Forming Real Estate Syndicates

first tuesday

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Forming Real Estate Syndicates

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Introduction

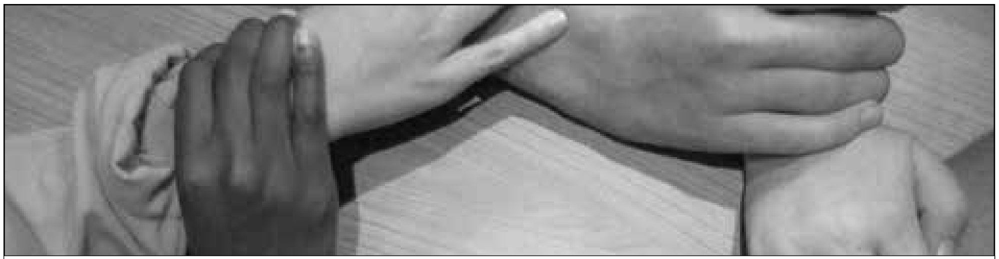
Forming Real Estate Syndicates is written for real estate licensees, syndicators, attorneys and investors. This course material is designed to be an educational tool for use in the classroom and as a technical research and reference tool.

The objective of this material is to fully provide the real estate professional, acting as a syndicator, with the knowledge needed to use the limited liability company (LLC) entity in group investment programs. **Forming Real Estate Syndicates** also discusses syndication activities and their chronology, the laws governing LLCs, the use of investment circulars and supplemental materials to solicit investors, and LLC operating agreements for the management of the investment group. Also analyzed in this material are investment activities that present a risk of loss controlled by securities law and tenant-in-common co-ownerships.

Included in each chapter is a summary of issues reviewed in the chapter with definitions of the key terms essential to the reader's comprehension of the topic. Unless a form cited in the book says, "See Form XXX *accompanying this chapter*" [emphasis added], it is not in the book. However, the reader has access to a fillable and savable version of all 400+ **first tuesday** forms online at *firsttuesdayjournal.com*.

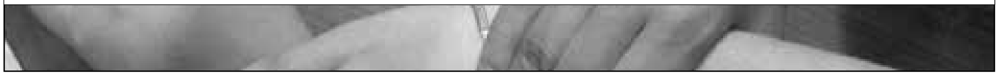
All materials are also accessible online from the reader's Student Homepage at *www.firsttuesday.us* during their one-year enrollment period.

Future errata, supplemental material and recent developments specific to **Forming Real Estate Syndicates** are available for further research within the Online Reading section of the reader's Student Homepage at *firsttuesday.us*.



Chapter 1

A chronology for syndication



Learning Objectives

After reading this chapter, you will be able to:

- explain the activities of a syndicator needed to form a group investment structured as a limited liability company (LLC) for the acquisition and ownership of an income-producing property; and
- appreciate the steps taken by a syndicator to locate property, solicit investors, form an LLC and acquire income producing real estate.

Key Terms

syndication **syndicator**

Guidelines for forming a group

Consider a real estate broker or agent who gathers investors into a group for the purpose of buying, operating and ultimately selling income-producing property. Here, the broker is involved in a process known as **syndication** or **syndicate brokerage**.

A broker who arranges the acquisition of income-producing property, organizes the group of investors and will oversee property management is known as a **syndicator** or **manager**.

syndication
The activity of a syndicator to bring together a group of investors in co-ownership formed as a limited liability company to fund the purchase of a propety, and perform property management during ownership and eventually resell the property.

Unlike sophisticated real estate investors who tend to operate alone, individuals who join together in *syndication programs* are generally uninformed and inexperienced about:

- the legal aspects and accounting of co-ownership;
- the economic factors that influence the movement of real estate rents and values;
- the responsibilities of property management; and
- the compensation a syndicator or manager is entitled to receive.

syndicator
An individual who solicits cash contributions from investors to fund a limited liability company which will acquire real estate for investment purposes.

