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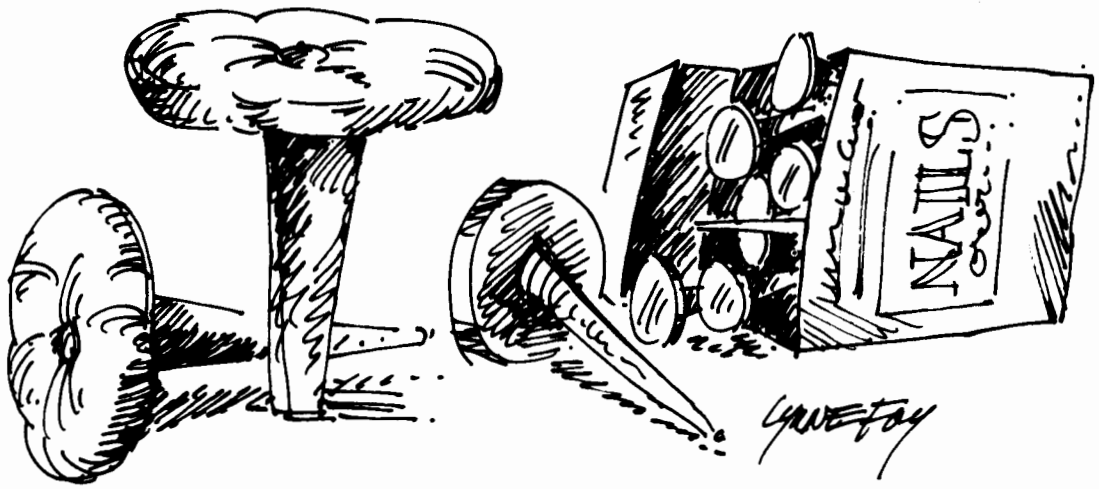
"Soft" equity and careful structure increase write-off ratios.

Structuring Real Property Acquisitions for Syndication

Paul Zane Pilzer



AMONG THE PRIMARY objectives of purchasing real estate for syndication to investors who have outside taxable income are maximization of the investors' tax losses and minimization of their after-tax cash investment. Ideally, in a given year of investment a syndicate investor's income tax savings from the investment should equal or exceed his cash equity investment in that year. In that ideal case, the investor is "using the government's money" to invest in real estate. This article examines several techniques used to approach this ideal when purchasing real property for syndication.

A STANDARD EQUITY PURCHASE: EXAMPLE 1

Assume that a property is available for purchase on the following terms:

Purchase price: $10 million
Assumable first mortgage: $7 million (10 yrs.)
Debt service: $840,000 per annum (12% interest only)
Cash down payment: $3 million
Expected NOI: $900,000 in Yrs. 1-5, $1.4 million in Yrs. 6-10
Seller: Tax-insensitive financial institution

Exhibit 1 is a ten-year analysis of cash flows and returns from the investor's standpoint. As shown in lines 11 and 8, the investor would receive during Years 1 to 5 an 11 percent ($330,000) per annum after-tax

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EXHIBIT 1

ANALYSIS OF A STANDARD EQUITY PURCHASE
($ in 000)

Investment Assumption: $3 million cash equity

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*
1. Net operating income	$ 900	$ 900	$ 900	$ 900	$ 900	$1,400	$1,400	$1,400	$1,400	$1,400
2. First mortgage interest	840	840	840	840	840	840	840	840	840	840
3. Property cash flow	60	60	60	60	60	560	560	560	560	560
4. Before-tax cash flow	60	60	60	60	60	560	560	560	560	560
5. Depreciation	600	600	600	600	600	600	600	600	600	600
6. Taxable income (line 4 minus line 5)	(540)	(540)	(540)	(540)	(540)	(40)	(40)	(40)	(40)	(40)
7. Tax benefit (50% of line 6)	270	270	270	270	270	20	20	20	20	20
8. After-tax cash flow (line 3 plus line 7)	330	330	330	330	330	580	580	580	580	580
9. Equity investment	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000
10. Before-tax return	2.00%	2.00%	2.00%	2.00%	2.00%	18.67%	18.67%	18.67%	18.67%	18.67%
11. After-tax return	11.00%	11.00%	11.00%	11.00%	11.00%	19.33%	19.33%	19.33%	19.33%	19.33%

Investor Residual Calculation

Property sale price (Year 10)[a]	$15,556
First mortgage principal	$ 7,000
Pretax sales proceeds	$ 8,556
(Less) Capital gains taxes	
20% × Capital appreciation	$ 1,111
20% × Depreciation recapture	$ 1,200
After-tax sales proceeds	$ 6,244

Investor net cash	($3,000)	$ 330	$ 330	$ 330	$ 330	$ 330	$ 580	$ 580	$ 580	$ 580	$6,824
Investor IRR	18.10%										
Net present value @ 12%	$1,238										

[a] Year 10 income capitalized at 9 percent.

return, composed of 2 percent ($60,000) cash flow component (lines 10 and 4) and a 9 percent ($270,000) tax benefit component (line 7).

