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Repositioning Real Estate Ownership in a Down Market

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Whether in a boom or bust market, businesspeople will constantly develop strategies and transactions by which they can take advantage of both the tax laws and business opportunities. Today's depressed real estate market is no different. One interesting transaction that has been employed in the past year involves a joint venture between a homebuilder (or other real estate developer) and an equity partner. Typically, such a joint venture would be operated through a newly formed limited liability company.

The equity partner contributes cash to the venture and takes a majority equity interest along with a 50 percent voting interest in the LLC. The homebuilder generally makes a co-invest capital contribution to the LLC. If the homebuilder is short on cash, it may contribute other property, including real estate. In exchange for the capital contribution, the homebuilder takes back a small equity interest, a 50 percent voting interest, the right to certain annual management fees and possibly the right to an increase in its profit-sharing percentage if certain financial targets are met.

Following the homebuilder's and equity partner's contributions, the LLC purchases depreciated real estate from the homebuilder. To sweeten the deal for the homebuilder, it may also receive certain limited repurchase options and/or rights of first refusal with respect to the property owned by the LLC.

By engaging in this transaction, our homebuilder has exploited a number of beneficial tax and business opportunities.

Tax Benefits

The primary tax benefit to the homebuilder is the ability to deduct losses realized on the depreciated real estate sold to the LLC. However, the homebuilder cannot deduct losses attributable to any property contributed to the LLC. If the homebuilder has taxable income for the present year, the homebuilder can shelter its current income with the loss realized on the sale portion of the transaction.

In some cases, the tax loss could generate a tax refund. To the extent the loss exceeds the homebuilder's taxable income (i.e., the transaction generates a net operating loss), it can carry back the loss and deduct it against any taxable income earned over the previous two tax years. If the homebuilder reported taxable net income during either of the two preceding tax years, carrying back the loss could entitle the homebuilder to a refund of some or all of the taxes paid in such years. Additionally, there has recently been talk in Congress of extending the two-year carry back period to a five-year period. If Congress were to extend the carry back period to five years, many taxpayers would likely enjoy an increase in the likelihood and/or amount of a tax refund.

The tax loss may also be used to shelter the homebuilder's future income. If a net operating loss is not fully used to offset net income for the previous two years, the homebuilder may deduct any unused portion of the net operating loss from its income in any of the following 20 tax years.

Because our homebuilder is in the business of developing and selling real estate, this tax discussion presumes the loss is an ordinary loss. If the loss generated from the sale is a capital loss for tax purposes that exceeds the homebuilder's capital gains, if any, for the year of sale, different carry-back and carry-forward periods would apply to the net capital loss.

Tax Risks

Of course, this strategy is not risk-free from a tax perspective. In order to book a tax loss, the homebuilder must navigate a series of potential tax pitfalls. For example, a number of Internal Revenue Code provisions bar taxpayers from realizing losses on sales to certain related parties or entities (including any LLC in which a seller has direct, indirect or constructive ownership of more than 50 percent of LLC capital or profits). Hence the small equity interest the homebuilder receives in our example.

Additionally, our homebuilder must navigate case law and Treasury regulations which sometimes recharacterize sale transactions as either leases, loans, other types of financing transactions or a contribution to a tax partnership. If our homebuilder fails to successfully characterize the transaction as a taxable sale, it would be unable to deduct the loss on the sale of the property to the LLC. The result of failing to properly structure the transaction to comply with relevant authorities could subject the homebuilder to significant penalties.

Opportunities in Real Estate

The transaction allows the homebuilder to maintain a significant amount of control over the transferred property. If at some point in the future economic conditions are such that development of the transferred property is once again advantageous, the transferred property can be developed through the LLC - in which case the homebuilder may be entitled to an increased share of profits if the development project is a success. Or, the homebuilder may exercise its option to repurchase a portion of the property pursuant to previously negotiated option terms. In any event, our homebuilder can prevent competitors from acquiring and developing the property it transferred to the LLC.

With the cash generated by the sale plus any potential tax refund, our homebuilder can make whatever other investments it desires, including purchasing distressed properties. At first glance it may appear that by purchasing additional real estate the homebuilder would simply be swapping one depreciated property for another. However, keep in mind that the sale could potentially generate a net operating loss, which, in turn, could generate a tax refund. If the homebuilder happens to be lucky enough to receive a refund, it could be used to fully or partially fund the purchase of additional properties.

Using the proceeds of the sale to acquire additional real estate will expand the total acres of real estate under the homebuilder's control. In addition to any newly purchased properties, the homebuilder retains an indirect ownership interest in the property through the LLC as well as a considerable degree of control over any disposition of the property. Therefore, the homebuilder should be in a stronger position to pursue development opportunities following a rebound in the real estate market.

Expansion of Business Line

On the other hand, our homebuilder may desire to expand its business to areas outside of the real estate industry in order to ride out the weak real estate market. If so, it may use the cash generated by the sale to invest in new businesses. Again, any such investment could be fully or partially funded with a tax refund, or future income from the business may be sheltered by any net operating loss carry forward. If the expansion is partially funded by a tax refund or if the new business' future income is sheltered by a net operating loss carry forward, the net effect is a higher after-tax return on investment for the homebuilder.

This type of joint-venture strategy is only one creation of businesspeople and their tax advisers. There are various possible permutations of this transaction that real estate professionals and their advisors may exploit in the near future. Depending on individual circumstances, real estate developers may try creating investment funds which can be used in place of an equity partner, or possibly the LLC itself could be an investment fund. In any event, expanding this transaction to various differing fact patterns seems likely so long as the real estate market remains in turmoil. Before the dust settles with respect to the current economic downturn, additional creative strategies will be employed.

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