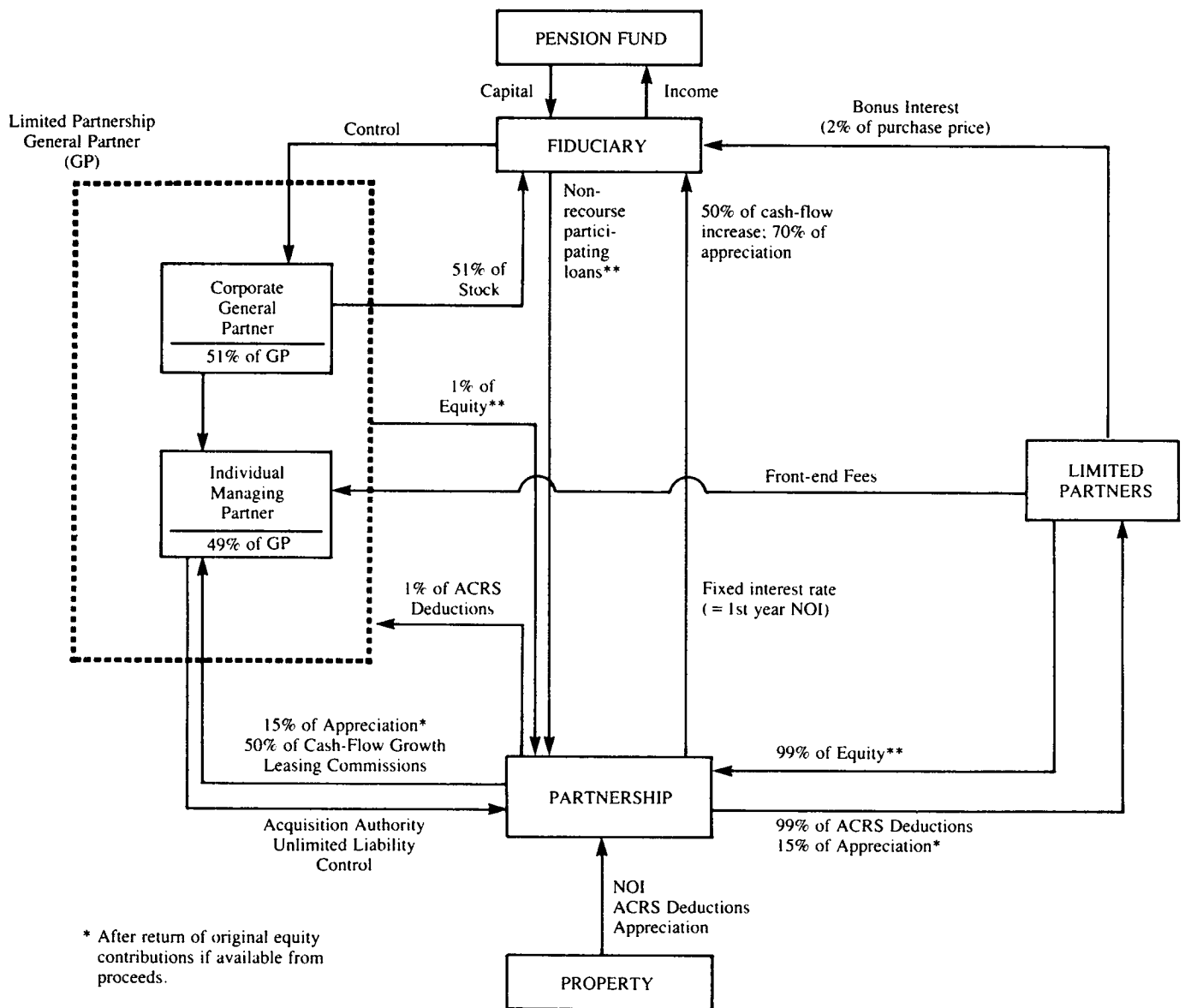
The effect of these changes on the internal rate of return (IRR) to the participating lender (pension fund) and on the after-tax internal rate of return (ATIRR) to the equity investors (limited partners) was noted. Exhibit 2 is a schematic of the proposed hybrid A/B partnership format that developed as a result of this variation testing.

The Suggested Partnership Structure

Exhibit 2 indicates that the pension fund entrusts capital to a fiduciary which provides 95 percent of partnership capital in the form of a participating, non-recourse loan with the following terms:

- An interest-only, fixed-rate payment equal to the property's first year NOI (no principal amortization); plus
- 50 percent of any cash flow increase;

EXHIBIT 2
SCHEMATIC OF AN A/B PARTNERSHIP



* After return of original equity contributions if available from proceeds.

** Loan = 95 percent of purchase price;
Equity = 5 percent of purchase price.

- 70 percent of appreciation and the entire principal amount are due on sale;
- The limited partners agree to pay the fiduciary an annual bonus interest amount of 2 percent of the property purchase price;
- Loan term is fifteen years.

