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## Back from the Abyss: Real Estate Tax Planning from the Bottom Up (Slides)

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# Back from the Abyss – Real Estate Tax Planning from the Bottom Up

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# Back from the abyss . . .

## Working assumptions

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- ▶ The Great Recession is over
- ▶ Real estate asset values have bottomed . . . And in some instances have started recovering. (There's an exception that we'll talk about)
- ▶ Clients have intestinal fortitude to get back into the game
- ▶ Analogy: Energy bust of 1986 . . . Pawning Rolexes
- ▶ Remember the mantra from the Oil Patch
- ▶ “Lord, give me one more boom and I promise not to screw it up again . . .”

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# What are the lessons learned?

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- ▶ Real estate doesn't defy the laws of gravity
  - ▶ What goes up does come down . . . Sometimes with a thud!
  - ▶ Polite phrase: "Real estate remains a cyclical industry sector"
- ▶ Leverage is like a magnifying glass
  - ▶ On the way up, it enhances returns
  - ▶ On the way down, it causes myocardial infarctions
- ▶ Just because a lender offers you a loan doesn't mean you should take the money
- ▶ If it sounds too good to be true, it probably is . . .

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# Some observations on the existing economic environment

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- ▶ Investors are very nervous about relatively high equity market valuations and their sustainability
- ▶ Public equity markets are relatively close to all-time peaks
  - ▶ DJIA: 13,100 (YOY ↑ 10.4%)
  - ▶ S&P 500: 1,400 (YOY ↑ 12.2%)
  - ▶ Nasdaq: 2,990 (YOY ↑ 9.2%)
- ▶ Interest rates, both for investors and lenders, are at 40-year lows
  - ▶ Great for borrowers
  - ▶ Not so great for retirees and folks on fixed incomes
- ▶ So, what are the opportunities?

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# Capital for residential land developers . . .

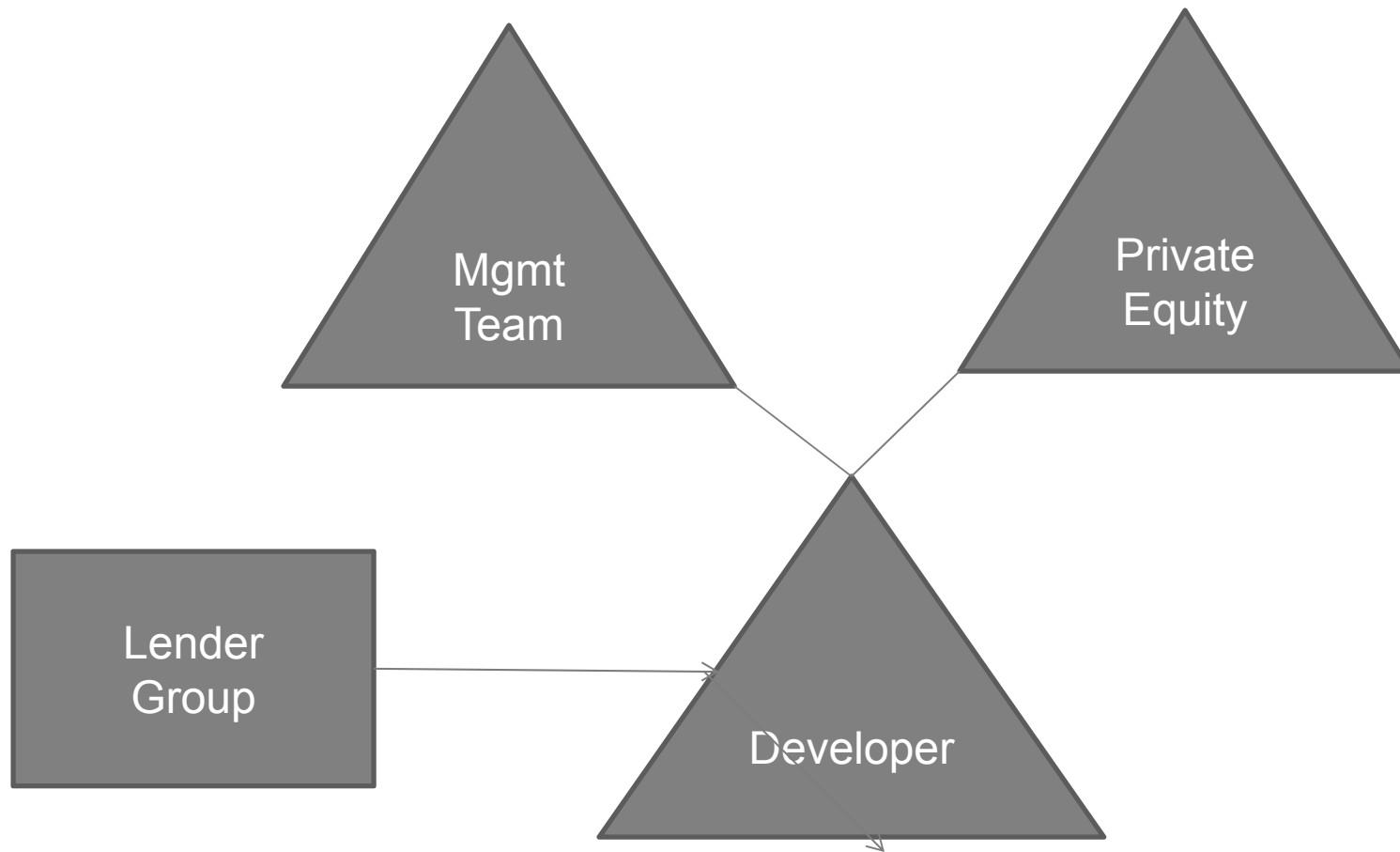
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- ▶ Investment thesis –
  - ▶ Finished lots in good locations in short supply
  - ▶ Home buyer and home builder demand is returning
- ▶ Private equity is expensive but available
- ▶ Shortfall: Commercial lending virtually nonexistent – Debt capital difficult to find
- ▶ Opportunity: High-net worth individual network
- ▶ Invest in front of private equity to provide “debt-like” funding
- ▶ Advance rate of, say, 65% loan-to-cost
- ▶ Returns of 6% up to 10% should make everyone happy