The broker acting as a *syndicator*, sometimes called **syndicate brokerage**, undertakes **agency duties** to:

- conduct a competent due diligence investigation into the property to be acquired; and
- fully inform each individual prospective investor of all aspects of the property and the investment program that might influence a prudent investor's decision whether or not to contribute funds for its acquisition.

Checklist of syndicator activities

When a broker or agent decides to solicit investors and form a *limited liability company (LLC)* in a syndication effort to acquire ownership and operate an income-producing property, they need to consider all the steps set out in the following **chronological list of activities**:

- Research available residential or nonresidential rental properties and select one to be investigated and confirmed as suitable to purchase. [See **first tuesday** Form 185 and 279; see Chapter 2]

  Editor's note — Non-income-producing property acquired by an LLC will require modification of the documents in this material.
- Analyze the property selected, including its physical condition, the economic risks, environmental and natural hazards of the property's location, personal security, title conditions and property operating data. [See **first tuesday** Form 304, 314, 321, 324 and 352; see the **first tuesday** Income Property Brokerage suite of forms; see Chapter 22]
- Contract to purchase the property in the name of the syndicator under a(n):
  - *purchase agreement* [See **first tuesday** Form 159];
  - *option to purchase* [See **first tuesday** Form 161 and 161-1]; or
  - *escrow instructions* with a vesting provision allowing the syndicator to assign their right to purchase the selected property to the LLC. [See **first tuesday** Form 401]
- Open escrow in the name of the syndicator, not the LLC, as the buyer. Prior to closing and after the LLC has been formed, the syndicator will assign their right to buy the property to the LLC. [See **first tuesday** Form 161 and 401]
- Complete a **due diligence analysis** and confirm the seller's disclosures regarding the condition of the property's improvements, operations, location and title. [See Chapter 2]
- Apply for new financing or an assumption of the existing financing as called for in the purchase agreement. [See **first tuesday** Form 159]
- Review plans for the formation and management of an LLC entity with competent legal and accounting advisors. [See Chapter 6 and 19]
- Prepare the *investment circular (IC), subscription agreement, LLC-1 (Articles of Organization)* and *LLC operating agreement*, along with their exhibits and addenda, naming the syndicator as manager of the LLC. [See **first tuesday** Form 371 and 372; see Chapter 19]

Checklist of syndicator activities, cont'd

- Deliver copies of the IC to prospective investors to solicit them to become members and fund the LLC so escrow can close and the property be acquired.
- Obtain the signature of each investor on a separate subscription agreement and the signature page of the LLC operating agreement, and receipt of their funds by the syndicator or escrow. [See **first tuesday** Form 373]
- Enter into a *property management agreement* to employ a syndicator to manage the day-to-day operations of the property. This agreement needs to be signed by each investor who became a member of the LLC. [See **first tuesday** Form 590]
- Arrange mortgage financing and sign loan documents for an assumption of an existing loan(s) or the origination of a purchase-assist loan, either in the name of the syndicator or on behalf of the LLC, as demanded by the lender.
- File the *LLC-1 Articles of Organization*, prepared and signed by the syndicator, with the California Secretary of State.
- Assign the syndicator's right to purchase the property to the LLC in an amendment to the escrow instructions, and vest title to the property in the name of the LLC on closing. [See **first tuesday** Form 370 or 401-2]
- Fund the purchase price and closing costs from cash contributions received from the members of the LLC and mortgage financing.
- Close escrow and take possession of the property.
- Send copies of all closing documents to each member of the LLC.
- File an LLC-12 with the Secretary of State within 90 days after filing the LLC-1 and biennially thereafter, and identify the *manager* as the agent for service.
- Operate the property on behalf of the LLC during the LLC's ownership of the property and distribute earnings to the members.