The General Partner

The general partner allows the fiduciary to function as a director and to oversee partnership decisions. The fiduciary can do so because it owns 51 percent of the corporate general partner, which is 51 percent of the limited partnership general partner. This entity tiering isolates the fiduciary from the unlimited liability risk that participation in the general partnership normally entails. Corporate general partner net worth requirements⁵ pose no significant impact on return because funds required for net worth compliance can be assigned to the pension asset managers and earn a portfolio rate of return. In addition to assigning assets for net worth compliance, the fiduciary contributes 51 percent of 1 percent of partnership equity and receives 51 percent of 1 percent of ACRS deductions.



This general partner structure and the participating, nonrecourse loan terms that were outlined above protect the pension fund from being classified as a partner. Case law imputes partnership status to the lender if "substantial day-to-day control" exists and if no specific repayment date is defined.⁶ The partnership structure in Exhibit 2 avoids these two pitfalls. Treasury regulations governing "hybrid corporate debt instruments"⁷ are more specific and state that "straight debt payments" must equal or exceed 50 percent of "fair market value of the instrument."⁸ That is, unless the present value of the fixed interest and principal payments (if principal is amortized) equals or exceeds the present value of participating or contingent interests, the debt will be classified as equity and the issuer (pension fund) will be a partner. The participating loan structure that was outlined above falls within the

straight debt payments test unless annual NOI growth and property appreciation exceed the 25-27 percent range.

The Limited Partners

The limited partners contribute 99 percent of total equity (remember, equity equals 5 percent of partnership capital) and pay front-end fees and the 2 percent bonus interest, but they receive 99 percent of ACRS deductions and 15 percent of appreciation. The 99 percent ACRS allocation to the limited partners and the 1 percent ACRS allocation to the general partner are designed to comply with Revenue Procedure 74-17,⁹ which requires the general partner to maintain a 1 percent interest in all items of income, deduction, and credit. The 15 percent appreciation share of the limited partners assures that the equity after-tax ATIRR goal is met and that "economic consequence"¹⁰ and "requisite profit motive"¹¹ exist.

Since the limited partners contribute 99 percent of equity, their 99 percent allocation of ACRS deductions is consistent with partnership interest and thus not a special allocation.¹² However, any liquidation proceeds that remain after lender (pension fund) repayment should, to the extent available, be allocated 99 percent to the limited partners and 1 percent to the general partner until original equity contributions are reached. So, if a sum less than original equity remains

EXHIBIT 3
SUMMARY MATRIX OF RETURNS

Annual NOI Growth	Holding Period (years)	Limited Partner ATIRR	Pension Fund IRR 95% Loan to Partnership	All-Cash Purchase
0%	4	14.47%	11.58%	9.0%
	7	22.46	11.58	9.0
	10	27.97	11.58	9.0
2.22%	4	17.93	12.73	10.69
	7	25.06	12.79	10.88
	10	29.28	12.76	10.93
4.44%	4	21.02	13.86	12.31
	7	27.23	13.93	12.60
	10	30.49	13.85	12.63
6.66%	4	23.81	14.96	13.88
	7	29.12	15.02	14.19
	10	31.43	14.85	14.15

⁵ Rev. Proc. 72-13, 1972-1 C.B. 735.

⁶ *Margolis v. Comm'r*, 337 F.2d 1001 (1964); *Farley Realty Corp. v. Comm'r*, 279 F.2d 537 (1960); *Gibson Prod. Co. v. United States*, 460 F. Supp. 1109 (1978).

⁷ I.R.C. § 385. Note: although the pension fund may not be classified as corporate, § 385 is the only part of the Code that quantifies a debt/equity test.

⁸ Reg. § 1.385(5)(c).

⁹ 1974-1 C.B. 438.

¹⁰ Reg. § 1.704(b)(2)(iii)(b); *Estate of P.L. Helliwell v. Comm'r*, 77 T.C. 964 (1981). Partnership participation must have a "business purpose" and not simply provide a "tax loss conduit."

¹¹ I.R.C. § 183-2.

¹² Reg. § 1.704(b)(3).

A Proposed Structure for a Syndication/Pension Fund Joint Venture

EXHIBIT 4

SENSITIVITY ANALYSIS PRO FORMA FOR LIMITED PARTNER: 4.44% SIMPLE ANNUAL NOI GROWTH

Assumptions with property simulation model:

1. Limited partners are in the 50% marginal tax bracket.
2. Annual depreciation deduction of \$60 is 99% of ACRS deduction.
3. Front-end fees are entirely expensed.
4. No sales costs.

	1/84	12/84	12/85	12/86	12/87	12/88	12/89	12/90	12/91	12/92	12/93
Outlays											
Equity	\$50										
Front-end fee	15										
Bonus interest		20	20	20	20	20	20	20	20	20	20
Capital gain tax if sold*					<u>52</u>			<u>92</u>			<u>132</u>
Total outlays	65	20	20	20	72	20	20	112	20	20	152
Receipts											
Tax savings**	—	47	40	40	40	40	40	40	40	40	40
Return of capital if sold	—				50			50			50
Appreciation if sold***	—				<u>20</u>			<u>40</u>			<u>60</u>
Total receipts	—	47	40	40	110	40	40	130	40	40	150
ATIRR if sold					21.02%			27.23%			30.49%

* Equity - total deductions - cash received at sale = total gain \times .2 = capital gain tax.