# Capital for residential land developers . . . Traditional debt structure

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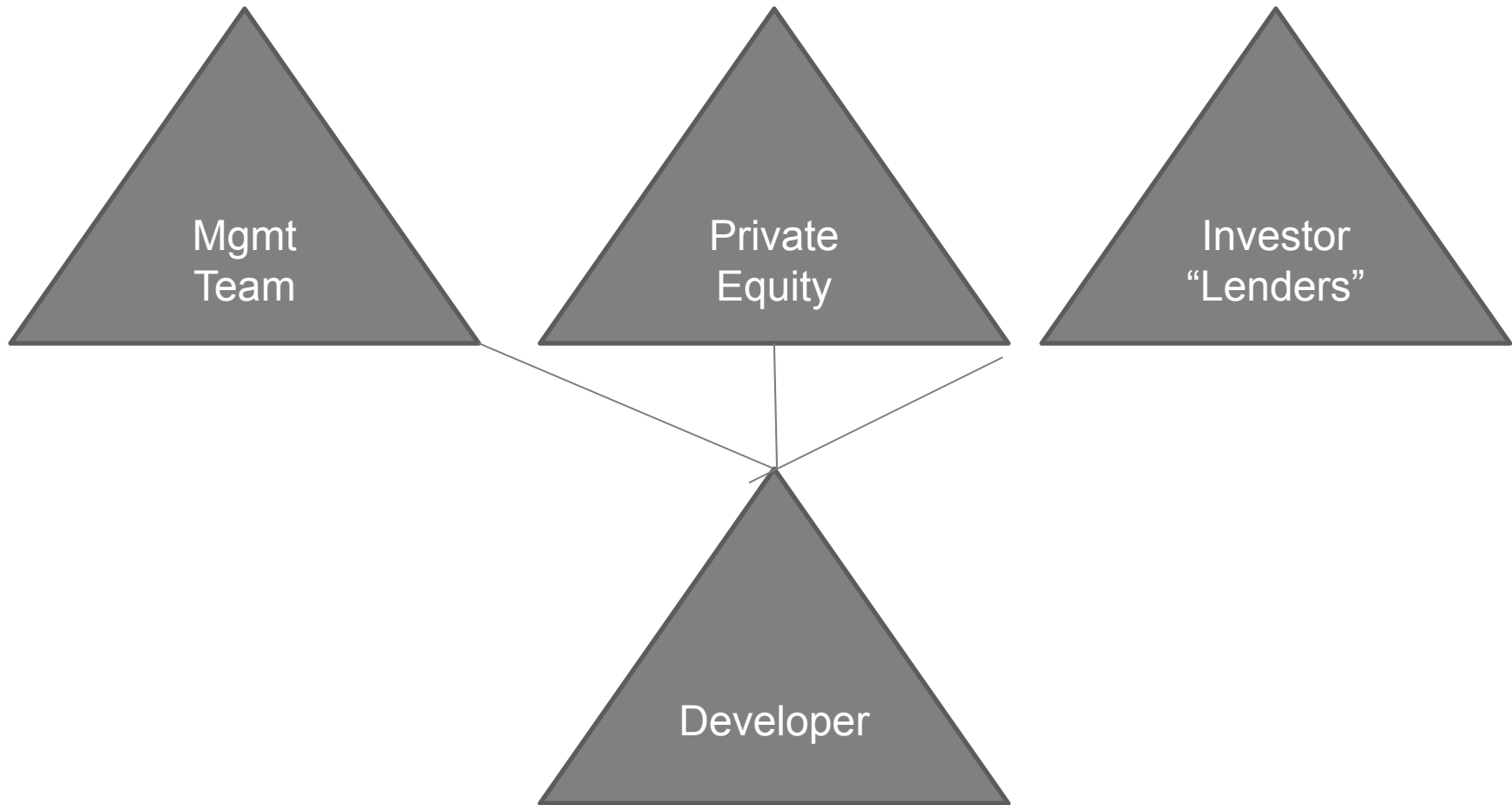


