Getting Your Hands Dirty with Real Estate Investors

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2017 Tax Act Changes Affecting Real Estate

- Up to a 20% deduction for pass-throughs until 2026
- Permanent reduction of corporate tax rate from 35% to 21%
- Changes to depreciation
- Exception to 30% of AGI limitation on interest deduction
- 3-year holding period for carried interests
- 1031 Exchanges - only for real property
- $10,000 limitation on SALT deductions, including property taxes
- Changes to mortgage interest deductions and home equity loans
Scenario 1 – Individual Ownership Issues

• Dr. Richard Webber, a surgeon at Grace Hospital, and his wife Adele are new clients.
• Richard owns the primary residence in his own name, as he purchased it before he and Adele married and never retitled the property.
• Richard and his two brothers inherited a vacation residence in another state when their mother passed away intestate.
• Richard is the only brother of the three who is independently wealthy. His brothers struggle to get by, so Richard pays the mortgage, property taxes, and all maintenance and repairs for the vacation residence, while the three brothers use it about equally, and rents are shared equally.
• Richard dislikes the wife of one of his brothers and worries he will become a co-owner of the property with her if his brother dies.
Scenario 1 - Questions

• How should the primary residence be titled?
• How is the vacation residence likely titled?
• Can Richard deduct all of the expenses he pays for the vacation residence?
• Should the vacation residence be transferred to an entity?

2017 Tax Act Scenario Update: Richard buys the vacation residence from his two brothers. Is there a way he can deduct the property taxes he pays on the property even though his own state income and property taxes exceed $10,000?
Scenario 2 – Review of Deal Terms

• Carrington James Chandler, III (Trey) is a well-connected, wealthy 20-something who has decided to use his connections to develop an industrial-zoned raw parcel of land he has been given by his grandfather.
• The mother of one of Trey’s boarding school friends is an executive at Dropbox and she is looking for a new site in Trey’s state to build a server storage facility. She and Trey have begun negotiations for his site.
• Some of Trey’s B-School friends have started a private equity fund and have tentatively agreed to put up capital to allow Trey to build the facility on the site.
• Trey wants your help structuring a deal with the private equity fund.
Scenario 2 – Review of Deal Terms

• What are the roles and responsibilities of the equity investor versus the developer?
• I keep hearing about “mezz loans” and mezzanine financing. What is it and how does it differ from an “A&D loan”, a construction loan or a “take out loan”?
• What’s the difference between a preferred return and a promote?
• Can I be paid a fee for my work in addition to my equity interest?
• What is my exposure to risk and liability, and -- I’ve always wanted to know -- what’s a “bad boy” carve-out?
Scenario 3 – Dealer versus Investor

• You represent a local bank trust company, which serves as trustee of the trust for the son of a local real estate developer.

• Several years ago, at the recommendation of the grantor of the trust, the trustee purchased a small tenant-in-common interest in a large parcel of raw, undeveloped land.

• Unbeknownst to the Trustee, the grantor of the trust has been working to subdivide the land, obtain building permits and market it to potential investors.

• The bank board has decided it will no longer permit its trusts to own real estate, so the bank has agreed to sell the property to a colleague of the grantor. Can the trust claim capital gains on the sale?
Scenario 4 – Deductibility of Losses

• Dimitri and Maria Spiros are new clients who came to the US from Greece many decades ago and purchased an apartment complex in their community.
• The value of the land (and thus the property taxes) has increased dramatically, but rent controls have kept rental receipts down, and now the property operates at a loss.
• The couple mortgaged the property to buy a new apartment complex with higher rents and have been using the losses to offset the rental income from the new apartment complex.
• Dimitri brags to you about what a great cash cow the new place is – and he doesn’t even have to lift a finger! He hires a management company to run the buildings.
Scenario 5 – 1031 Exchange

• Your clients, Morris and Deb Brown, decided to buy a few residential rental properties to provide an income stream in their retirement. Over the course of a few years, they purchased townhouses on Elm Street, Main Street and Broad Avenue. You counseled Morris and Deb to purchase each property in an LLC that was owned 50/50 by each of them, and so they now have Elm Street LLC, Main Street LLC and Broad Ave LLC.