Resale of the property

Lastly, the syndicator will resell the property when its ownership no longer meets the objectives of the investment group, or when the initial goal was to sell or exchange the property after a period of time.

The manager will negotiate the sale and the net proceeds to be distributed to the members on closing.

All these activities will be discussed in greater detail in later chapters of this material.

Chapter 1 Summary

The process of syndication occurs when a real estate broker or agent gathers a group of investors together to form a limited liability company (LLC) for the purpose of buying, operating and ultimately selling income-producing property. A broker who arranges the acquisition of income-producing property and organizes the group of investors is known as a syndicator or manager.

A broker acting as a syndicator undertakes the agency duty of investigating and fully informing each individual prospective investor of all aspects of the property and the investment program that might influence a prudent investor's decision to contribute funds.

When forming an LLC for the acquisition and ownership of an income-producing property, the syndicator performs numerous activities, including but not limited to:

- researching available properties and selecting one to be investigated as suitable for purchase;
- analyzing the property selected, including its physical condition, the economic risks, environmental and natural hazards of the property's location, personal security, title conditions and property operating data;
- contracting to purchase the property in the name of the syndicator;
- opening escrow in the name of the syndicator as the buyer then assigning their right to buy the property to the LLC; and
- reviewing plans for the formation and management of an LLC with competent legal and accounting advisors, and completing the required documents for formation.

Chapter 1 Key Terms

syndication .... pg. 1
syndicator .... pg. 2

Chapter 2

Selection and acquisition of property

Learning Objectives

After reading this chapter, you will be able to:

- identify the five basic categories of real estate for syndication purposes and determine which is the most prudent type for group investment;
- schedule the activities to be performed by the syndicator after entering into a purchase agreement to acquire property for syndication; and
- control a property without unconditionally committing to its purchase by the use of a purchase agreement with contingencies, an option to purchase the property, or escrow instructions with contingencies.

Key Terms

corporate securities risks	**letter of intent**
existing rental property	**liability limitation provision**
good faith deposit	**liquidated damages clause**

The benefits of group investment in existing rental property

For syndication purposes, real estate can be broken down into five basic categories:

- existing residential and nonresidential income-producing properties, called **existing rental property**;
- yet-to-be-built **construction and subdivision projects**;
- **pre-builder developable land** *to hold for profit on resale*;
- **agricultural land**; and
- **remotely located land** with no present economic use.

existing rental property
The category of property most prudent for real estate investment groups to own consisting of existing residential and nonresidential income-producing properties.

This discussion presumes a limited liability company (LLC) will be formed to acquire and operate an *existing income-producing property*, the category of property most prudent for real estate investment groups to own.

The benefits derived from the co-ownership of *existing income-producing rental property* include:

- an initial capital investment without the expectation of future additional contributions;
- minimal involvement by the investor;
- spendable income distributed periodically;
- equity buildup due to amortization of the mortgage principal through monthly payments made from rental income;
- an increase in value resulting from consumer price inflation and asset appreciation; and
- tax benefits provided by depreciation deductions for capital recovery and reinvestment on a sale of the property.

The other four categories of real estate investment properties do not offer these advantages.

Construction projects, agricultural and business opportunities

Group investments in *construction projects* and *agricultural* or *business opportunities* contain additional inherent risks of loss for investors which are classified as **corporate securities risks**. [See Chapter 13]

corporate securities risks
A risk of loss of investor funds that arises due to investment discretion when a syndicator acquires investor funds before identifying and disclosing an existing asset to be purchased.

These “quasi-real estate” investment programs require the expertise of the manager in an ongoing business-related service or trade. The manager, or others, promise to create value and earnings for the co-owners after acquisition of real estate and a business operation through development, managing resale inventory or the husbandry and sale of crops before a return on or of the investment can be expected.