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# Capital for residential land developers . . .

## Equity alternative structure

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# Capital for residential land developers . . .

## Federal income tax considerations

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- ▶ Consequences to the parties . . .
- ▶ Are the lenders “lenders” or “investors”?
- ▶ What do you **want** them to be?
  - ▶ *Historic Boardwalk Hall v. Commissioner*, 2012-2 USTC ¶150,538 (3d Cir. 8/27/2012)
  - ▶ *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4<sup>th</sup> Cir. 2011)
- ▶ Meaningful economic upside/downside share
- ▶ Debt –
  - ▶ Interest expense to borrower
  - ▶ Interest income to lender
  - ▶ Each with its own method of tax accounting

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# Capital for residential land developers . . .

## Federal income tax considerations

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- ▶ Investor equity – LLC members/partners –
- ▶ The cash receipt and timing may be identical, but . . .
- ▶ Tax consequences can vary
- ▶ Range of possibilities –
  - ▶ Distributive share – IRC §704(b)
  - ▶ Guaranteed payment – IRC §707(c)
  - ▶ Payment to a partner in a non-partner capacity – IRC §707(a)
- ▶ Avoid the “whoops” moment – is the partner a partner?

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# Capital for residential land developers . . .

## Federal income tax considerations

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- ▶ Typical “whoops” #1: Reg. §1.707-1(a) – Partner not acting in capacity as partner
  - ▶ “A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money . . . by the partner to the partnership”
- ▶ Typical “whoops” #2: Reg. §1.707-1(c) – Guaranteed payments
  - ▶ “Payments made by a partnership to a partner for . . . the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership”

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# Capital for residential land developers . . .

## Federal income tax considerations

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- ▶ Typical “whoops” #3: Reg. §1.707-1(c) -- income recognition timing . . . Temporary phantom income risk
  - ▶ “A partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting.”
  - ▶ In case you missed the point, Reg. 1.706-1(a) contains a reminder: “A partner must also include in taxable income for a taxable year guaranteed payments under section 707(c) that are deductible by the partnership under its method of accounting in the partnership taxable year ending within or with the partner's taxable year.”

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# Capital for residential land developers . . .

## Federal income tax considerations

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- ▶ Are §707(c) payments “interest”?
  - ▶ If §263A applies, they are subject to UCR by the payor
  - ▶ IRS view of recipient: Treat like interest (GCM 38133; 10/10/79)
- ▶ §704(b) distributive share can be a preferred return
- ▶ Passive activity character
  - ▶ Interest on a loan: Investment income
  - ▶ §707(c) guaranteed payment: Portfolio income – Reg. §1.469-2T(c)(3)(i)(A) and §1.469-2T(e)(2)
  - ▶ §704(b) distributive share: Passive income – interesting planning opportunity for individuals with suspended passive losses

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# Capital for residential land developers . . .