** (Front-end fee + interest + depreciation) \times .5.

*** ((NOI / .09) - 1,000) \times .15.

after liquidation, partners bear the economic burden or loss in proportion to the ACRS deductions that they have taken.¹³



The Individual Managing General Partner

The individual managing general partner, who is 49 percent of the limited partnership general partner, owns 49 percent of the corporate general partner. He is responsible for property acquisition, management and disposition, but his decisions are subject to approval by the corporate general partner. The individual managing general partner has unlimited liability, contributes no partnership capital, and receives 49 percent of 1 percent of ACRS deductions, 50 percent of the cash-flow increases as a management incentive fee,¹⁴ leasing

commissions, 15 percent of the appreciation, and a front-end fee equal to 22 percent¹⁵ of the limited partners' equity investment.

IRRs After Tax and Before

Exhibit 3 presents ATIRR and IRR sensitivity analysis results of the property simulation model and the proposed partnership structure. It lists the limited partners' ATIRR and it compares the IRRs generated by the pension fund's loan to the partnership with the return potential of an all-cash purchase by the pension fund. Partnership design goals of return potentials that exceed those of a typical syndication for limited partners and an all-cash purchase for a pension fiduciary have been achieved.

Exhibit 4 is a limited partner pro forma for sensitivity analysis based on 4.44 percent NOI growth presented in Exhibit 3. Exhibit 5 is a pro forma for the pension fiduciary based on 4.44 percent NOI growth in

¹³ Reg. § 1.704(b)(2)(ii).

¹⁴ Since the fee is based on income, it cannot be a § 707(c) guaranteed payment but can be a distributive share to the payee partner and not classified as a special allocation.

¹⁵ Includes acquisition fees, organizational expenses, and commissions. The maximum allowable front-end as defined by the North American Securities Administrators Association is 30 percent of the total equity offering. The 22 percent front-end charge by the general partner does not include sales commissions.

REAL ESTATE REVIEW

EXHIBIT 5

SENSITIVITY ANALYSIS PRO FORMA FOR PENSION FIDUCIARY: 4.44% SIMPLE ANNUAL NOI GROWTH: 95% LOAN COMPARED TO ALL-CASH PURCHASE

Assumptions with property simulation model:

1. No sales costs.
2. No unrelated business taxable income.*

	1/84	12/84	12/85	12/86	12/87	12/88	12/89	12/90	12/91	12/92	12/93
NOI	—	90	94	98	102	106	110	114	118	122	126
Less: fixed interest rate to pension (= NOI at purchase)		(90)	(90)	(90)	(90)	(90)	(90)	(90)	(90)	(90)	(90)
Cash flow		0	4	8	12	16	20	24	28	32	36
Share to fiduciary		× 50%	× 50%	× 50%	× 50%	× 50%	× 50%	× 50%	× 50%	× 50%	× 50%
Fiduciary cash flow share		0	2	4	6	8	10	12	14	16	18
95% Loan											
Outlays											
Loan proceeds	\$ 950										
Receipts											
Fixed interest		90	90	90	90	90	90	90	90	90	90
Cash flow share		0	2	4	6	8	10	12	14	16	18
Bonus interest		20	20	20	20	20	20	20	20	20	20
Loan repayment if resold					950			950			950
Appreciation share if sold**					93			186			280
Total receipts		110	112	114	1159	118	120	1258	124	126	1358
IRR if sold					13.86%			13.93%			13.85%
All-Cash Purchase											
Outlays											
Purchase price	\$1,000										
Receipts											
NOI	—	90	94	98	102	106	110	114	118	122	126
Proceeds if sold					1,113			1,266			1,400
Total receipts	—	90	94	98	1,215	106	110	1,380	118	122	1,526
IRR if sold					12.31%			12.60%			12.63%

* Assume that no rental receipts exceed incidental personal property rent as covered in Sections 512(b)(3)(B)(i) and 512(b)(c)(2)(ii). Also assume that no percentage rents on gross receipts or income will be categorized as UBTI under Section 512(b)(c)(2)(iii)(b) or Revenue Ruling 74-198.

** $((\text{NOI}/.09) - 1,000) \times .7$.

Exhibit 3 comparing a 95 percent loan to the partnership and an all-cash purchase.

CONCLUSION

When the pension fund commits to a 95 percent loan in the recommended partnership format, it possesses increased IRR potential and fiduciary management authority without additional liability, and has greater safety than it could achieve with an all-cash purchase because of the equity position. Under the partnership structure, the property could decrease 5 percent in value, and the pension fund could be made whole. This partnership structure is readily suited for joint venture with a real estate professional (the individual managing

general partner) who is an expert in a given property type or locale, allowing management diversification.

The structure also increases return potential for the limited partner without reliance on short-term seller financing, accrued interest, or unrealistic pro forma increases in rent or value, all of which are common syndication attributes that have questionable reliability and security. Use of straight-line depreciation also limits limited partners' risk by avoiding recapture.

The individual managing general partner acquires and substantially controls the property with 102 percent financing (including front-end fees); thus, he is able to receive infinite returns from commissions, fees, and contingent interests.