However, the co-ownership and operation of existing rental property, brought to the attention of the investor before their release of funds to the syndicator, does not contain *corporate securities risks*. The investors in a rental property receive an ownership interest in land and existing improvements with no further improvements or other value-adding changes promised by the syndicator. The asset they acquired as a group provides them with *full present value* for their contributions at the time of closing — the moment their funds are first placed at risk of loss.

Further, rental property acquired with a down payment sufficient in size to give rise to spendable income can be held without the foreseeable need of additional capital contributions. The risk that co-investors might default on future periodic advances needed to maintain ownership is eliminated by buying a “net cash flow” property.

Further, *yet-to-be-built* construction projects expose the investors’ contributions to all the risks inherent in real estate development. The need to complete the value-creating activity of construction to achieve success is a risk of loss controlled by securities law, not the economic workings of the real estate rental marketplace.

An infinite number of persons and factors — contractors, subcontractors, laborers, material suppliers, architects, construction lenders, government agencies, insurance, costs, etc. — need to be coordinated to complete the improvements before the investment program can enter the market, much less succeed.

Remotely located, unusable land

Remote, unusable land is not as flexible an investment as other types of property, such as existing income-producing rental property.

However, the co-ownership of land to hold for resale does not create a securities risk. Unusable land is purchased merely to be held for profit when it is later resold. Remote, fallow land is unlikely to see its value increase by surrounding development or economic activity in the near future.

Also, remote land can be difficult and cumbersome to own. Since the land lacks any immediate use and generates no income, investment groups tend to grow tired of the constant contributions for insurance premiums, taxes and mortgage payments required of owners of unusable property.

Developable land

Undeveloped land located near existing development is more likely than remote land to be successful as a group investment.

However, the syndicator needs to correctly anticipate the demand for the land will increase and appreciate the property's value over time due to local economic conditions and surrounding developments that reduce availability of developable land.

The members of an LLC invested in undeveloped land need to be willing to make periodic contributions of additional funds to carry ownership of the property since undeveloped land generates no income. Thus, the selection of investors with stable sources of funds for future contributions toward annual carrying costs of ownership becomes important.

If the LLC is formed to purchase undeveloped land, the operating agreement needs to include a provision requiring members to make additional cash contributions based on assessments set by the manager. [See **first tuesday** Form 372]

Escrow period

After entering into a purchase agreement to acquire property for syndication, the time period for closing escrow is best scheduled to be 120 days or more.

A typical *120-day timetable of events*, following the syndicator's entry into a purchase agreement, option or escrow to acquire an existing income-producing property, is comprised of the following periods of activity:

- First 30 days: The completion of a **due diligence investigation** of the property and clearance of contingencies regarding suitability of the property.
- Next 15 days: The completion of the **investment circular (IC)** with its exhibits, Articles of Organization (LLC-1) and **LLC operating agreement.** [See **first tuesday** Form 371 and 372]
- Next 45 days: The solicitation of investors and full subscription of membership in the LLC.
- Remaining 30 days: Extra time, if needed, to fund and close escrow.

If the LLC is not fully subscribed within 45 days after the IC is first presented to investors, it becomes increasingly unlikely the LLC will ever be fully subscribed. Without investors, the syndicator will not be able to close the purchase escrow and acquire the property.

Taxwise, escrow is opened in the name of the syndicator for the same reason the syndicator makes the offer to purchase in their name: to establish their ownership of **property rights** created by entering into an agreement to purchase real estate in their name. Before closing, the syndicator files an LLC-1 with the California Secretary of State and assigns their purchase rights in escrow, a tax-free transfer, to the newly formed LLC.[1]

Purchase escrow and funding escrow

To accomplish the assignment of purchase rights in the property and funding by the investors solicited, the syndicator needs to consider opening two separate escrows.

The first escrow is the **purchase escrow**, in which the syndicator as an individual is initially named as the buyer. Prior to closing this *purchase escrow*, the syndicator's right to purchase the property is assigned to the LLC. In exchange, the syndicator receives a Class B membership interest with a percentage of co-ownership in the LLC. [See Form 370 accompanying this chapter]

Thus, the purchase escrow is opened by the syndicator (as an individual) but closed by the LLC. Title to the real estate will be vested in the LLC on closing.