## Federal income tax considerations

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- ▶ §1411 Medicare tax considerations
- ▶ Effective for tax years beginning after 12/31/2012
- ▶ 3.8% additional federal income tax on “high income” taxpayers
- ▶ Tax levied on lesser of:
  - ▶ Net investment income or
  - ▶ Modified AGI > “threshold amount”
    - ▶ \$250,000 MFJ
    - ▶ \$125,000 MFS
    - ▶ \$200,000 HH or S
  - ▶ Modified AGI: AGI + net foreign earned income exclusion



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# Capital for residential land developers . . .

## Federal income tax considerations

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- ▶ “Net investment income” includes:
  - ▶ Interest, dividends, royalties, annuities and rents
  - ▶ Capital gains generally
  - ▶ Trade or business income from passive activities
- ▶ Net investment income does not include any self employment income
- ▶ Net result?
  - ▶ Loan interest: Subject to §1411 tax
  - ▶ Guaranteed payment: Subject to §1411 tax
  - ▶ §704(b) distributive share preferred return subject to §1411 – unless partner is a material participant

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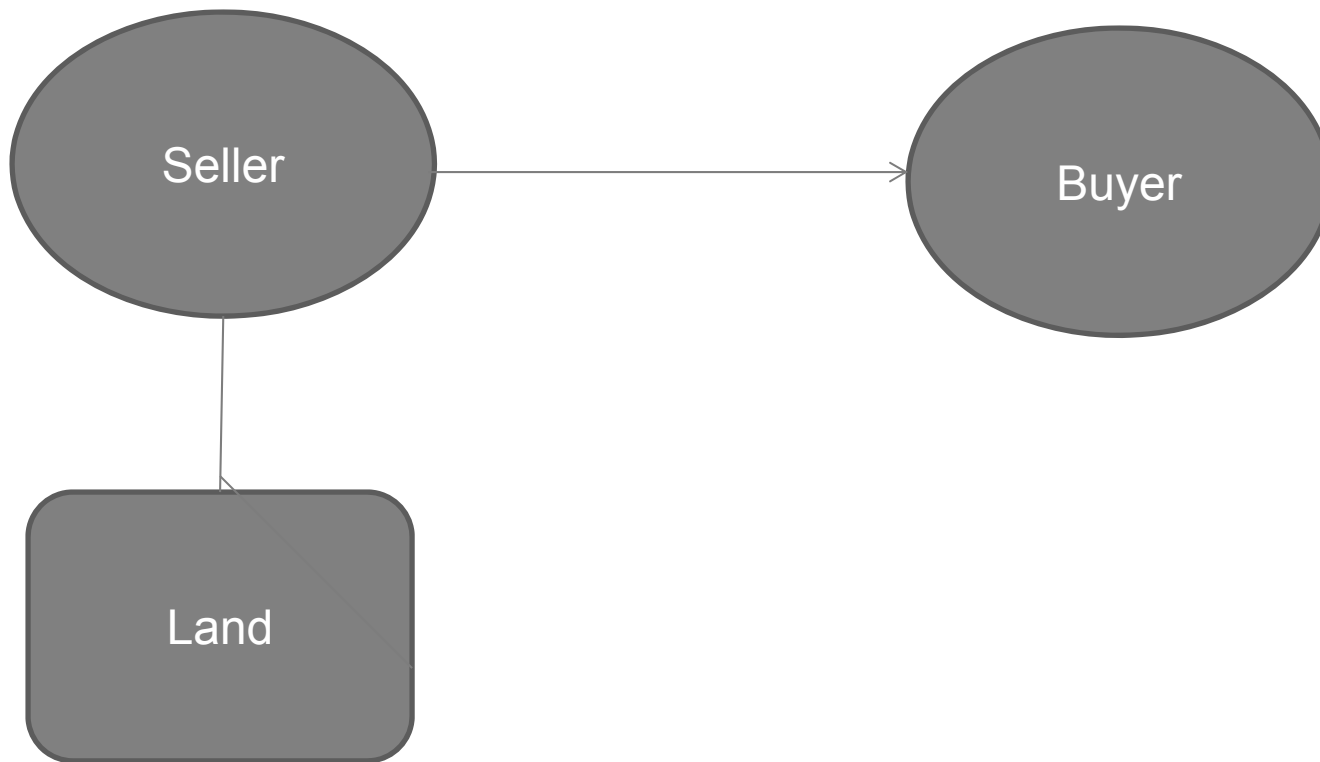
# Real property installment sale