The problem with this structure is that it requires the tax-sensitive investor to make a large ($3 million) investment of after-tax cash.

A DEFERRED EQUITY PURCHASE: EXAMPLE 2

We now assume that the investor is able to borrow the $3 million cash equity requirement on terms that require him to repay the loan over five years at 12 percent interest, self-amortizing, payable at $743,062 per annum for a total of $3,715,309. Typically, the investor is required to secure his deferred payments with some outside collateral if he borrows the equity requirement from a third-party lender. The investor's cash flows and returns are analyzed in Exhibit 2.

As shown in line 10 of Exhibit 2, the tax-sensitive investor's initial after-tax cash outlay is considerably reduced. The investor pays $743,062 at the beginning of the first year but receives back a 68.63 percent ($510,000) after-tax return (line 9) composed of an 8.07 percent ($60,000) cash component (lines 11 and 3) and a 60.56 percent ($450,000) tax benefit component (line 8). The $180,000 increase in the tax benefit component arises because $360,000 of the investor's $743,062 first-year investment is tax-deductible interest on his deferred contribution. Thus the investor's cost of borrowing his equity requirement is actually only 6 percent after-tax (50 percent of 12 percent interest rate). The investor's internal rate of return over the ten-year life of the investment rises from 18.10 percent in Exhibit 1 to 24.35 percent in Exhibit 2, because the investor is borrowing 6 percent dollars to invest in an investment in which the unleveraged equity internal rate of return is in excess of 18 percent.

A common method of evaluating this type of deferred pay-in plan is to look at the investor's annual "write-off ratio." In the first year, this is the investor's $900,000 tax deduction (line 7) divided by the investor's net $683,082 cash outlay ($743,062 investment minus $60,000 cash flow), or 1.32-to-1. The ratio indicates that in Year 1 the investor can deduct $1.32 from his taxable income for every $1 he invests. The ratio is misleading if the investor is required to provide collateral other than the real estate investment itself to secure his future payments, because in such a case his total investment (cash *plus* credit) has not been considered in calculating his write-off ratio.

EXHIBIT 2

ANALYSIS OF AN EQUITY PURCHASE FOR WHICH THE INVESTOR IS ABLE TO BORROW THE REQUIRED EQUITY

Investment Assumption: $3 million paid over five years @ 12% interest investment ($743,062 per annum in advance).

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*
1. Net operating income	$ 900	$ 900	$ 900	$ 900	$ 900	$1,400	$1,400	$1,400	$1,400	$1,400
2. First mortgage interest	840	840	840	840	840	840	840	840	840	840
3. Property cash flow	60	60	60	60	60	560	560	560	560	560
4. Interest on equity loan	360	314	263	205	140					
5. Before-tax cash flow	(300)	(254)	(203)	(145)	(80)	560	560	560	560	560
6. Depreciation	600	600	600	600	600	600	600	600	600	600
7. Taxable income (line 5 minus line 6)	(900)	(854)	(803)	(745)	(680)	(40)	(40)	(40)	(40)	(40)
8. Tax benefit (50% of line 7)	450	427	401	372	340	20	20	20	20	20
9. After-tax cash flow (line 3 plus line 8)	510	487	461	432	400	580	580	580	580	580
10. Equity investment	$ 743	$1,486	$2,229	$2,972	$3,715	$3,715	$3,715	$3,715	$3,715	$3,715
11. Before-tax return	8.07%	4.04%	2.69%	2.02%	1.61%	15.07%	15.07%	15.07%	15.07%	15.07%
12. After-tax return	68.63%	32.77%	20.69%	14.55%	10.77%	15.61%	15.61%	15.61%	15.61%	15.61%
Investor write-off ratio	1.32	1.25	1.17	1.09	1.00					
Investor net cash ($ 743)	($ 233)	($ 256)	($ 282)	($ 311)	$ 400	$ 580	$ 580	$ 580	$ 580	$6,824
Investor IRR 24.35%										
Net present value @ 12% $1,670										

Investor residual calculation: Identical to that in Exhibit 1.