However, neither the LLC nor the members are to deposit funds in the purchase escrow until it is actually ready to close. The *deposit of funds* is the function of a second escrow, known as a **funding escrow**. The sole purpose of the *funding escrow* is to keep the funds contributed by the LLC members separate from the purchase escrow until the purchase escrow can be closed.

---

1 26 United States Code §721

At closing, escrow is instructed to transfer the funds deposited in the funding escrow to the purchase escrow. The transfer will be made when the purchase escrow can close and vest title to the property in the LLC.

Two escrows allows for the unrestricted return of the investors' contributions in the event any complications interfere with the closing of the purchase escrow. The funds deposited in the funding escrow are at liberty to be returned to the investor without the consent of the seller in the purchase escrow.

Alternatively, investors may deposit funds directly into the purchase escrow for the benefit of the LLC if the escrow used will provide for a *unilateral return* of those funds to the investors.

Escrow may receive funds directly from each investor under a "receipt of third-party deposit" arrangement, stating the conditions for use or return of the funds. The investors are third parties, the seller and the LLC (by assignment from the syndicator) being the contracting principals.

Another arrangement the syndicator can provide to hold the investors' funds is an interest-bearing bank account in the name of the LLC. The account will hold the investors' funds from the time they are received until they need to be transferred to the purchase escrow at closing.

Controlling the property

Consider a syndicator who locates an income-producing property that appears suitable for an LLC investment program. It is available on advantageous terms if the due diligence investigation is successful. [See Chapter 22]

Initially, the syndicator will not enter into a purchase agreement that commits them to the unconditional purchase of the property. Only after the syndicator has fully investigated the property and is satisfied with the condition of the improvements and income and expenses of operations will they be willing to unconditionally commit to the purchase of the property.

For permission to conduct a due diligence review, syndicators often use a non-binding **Letter of Intent**. A *Letter of Intent* is used by the syndicator or their agent, before making an offer to purchase a property, to request the seller provide information necessary for the syndicator to complete their due diligence and determine its suitability for acquisition. However, it provides no contractual control over the property if the syndicator later decides to buy it. [See **first tuesday** Form 185]

letter of intent
A non-binding proposal signed and submitted to a property owner to start negotiations. [See **ft** Form 185]

After the Letter of Intent is submitted, the syndicator has time to prepare an IC. The IC will be distributed to investors to solicit their subscription and contribution to the purchase and joint ownership of the property. Only then does the seller enter into a purchase agreement with the syndicator as the buyer, the purpose of the delay being the seller's demand to avoid contingencies. [See **first tuesday** Form 371]

Control without unconditional commitment

To control a property without an unconditional commitment to its purchase (and avoid use of an unenforceable Letter of Intent), the syndicator has a variety of contract situations to choose from, including:

- a purchase agreement with contingencies;
- an option to purchase the property; or
- escrow instructions with contingencies, without first entering into an underlying purchase agreement or option to purchase.

A **contingency provision** in a purchase agreement identifies a condition that needs to be satisfied or waived by the syndicator for the agreement to become enforceable by the seller. If the condition is not satisfied, the syndicator may cancel the agreement and avoid any obligation to purchase the property.

Contingency provisions requiring the syndicator's approval (or cancellation of the purchase agreement) are to include, among other items:

- the condition of the property improvements;
- leasing income and operating expenses;
- financing and title information; and
- the property's location and natural hazards surrounding the property. [See **first tuesday** Form 279 and 159 §11]

A prudent syndicator also considers including a contingency provision allowing them to cancel and avoid closing escrow if they are unable to fully subscribe an LLC investment program to fund the acquisition of the property. [See Form 376 accompanying this chapter]

No underlying written purchase agreement

Occasionally, negotiations with a seller, either oral or through the use of a Letter of Intent, do not evolve into a signed purchase agreement. Here, escrow instructions are entered into in lieu of first entering into an option or purchase agreement. However, instructions need to include contingency provisions necessary to protect the syndicator by allowing cancellation if conditions are not met.