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- ▶ Base facts –
- ▶ Taxpayer owns land that has economically depreciated
- ▶ Current FMV still greater than adjusted tax basis
- ▶ Taxpayer thinks the property has significant upside
- ▶ Taxpayer wishes to transfer appreciation to others, whether family or nonfamily members
- ▶ Taxpayer would like some form of current income stream
- ▶ Good examples: Family farmland; rural acreage

# Real property installment sale

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# Real property installment sale

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- ▶ This is “mom and apple pie” . . . Where’s the sizzle?
- ▶ Business drivers –
- ▶ Property appreciates at a rate > installment note interest
- ▶ Classic value creation technique: Rezoning
- ▶ Current low rate environment is a key attraction
- ▶ Rev. Rul. 2012-30: Current (Nov.) long-term AFR < 2.40%
- ▶ Potential threat: Real of installment sale treatment part of Shelf Project

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# Revisiting General Utilities repeal

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- ▶ Conventional wisdom: Real estate shouldn't be in corporate solution
- ▶ Reinforced by repeal of General Utilities doctrine in 1986
- ▶ What if your client didn't listen?
- ▶ Earlier assumption: Values down, but still > adjusted basis
- ▶ Consider corporate liquidation under §337?
- ▶ Triggers §311(b) gain . . . Arguably reduced
- ▶ Shelter §311(b) gain with corporate NOLs?
- ▶ Mechanics: Form 8832, Entity Classification Election

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# Unlocking integrated, but trapped, business real estate . . .

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- ▶ Typical facts –
- ▶ Closely held, successful operating business
- ▶ The operating real estate is owned by the business entity
- ▶ That entity often is a C corporation or an S corporation
- ▶ Lenders historically have focused on the business
- ▶ Lack of appreciation (no pun intended) for the intrinsic value of the real estate component
- ▶ Goal: Separate operating business and real estate
- ▶ Allow each to be evaluated in ways that make business sense
- ▶ Create more family estate planning flexibility

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# Unlocking integrated, but trapped, business real estate . . .

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- ▶ Liquidation generally doesn't work – complexities of the operating business
- ▶ At least 3 options . . .
- ▶ #1: Elect S status – doesn't solve the business problem
  - ▶ Probably already done if feasible – just a reminder
  - ▶ General rule: §1374 built-in gains tax imposes C corporation tax
  - ▶ §1374(c) exception: Expiration of 10-year recognition period
  - ▶ C corporation NOLs can shelter built-in gains tax
- ▶ #2: Installment sale
  - ▶ Gain recognition
  - ▶ Potential depreciation recapture

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# Unlocking integrated, but trapped, business real estate . . .

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- ▶ #3: Tax deferred spin-off . . . Is it possible?
- ▶ Active trade or business requirement
  - ▶ Tenant functions under Rev. Rul. 2001-29
- ▶ Business purpose
  - ▶ Estate planning – shareholder purpose
  - ▶ Debt financing
  - ▶ Liability protection
- ▶ Existence of a “device”
- ▶ S corporation v. C corporation



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# Some additional capital markets considerations . . . REITs

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- ▶ Real estate investment trusts can be a great form of legal entity to own or operate real estate
- ▶ Background – 1960 enabling legislation:
  - ▶ Historically designed as passive rent collectors
  - ▶ Allow small investors access to “big money” opportunities
- ▶ Emerging “flavors” of REITs
- ▶ Private REITS
- ▶ Non-traded REITS
- ▶ Non-traditional REITS
- ▶ Each of these are intended to qualify as REITs, so . . .
- ▶ Full and timely compliance with the REIT tax rules

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# Some additional capital markets considerations . . .

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- ▶ Highly simplified overview of the REIT tax rules . . .
- ▶ Otherwise taxable as a domestic corporation
- ▶ Elects status as a REIT
- ▶ Domestically controlled
- ▶ 100 shareholders
- ▶ Transferable shares
- ▶ 1 class of stock
- ▶ Not “closely held”
- ▶ Asset and income tests –95%/75%
- ▶ 90% taxable income distribution requirement

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## Some additional capital markets considerations . . .