EXHIBIT 3
ANALYSIS OF PURCHASE WHEN THE INVESTOR PAYS $1 MILLION IN HARD EQUITY AND $2 MILLION SOFT

Cash Pay-In Assumptions:

$1 million equity paid over five years @ 12% interest = ($247,687 per annum in advance)
$2 million interest (line 4) and fees (line 6) paid over five years = ($495,375 per annum in advance)
Total paid in = ($743,062 per annum in advance)

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*
1. Net operating income	$ 900	$ 900	$ 900	$ 900	$ 900	$1,400	$1,400	$1,400	$1,400	$1,400
2. First mortgage interest	840	840	840	840	840	840	840	840	840	840
3. Property cash flow	60	60	60	60	60	560	560	560	560	560
4. Wrap mortgage interest	420	420	420	420	420					
5. Defined contribution interest	120	105	88	68	47					
6. Deduct. fees to seller	75	75	75	75	75					
7. Before-tax cash flow	(555)	(540)	(523)	(504)	(482)	560	560	560	560	560
8. Depreciation	480	480	480	480	480	480	480	480	480	480
9. Taxable income (line 3 minus line 4)	(1,035)	(1,020)	(1,003)	(984)	(962)	80	80	80	80	80
10. Tax benefit (50% of line 9)	518	510	501	492	481	(40)	(40)	(40)	(40)	(40)
11. After-tax cash flow (lines 3 plus 10)	578	570	561	552	541	520	520	520	520	520
12. Equity investment	$ 743	$1,486	$2,229	$2,972	$3,715	$3,715	$3,715	$3,715	$3,715	$3,715
13. Before-tax return	8.07%	4.04%	2.69%	2.02%	1.61%	15.07%	15.07%	15.07%	15.07%	15.07%
14. After-tax return	77.74%	38.36%	25.19%	18.57%	14.56%	14.00%	14.00%	14.00%	14.00%	14.00%

Investor Residual Calculation

Property sale price (year 10)	$15,556
First mortgage principal	$ 7,000
Pretax sales proceeds	$ 8,556
(Less) Capital gains taxes	
20% × Capital appreciation	$ 1,511
20% × Depreciation recapture	$ 960
After-tax sales proceeds	$ 6,084

Investor write-off ratio		1.52	1.49	1.47	1.44	1.41				
Investor net cash	($ 743)	($ 165)	($ 173)	($ 182)	($ 191)	$ 541	$ 520	$ 520	$ 520	$ 520	$6,604
Investor IRR	26.78%									
Net present value @ 12%	$1,831									

PARTIAL SOFT EQUITY PURCHASE: EXAMPLE 3

The equity that was required in the two cases that we have discussed is often called "hard" equity. The word "hard" refers to the fact that the tax-sensitive investor made his investment with expensive pretax dollars. Hard equity is not tax deductible for the investor and is considered part of the investor's basis in the property when he calculates depreciation and capital gain upon sale. Hard equity paid to the seller is considered part of the seller's sale price and is taxed to the seller at capital gains rates.

It is possible for equity to be "soft" equity. That is, an investor can make an investment with less expensive after-tax dollars. Soft equity typically consists of tax-deductible interest or fees that the investor pays to the seller in lieu of paying hard equity as the purchase price. The soft equity dollars that the investor pays are tax deductible to him when he pays them. Ultimately, at the time of sale they will not be considered part of the investor's basis in the property for the purpose of calculating depreciation or capital gain. Because they are not included in the investor's basis, the soft equity dollars that the investor deducts at the time of purchase will be recaptured as capital gain dollars at the time of sale. The soft equity that the seller receives is taxed to him as ordinary income, and it is not considered part of the seller's sale price when he calculates his capital gain upon sale.

In Exhibit 3, we return to our example property to examine the structure of a third sale. The seller lowered the purchase price from $10 million to $8 million. He then "wrapped" the existing $7 million, 12 percent interest first mortgage in a $7 million, five-year, 18 percent wraparound mortgage. The terms of the agreement also require the investor to pay the seller for five years various tax deductible advisory and/or management fees.