When a written purchase agreement does not exist and written escrow instructions are the only documents entered into by the syndicator and the seller (Letters of Intent are not agreements to do anything except arrangements for a due diligence review), the escrow instructions take the place of a purchase agreement or option as the contract binding the syndicator and seller.[2]

Thus, when an underlying written purchase agreement does not exist, any contingencies in the escrow instructions have the same effect as contingencies in a purchase agreement.

However, if a purchase agreement exists, the contingencies stated in it do not need to be restated in the escrow instructions unless they are of concern to the

2 **Tuso** v. **Green** (1924) 194 C 574

SUPPLEMENTAL ASSIGNMENT INSTRUCTIONS

Assignment of Purchase Rights to LLC

Prepared by: Agent ____________ Phone ____________
Broker ____________ Email ____________

DATE:__________, 20____, at ______________________________, California.

To ______________________________

____

____

Escrow Number ______________________

Date ______________________, 20____

1. You are hereby authorized and instructed to:
   1.1 Prepare a grant deed showing vesting in ______________________________, a California Limited Liability Company; and
   1.2 Receive third party deposits for the account of the limited liability company.
2. Buyer hereby assigns to this limited liability company all his interest in your escrow including any funds deposited by Buyer.
3. The limited liability company hereby assumes and agrees to meet all the obligations of Buyer in your escrow.
4. Seller hereby releases original Buyer(s) from all obligations under the escrow instructions and any underlying purchase contracts, and accepts the limited liability company as the substitute Buyer in these escrow instructions.

(Seller's Name)	(Buyer's Name)
(Seller's Signature)	(Buyer's Signature)
	(Assignee, LLC)
(Seller's Name)	(Manager's Name)
(Seller's Signature)	(Manager's Signature)

☐ See attached Signature Page Addendum. [ft Form 251]

FORM 370 03-11 ©2011 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Form 370

Supplemental Assignment Instructions – Assignment of Purchase Rights to LLC

escrow officer's performance. Escrow instructions merely authorize a third party (escrow) to carry out the actions required of the seller and the buyer to close the transaction on the terms and conditions agreed to in the purchase agreement (and as may be deliberately amended in the escrow instructions).

As the initial buyer, the syndicator needs to include a vesting provision in the purchase agreement allowing them to *assign their rights* under the purchase agreement to the LLC. The right to assign requires the seller's cooperation to deed the property directly into the LLC vesting. [See **first tuesday** Form 159 §10.6]

Purchase options

Some sellers are uncomfortable with purchase agreements loaded with contingencies. The contingencies may interfere with the seller's ability to cancel the transaction if the syndicator is unable to close the purchase by the scheduled date and unwilling to enter into a mutual cancellation of the transaction.

Also, a seller might not want their property subjected to a binding purchase agreement that may ultimately be rendered unenforceable by the syndicator's use of contingency provisions to cancel the transaction. Idiosyncrasies which need to be accommodated do exist in the marketplace.

There is an acceptable alternative for both the seller and syndicator. The seller may avoid the use of contingencies in a purchase agreement by granting the syndicator an **option to purchase** the property for a specific period of time. [See **first tuesday** Forms 161 and 161-1]

By an option agreement, the seller grants the syndicator an irrevocable right to purchase the property. To form a binding contract to acquire the property, the syndicator simply exercises their right to purchase within a fixed time period, called the **option period**.