• Several years later, Morris and Deb want to sell these properties and buy one parcel of commercial real estate in a Carolina beach town that will enter into a long term ground lease with a “Wings Beachwear” store. The Browns want to use a 1031 exchange to defer income tax.

• Morris wants the new property to be owned by a new LLC that will collect the rents.

• What issues might arise with respect to the 1031 treatment?
Scenario 6 – Gift of Promote

• A developer, Bob Sponsor, already has a few successful real estate development projects under his belt and cash in the bank. He is entering into a new project and will contribute to “New Project LLC” land worth $5 million and cash of $5 million for a 10% Class A membership interest.

• His equity investor partner will contribute $90 million in cash for an 90% Class A membership interest.

• Bob will also receive a Class B interest with no invested capital.

• Both the Class A and B interests will be non-managing members, and a Management LLC owned wholly by Bob will be the manager of the LLC.

• All net cash flow and profits will be allocated to the Class A members up to the first $110 million received (a 10% IRR). Next, net cash flow and profits will be allocated 25% to the Class B interest and 75% to the Class A interest until the Class A interest has received $120 million (a 20% IRR). After that point, net cash flow and profits will be allocated 40% to the Class B member and 60% to the Class A members.
Scenario 6 – Gift of Promote

• Bob wants to make a gift of a portion of his Class B membership interest to a dynasty trust for his descendants, since the Class B interest (the promote interest) presumably has no value and the greatest potential for upside.

• What risks are inherent in this idea?
Scenario 7 – Selection of Trustees

• Brett King (fictional version of Brett Kingstone of Max King Realty in Orlando) has been a long-time client. You scored a major victory when King Realty Inc. was created by having a non-grantor, dynasty trust for the benefit of Brett’s descendants make an initial investment in the company.

• Since then, King Realty (an S corporation) has grown to become one of the biggest commercial real estate developers in Orlando.

• The Trustees of the Trust are (1) Brett’s wife, Maria, who is Director of Marketing for King Realty, and (2) Brett’s best friend, John, who is a creative director at the Walt Disney Company.
Scenario 7 – Selection of Trustees

• The SLAT is getting hit hard by the net investment income tax (NIIT). Is there any way to avoid it by converting the trust’s passive income into active income?

• Potential candidates for additional trustees include:
  1. Brett’s business partner, Robert, who was an initial investor in King Realty and who serves as the corporation’s General Counsel. Robert has a minority ownership interest in King Realty.
  2. Maria’s brother, Nico, who was also an initial investor in King Realty and owns a minority interest, but does not work for the corporation. Nico is a director of new development for Pulte Homes, one of the country’s leading residential real estate developers.
  3. Brett’s sister, Beatrice King, who has no ownership interest in King Realty but who owns her own boutique hotel development company, buying real estate and developing the hotels, and then partnering with a management company that operates the hotels.
Scenario 8 – Principal and Income

- Wife transferred the couple’s primary residence to an inter vivos QTIP trust for husband, in order to provide husband with assets to utilize his GST tax exemption upon his death.

- Wife also transferred a vertical slice of her equity and promote interests in a real estate LLC, which made no distributions in the current year but which did have K-1 income.

- Corporate Trustee serves as Trustee of the trust and charges $5,000 a year in trustee fees, which under the state Principal & Income Act are allocated half to income and half to principal.

- What trust accounting issues will Corporate Trustee face?
Scenario 9 – 754 Election

• Han Solo died leaving Leia, his surviving spouse, a QTIP Trust that included a 7% interest in Alderaan Apartments LLC.

• Leia remarries Joe Organa and settles in California.

• Upon Leia’s death, her estate passes to her son, Kylo, who is also her executor and the trustee of the QTIP Trust.

• Kylo learns that the manager of Alderaan Apartments is negotiating a sale of the apartment building to a third party for $5M.

• The QTIP’s inside basis in the LLC is $50,000.

• The FMV of Leia’s interest in the LLC is $350,000, reduced by a 40% discount to $210,000.
Scenario 9 – Questions

• Can Alderaan Apartments LLC make the 754 Election at Leia’s death?
• If not, can Kylo make the 754 Election?
• If Leia owned an interest in Alderaan Apartments LLC in her own name, what would be the impact on her surviving spouse, Joe Organa?
• Should Alderaan Apartments LLC make the 754 Election?
Scenario 10 – Your Questions