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- ▶ Not intended for “dealer” real estate – 100% prohibited transaction tax
- ▶ REITS perform alchemy – turn rents to dividends
- ▶ Attractive to tax-exempt investors – UBTI
- ▶ Investor reporting: Form 1099 – not Schedule K-1
- ▶ Observations from watching REIT “newbie's”
- ▶ “. . . You don’t know what you don’t know . . .”
- ▶ Initial compliance efforts can be painful
- ▶ The rule box gets easier over time

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# Private REITs

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- ▶ Not publicly registered
- ▶ Not publicly traded
- ▶ Analogy: Private real estate investment in a new/different wrapper
- ▶ Choice of entity typically driven by institutional capital
- ▶ Popular with tax-exempts
- ▶ Meeting the 100-shareholder requirement
- ▶ Trade off: Incremental compliance costs

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# Non-traded REITs

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- ▶ Not all real estate asset classes suffered equally
- ▶ Multifamily rental property generally fared well
- ▶ Retail investors are frustrated by low interest rates . . .
- ▶ They're seeking higher, steady returns – returns that apartment rentals generally can provide
- ▶ Result: Expansion of the market for “non-traded” REITs
- ▶ Publicly registered, but not publicly traded
- ▶ Typical format: Recurring monthly distributions to investors
- ▶ 2011 capital raised \$8.2 billion; 2012 expected \$9 billion±

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# Non-traded REITs

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- ▶ Area of concern: What's it worth?
- ▶ Unlike shares of publicly traded REITs, no current FMV data
- ▶ No standard for valuation practices for net asset value (NAV) –
  - ▶ Methodology (Who and how . . .)
  - ▶ Timing (When . . .)
  - ▶ Disclosures
- ▶ Some approaches:
  - ▶ Discounted cash flows
  - ▶ Direct capitalization
  - ▶ Rotating asset appraisals

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# Non-traded REITs

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- ▶ Lack of clarity around NAV generating investor and regulator (SEC & FINRA) scrutiny
- ▶ 2009 FINRA regulatory notice: Publish valuations no later than 18 months after conclusion of offering
- ▶ 2011 FINRA investor warning –
  - ▶ Borrowings can subsidize the investment – additional risk
  - ▶ Early redemption often limited
  - ▶ “Front end” costs can be high, eroding total return
- ▶ FINRA Proposal (Reg. 12-14) released March 2012
  - ▶ Per share valuations based on appraised values
  - ▶ Require inclusion of up-front fees and expenses

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# Non-traded REITs

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- ▶ Lack of valuation transparency driving evolution of the market for non-traded REITs
- ▶ Conversion to traded REITs (not as easy as it sounds)
- ▶ Early evolution of hybrid non-traded REIT vehicle
  - ▶ More frequent, comprehensive valuations
  - ▶ Greater levels of investor liquidity



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# Non-traditional REITs

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- ▶ What is “non-traditional” real estate?
- ▶ Definition by exclusion: What it’s NOT–
  - ▶ Health care real estate
  - ▶ Hotel real estate
  - ▶ Industrial real estate (warehouse and distribution facilities)
  - ▶ Multifamily
  - ▶ Office
  - ▶ Retail (centers, malls, strip centers, etc)
  - ▶ Single family
  - ▶ Personal storage

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# Non-traditional REITs . . .

## So, what is it?

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- ▶ Airports
- ▶ Cell towers
- ▶ Court houses
- ▶ Data centers
- ▶ Dams
- ▶ Electric transmission and distribution systems
- ▶ Gas stations and convenience stores
- ▶ Hospitals
- ▶ Military and other government housing
- ▶ Oil and gas, documents, and other types of non-personal storage assets
- ▶ Outdoor advertising properties
- ▶ Pipeline systems
- ▶ Privately-owned municipal parking and meters
- ▶ Privately-owned prisons
- ▶ Railroads
- ▶ Schools and student housing
- ▶ Seaports
- ▶ Ski resorts/slopes
- ▶ Stadiums and arenas
- ▶ Street furniture
- ▶ Timber
- ▶ Toll roads, bridges, and tunnels
- ▶ Water and wastewater facilities
- ▶ Waste facilities

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# Non-traditional REITs

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- ▶ Is this really for real?
- ▶ Global public and private investor focus on non-traditional real estate assets
- ▶ Driving the trend –
  - ▶ Search for stable, relatively high yields in a low-yield environment
  - ▶ Search for long-lived asset investment to match long-duration liabilities (like pensions)
  - ▶ Serious need for cash by governments that are overleveraged and unable to raise taxes in the current political climate
- ▶ Drivers are unlikely to change, so non-traditional real estate investment may be a secular trend

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# Non-traditional REITS . . .