The changes have been designed so that the investor still invests $743,062 per annum for five years, just as he did in the previous structuring. However, the purchase price has been changed, so instead of paying in $3 million of hard equity over five years, the investor pays $1 million hard and $2 million soft. The $743,062 per annum has thus been restructured. Originally, it represented amortization and interest on $3 million. Now it consists of the following components:

- Amortization and interest (at 12 percent) of $1 million in hard equity. (This amounts to $247,687 per annum for five years.)
- The difference between 18 percent interest on the seller's wrap mortgage and the original 12 percent interest on the underlying first mortgage. (This equals $420,000 per annum for five years.)
- Various tax-deductible fees that the investor pays to the seller for services. (These total $75,000 per annum for five years.)

These three components amount to the same $743,062 cash investment per annum for five years that the investor was required to pay in the preceding structure.

When $2 million of the investor's cash investment is restructured from hard to soft equity, the investor's basis is reduced by $2 million, and the investor's annual depreciation deduction falls $120,000 from $600,000 per annum to $480,000 per annum (fifteen-year ACRS straight-line depreciation assuming 10 percent land valuation). The $2 million reduction in basis also causes the investor to have a $2 million increase in his capital gain upon sale, although the effect of this increase is partially offset by having $1.2 million less in depreciation to recapture ($120,000 per annum for ten years). (Also, as we have previously indicated, the seller initially reports $2 million less in gain upon sale, but in subsequent years he receives the $2 million as cash and additional earnings that he reports as income.)

As Exhibit 3 shows, the conversion of part of the $3 million hard equity to soft equity causes the investor's average write-off ratio for the first five years to rise from 1.17-to-1 in Example 2 to 1.47-to-1 in this example. It raises the investor's first-year, after-tax return from 68.63 percent to 77.74 percent (line 14), consisting of a 69.72 percent ($518,000) tax benefit component (line 10) and the same 8.07 percent ($60,000) cash component (line 3). The 1.47-to-1 write-off ratio means that the investor receives in a given year a $1.47 average income tax deduction (which is worth $0.74 in tax savings to the 50 percent tax bracket investor) for every $1 he invests. The ideal situation would be to achieve a 2-to-1 or greater write-off ratio where the investor receives in a given year a $2 or greater income tax deduction for every $1 he invests.

FULL SOFT EQUITY PURCHASE: EXAMPLE 4

In order to achieve the ideal ratio, the investor must pay all of his equity investment as soft dollars and have a dollar of additional noncash deduction (e.g., depreciation) for at least each soft dollar he invests. If the investor in Example 3 could restructure the transaction so that all of his $3 million equity investment were soft, this investment would still not provide enough noncash deductions to achieve the desired 2-to-1 ratio, and the investor's basis for depreciation would be reduced even further to $7 million. Additionally, such a structure would require the seller to report a property sale price of only $7 million, and that might result in a paper loss for the seller.

EXHIBIT 4

ANALYSIS OF A SOFT EQUITY PURCHASE STRUCTURED TO YIELD A 2-TO-1 WRITE-OFF

Structure:

Institution purchases property for $3 million cash equity investment (above $7 million first mortgage)
Institution sells property to investor for $10 million
Institution takes back $10 million wrap mortgage @ 15.83%
Interest current + 2.0% Accrued Simple

Investor's Soft Investment:

$3 million interest (line 4) paid over five years
$3 million total paid to institution by investor

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*
1. Net operating income	$ 900	$ 900	$ 900	$ 900	$ 900	$1,400	$1,400	$1,400	$1,400	$1,400
2. First mortgage interest	840	840	840	840	840	840	840	840	840	840
3. Property cash flow	60	60	60	60	60	560	560	560	560	560
4. Wrap mortgage interest	743	743	743	743	743					
5. Before-tax cash flow	(683)	(683)	(683)	(683)	(683)	560	560	560	560	560
6. Depreciation	600	600	600	600	600	600	600	600	600	600
7. Wrap mortgage accrued interest	200	200	200	200	200					
8. Taxable income (line 5 minus line 6 minus line 7)	(1,483)	(1,483)	(1,483)	(1,483)	(1,483)	(40)	(40)	(40)	(40)	(40)
9. Tax benefit (50% of line 8)	742	742	742	742	742	20	20	20	20	20
10. After-tax cash flow (line 3 plus line 9)	802	802	802	802	802	580	580	580	580	580
11. Equity investment	$ 743	$1,486	$2,229	$2,972	$3,715	$3,715	$3,715	$3,715	$3,715	$3,715
12. Before-tax return	8.07%	4.04%	2.69%	2.02%	1.61%	15.07%	15.07%	15.07%	15.07%	15.07%
13. After-tax return	107.87%	53.93%	35.96%	26.97%	21.57%	15.61%	15.61%	15.61%	15.61%	15.61%

