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Overleveraged Real Estate: Understanding the Tax and Structural Issues that Arise in a Recapitalization

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ABOUT THIS WHITE PAPER:

Real estate companies seeking new financing on a loan have traditionally managed their outstanding debt by receiving funding from three commonly used options. Recently, a fourth option has emerged: working with a third party equity provider for tax free recapitalization of the borrower entity. This article explores the specific ways this option works, including the structure, voting rights, tax considerations and other issues to consider.

ABC Real Estate Company formed "Newco" in 2007 to acquire a retail property for $24 million. Newco funded the purchase with $19.2 million in nonrecourse debt, which matures in 2014. It raised the remaining $4.8 million from accredited investors who were admitted as members of Newco. When the company decides to get new financing to replace its existing debt, Newco is advised that the property's current value is $21 million. This means the maximum amount of nonrecourse financing now available only is $14.7 million. Many real estate companies and investors that used nonrecourse debt to acquire properties from 2005 to 2007 are facing difficult decisions as their loans mature. However, they have several alternative courses of action.

In some cases, the current owners will provide the cash for the refinancing from their own funds. Others will seek to borrow the money through a mezzanine loan. A third alternative is to sell the property before the loan matures and use the proceeds to repay the loan. Over the past few months, we have seen an emerging trend to adopt a fourth option: working with a third party equity provider for the tax-free recapitalization of the borrower entity.

Overview of the Third-Party Recapitalization Structure

In general, the structure for a transaction in which a third party equity provides funds under this tax-free recapitalization structure follows this pattern:

1. The current owners of the existing borrower ("Oldco") have the property dropped into a newly created limited liability company, which will become the borrower under the new loan ("Newco").
2. Newco issues Common Units to Oldco in exchange for contributing the property. This will occur at the same time the existing loan is repaid.
3. The additional funds needed to fill the gap between what is owed to the lender, the amount provided by the new loan, and any additional funds needed to reposition the property, are provided by the unrelated real estate fund (the "New Investors"). Money from the New Investors is treated as a contribution to Newco in exchange for preferred membership interests.

4. In many cases, the managing member of Oldco will remain the managing member of Newco.

Distribution and Voting Rights

In general, the managing member of Newco will continue to have the sole authority for the property's day-to-day management and operation. However, in a typical recapitalization structure, this authority will be subject to certain consent rights for matters involving a "major decision." These situations will require the advance written consent of the New Investors before the managing member can act.

What constitutes a major decision varies from deal to deal. Typically, these decisions will include 1) selling or refinancing, 2) making capital improvements or expenditures not in the approved budget, 3) making distributions to the members, and 4) entering into any agreement with affiliates of the managing member. In some cases, the list will be more expansive. It may cover the New Investors wanting the right to cause Newco to make a capital call to its members (i.e., Oldco and the New Investors).

In addition, the distribution waterfall requested by the New Investors also can vary. However, in each case, the distribution structure will take on the following structure. First, distributions will be made to the New Investors, to provide them with a stated per annum preferred return on their contributed capital. Next, distributions will be made to the New Investors to return their contributed capital. After the New Investors have been paid the accrued preferred return and a return of their contributed capital, distributions will be made to Oldco, in an amount equal to the net value of the property at the time it was contributed to Newco (this will be a negotiated amount in most cases). Further distributions then are made in accordance with each member's "percentage interest."

The New Investors typically will structure distribution provisions to provide them with their target internal rate of return (IRR), which generally ranges from 16% to 22%. In some cases, the structure for distributions from operations (i.e., net rental income) will differ from the distribution structure for capital event proceeds. Specifically, the New Investors may request a distribution structure from operations be made to them until this reaches their IRR. In other cases, the distribution structure from operations may simply provide for a priority distribution to the New Investors for the preferred return, and then to the New Investors and Oldco in accordance with their percentage interests.

Tax Considerations

If properly structured, the dropdown of the property to Newco, and the issuance of Common Units to Oldco and Preferred Units to the New Investors, will not create any current income tax liability. Depending upon whether the owners of Oldco have previously distributed proceeds from a prior refinancing, collateral agreements may be needed to avoid a "decrease in a partner's share of partnership liabilities" for tax purposes.

In addition, the New Investors will likely request special allocations under the provisions of Section 704(c) of the Internal Revenue Code. This will allow the New Investors to receive the same depreciation deductions as they would if they had purchased a pro rata share of the property. These special allocations can cause a corresponding increase to the amount of taxable income allocated to the members of Oldco. As a result, tax issues should be addressed as part of negotiating the LLC agreement for Newco.

Another tax issue that may arise in a recapitalization is the need for a "tax distribution" provision in Newco's LLC agreement, and how to treat the payment of the preferred return for federal income tax purposes. These issues may become contentious if the New Investors include tax-exempt investors with a different tax profile than the current members of Oldco.

Other Issues to Consider

The decision to liquidate Oldco, and distribute the Common Units in Newco directly to the members of Oldco in connection with the refinancing, will also raise tax issues. In some cases, Oldco members will need to keep Oldco in place to avoid triggering certain tax costs. In addition, if the limited liability company agreement of Oldco provided for a carried interest for the managing member, or the payment of a disposition fee, this will affect how the Common Units in Newco are distributed. If Oldco must continue to exist, then the carried interest or a disposition fee must be addressed, to determine if these provisions are waived or modified.

Conclusion

Taking on new capital as an alternative to a mezzanine loan, or sale of the property prior to the maturity date of an existing loan, may be an attractive alternative to a real estate company or investor with an overleveraged property. This makes it important to know what the New Investors will expect when it comes to voting and distribution rights, and understanding the tax pitfalls of the recapitalization structure.

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