## Examples of non-traditional real estate

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- ▶ **Cell towers:** **American Tower** (US listed multinational REIT); **Crown Castle** (US listed multinational C corporation)
- ▶ **Convenience stores/gas stations:** **Getty Realty** (US listed REIT); **Susser** (US listed C corporation)
- ▶ **Data centers:** **Coresite Realty** (US listed REIT); **Digital Realty** (US listed REIT); **DuPont Fabros** (US listed REIT)
- ▶ **Diversified infrastructure:** Brookfield Infrastructure Partners (Master Limited Partnership)
- ▶ **Document storage:** **Iron Mountain** (US listed C corporation that is in the process of converting to a REIT)
- ▶ **Outdoor advertising:** Lamar and Clear Channel Outdoor (both US listed C corporations)
- ▶ **Pipelines:** Kinder Morgan (US Master Limited Partnership)
- ▶ **Privately-owned municipal parking and meters:** Millennium Parking Garage (Chicago; owned by Morgan Stanley Infrastructure); Chicago parking meters (owned by Morgan Stanley Infrastructure, **Allianz**, and an **Abu Dhabi** sovereign wealth fund)
- ▶ **Privately-owned prisons:** **Corrections Corporation of America** (US listed C corporation); GEO Group (US listed C corporation)
- ▶ **Privatized government housing:** **Gagfah** (German listed corporation)
- ▶ **Railroads:** Florida East Coast Industries (known as “FECI”; owned by Fortress)
- ▶ **Seaports:** Maher terminals (owned by Deutsche Bank); Ports America (owned by Highstar)
- ▶ **Ski resorts/slopes:** Intrawest (owned by Fortress); Vail Resorts (US listed C corporation)
- ▶ **Student housing:** **American Campus Communities** (US listed REIT)
- ▶ **Timber:** **Plum Creek** (US listed REIT); **Potlatch** (US listed REIT); **Rayonier** (US listed REIT); **Weyerhaeuser** (US listed REIT)
- ▶ **Toll roads, bridges, and tunnels:** Chicago Skyway and Indiana Toll Road (owned by **Macquarie** and Cintra); Ambassador Bridge (family owned)

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# Non-traditional REITs

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- ▶ Non-traditional REITS have come in 2 flavors:
  - ▶ Formation of new businesses from scratch or via acquisition
  - ▶ Conversion of C corporation into REITs as “REIT conversions”
- ▶ REIT conversion transactions –
  - ▶ C corporation elects REIT status
  - ▶ All REIT requirements must be satisfied
  - ▶ Purge all C corporation earnings and profits
  - ▶ Resulting taxable income to shareholders
  - ▶ May be tax free to electing corporation, but assets subject to built-in gains tax of §1374 (10-year tax window)
  - ▶ Typically involves creation of UPREIT structure
  - ▶ Typically involves pre-election restructuring
    - ▶ Taxable REIT Subsidiary (TRS) planning and use

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# Non-traditional REITs . . .

## Why convert to REIT status?

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- ▶ Self-help tax integration . . .
- ▶ Minimize corporate level tax via dividends paid deduction
- ▶ REIT yield is attractive investment in low-yield environment
  - ▶ Many REITs trade at premiums to NAV
  - ▶ REITs generally trade at higher earnings multiples than taxable corporations
- ▶ Electing companies generally have experienced share price appreciation
- ▶ Converting to REIT status arguably provides greater/easier access to capital

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# Non-traditional REITs . . .

## But its not all about taxes

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- ▶ This is a fundamental business decision
- ▶ Can this business thrive in a different tax wrapper?
- ▶ Business, financial, and legal considerations
- ▶ Typically, there is substantial pre-election business entity restructuring and the formation of TRS entities
- ▶ Several real estate-intensive businesses are currently evaluating the pros and cons of converting to REIT status, in some cases as a result of demands by activist investors

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# Non-traditional REITs . . .

## When is the time right to convert to a REIT?

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- ▶ Has the company's tax costs become burdensome?
- ▶ Does the REIT format provide easier/better access to capital?
- ▶ Is there a better valuation proposition in becoming a REIT?
- ▶ Role of an advance ruling from the IRS



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# Questions?

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