Investor Residual Calculation

Property sale price (year 10)	$15,556
First mortgage principal	$10,000
Wrap mortgage accrued interest	($1,000)
Pretax sales proceeds	($ 4,556)
(Less) Capital gains taxes	
20% Capital appreciation	($ 1,111)
20% Depreciation	($ 1,200)
After-tax sales proceeds	$ 2,244

Investor write-off ratio		2.17	2.17	2.17	2.17	2.17				
Investor net cash	($ 743)	$ 58	$ 58	$ 58	$ 58	$ 802	$ 580	$ 580	$ 580	$ 580	$2,824
Investor IRR	33.57%									
Net present value @ 12%	$1,606									

But we can structure a deal with an ideal ratio and one that gives the seller the asking terms that he received in Example 1, the standard equity purchase. Assume that the investor puts the property under contract and requests a third-party lender to loan him $3 million on the following basis:

- The lender assumes the investor's purchase contract and purchases the property for $3 million cash above the $7 million first mortgage.
- The lender then sells the property to the investor for $10 million.
- The lender gives the investor a $10 million wrap-around mortgage at 15.83 percent interest only paid currently and 2 percent interest accrued simple. The 15.83 percent that must be paid currently for five years is $743,062/annum greater than the $840,000 debt service on the $7 million first mortgage. When the investor pays the lender the same $743,062/annum for five years that he paid in previous illustrations, this amount is now entirely the payment of wrap mortgage current interest.
- The interest rate of the wrap mortgage drops to that of the underlying first mortgage ($840,000) after five years.

The results of this structure are shown in Exhibit 4.

From a "cash at risk" standpoint the lender is in the same position as it was in the previous structures. It loans the investor $3 million cash and receives back the same $743,062 per annum for five years. However, the lender now also receives a $3 million asset in the form of the $10 million mortgage wrapped around the underlying $7 million first mortgage plus an additional $1 million in accrued interest earnings (2 percent per annum on $10 million for five years). This additional $4

million combination of assets and earnings provides a great incentive for the lender to make the $3 million loan to the investor. It would be reasonable for the investor to request that the lender defer payment of this $4 million for fifteen to twenty-five years by agreeing to make its lien assumable and to resubordinate to a new first mortgage in Year 10. However, in Exhibit 4, we shall assume that the investor pays off the full additional $4 million to the lender in Year 10.

Exhibit 4 shows that the investor's equity can be converted from hard to soft, while the investor's depreciable basis in the property is maintained at $10 million. Furthermore, the additional noncash deduction for the 2 percent ($200,000/annum) accrued interest, causes the investor's first, five-year average write-off ratio to rise to 2.17-to-1. Thus the investor has a first-year, after-tax return of 107.87 percent (lines 10 and 13) consisting of a 99.80 percent ($741,576) tax benefit component (line 9) and the same 8.07 percent ($60,000) (lines 12 and 3) cash component. The 2.17-to-1 write-off ratio means that the investor receives in a given year a $2.17 income tax deduction (which is worth $1.08 to the 50 percent tax bracket investor) for every net $1 (investment minus cash flow) he invests. Thus the investor actually receives back more money each year in income tax savings (and cash flow) than he invests.

CONCLUSION

The four structures demonstrate some of the techniques used by syndicators and others in structuring real property acquisitions for tax-sensitive investors. Additionally, the fourth example demonstrates the synergistic relationship that can exist between a syndicator/tax-sensitive investor and a sophisticated financial institution.

This article has deliberately avoided many complex tax, accounting, and financial reporting issues that would arise in structuring any of these transactions. There is no such thing as a totally tax-sensitive seller of real estate. A seller or wrap lender in any of these transactions should be as much concerned with how its auditors would record the transaction as it is with actual cash returns. Furthermore, there is always the risk to the investor that the quality of his tax deductions might be challenged because of such factors as whether he is the true (economic) owner of the property or whether the property's outstanding debt exceeds its fair market value.

However, most of the tax, accounting, and financial reporting problems can be solved if they are approached with a "this-is-the-best-way-to-solve-this-problem" attitude rather than a "this-is-why-the-deal-can't-work" attitude.

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