In exchange for the seller's grant of an *irrevocable offer to sell* the property, the syndicator pays the seller consideration, called **option money**. The option has not been purchased by the syndicator and is not enforceable unless the seller receives some type of consideration, although the amount of the consideration may be as little as $100.[3]

After the *option period* expires, the seller is free to sell the property to another buyer, unaffected by the expired option held by the syndicator. If the option is recorded, the option will not expire as a *cloud on title* until six months after either:

- the expiration date stated in the recorded option agreement or memorandum; or
- the date the option or memorandum of the option is recorded if the recording does not contain an expiration date.[4]

Seller obligated to sell; syndicator not obligated to buy

For the syndicator seeking to buy suitable property, entering into an option to buy imposes no obligation to purchase. Conversely, the seller *is* obligated to sell if the syndicator decides to buy the property by **exercising their option** during the option period. The exercise of an option is an acceptance of the seller's irrevocable offer to sell contained in the option.

Syndicators typically buy options with short option periods, such as three to six months. The syndicator only needs long enough to complete their investigation of the property and form an investment group to fund the purchase. The option money might be set at an amount that will compensate the seller for their inconvenience of keeping the property "off the market" during the option period. [See **first tuesday** Form 161]

3 **Kowal** v. **Day** (1971) 20 CA3d 720

4 Calif. Civil Code §884.010

Form 376

Buyer's Syndication Addendum — Equity Financing Contingency

BUYER'S SYNDICATION ADDENDUM
Equity Financing Contingency

Prepared by: Agent ________________ Phone ________________
Broker ________________ Email ________________

DATE: ____________, 20_____, at ________________________________, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:
☐ Purchase Agreement ☐ Counteroffer
☐ Escrow Instructions ☐ ________________

1.1 ☐ of same date, or dated ____________, 20_____, at ________________________, California,
1.2 entered into by ____, as the Buyer, and
1.3 ____, as the Seller,
1.4 regarding real estate referred to as ____
____.

AGREEMENT:

In addition to the terms of the above referenced agreement, Buyer and Seller agree to the following:

2. Close of escrow is conditioned on Buyer funding the down payment on the price from contributions made by investors Buyer solicits who subscribe to membership interests in a limited liability company (LLC) (or co-ownership interests as tenants in common) which will close escrow as the assignee of Buyer.
2.1 On acceptance of this offer, Buyer to promptly undertake his due diligence investigation and complete his analysis of the property in a timely manner.
2.2 Buyer to promptly prepare an investment circular on satisfaction of his due diligence investigation at which time Buyer will solicit investors to contribute to the LLC (or as tenants in common).

3. Buyer may terminate the above referenced agreement on or before closing should Buyer be unable to sell sufficient LLC membership interests (or tenant-in-common interests) to fund the close of escrow on this transaction. [See ft Form 183]

4. ____
____
____
____

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [ft Form 251]	☐ See attached Signature Page Addendum. [ft Form 251]
Date: ____________, 20_____	Date: ____________, 20_____
Buyer: ________________	Seller: ________________
Signature: ________________	Signature: ________________
Buyer: ________________	Seller: ________________
Signature: ________________	Signature: ________________

FORM 376 03-11

Often, an insignificant amount of option money is paid for a short, initial option period, sometimes called a "free-look" period, comparable to investigations arranged under most Letters of Intent. During this "free-look" period, the syndicator completes their due diligence investigation of the property.

The term of the typical free-look option is 30 to 60 days in exchange for a minimal payment of *option money.*

However, the syndicator will need more time after the free-look period if they decide the property meets their investment objectives and they intend to acquire the property through syndication. Here, the syndicator may negotiate an option with one or more *extensions* following the expiration of the initial option period. More option money as agreed is paid to extend the closing date to provide more time to close escrow as needed by the syndicator to complete their investigations and solicit investors. [See **first tuesday** Form 161-1]

Any number of additional option periods may be agreed to by the seller and syndicator, each following the expiration of the prior period. The number of option periods depends only on the seller's willingness to agree to grant extensions in exchange for compensation, and the syndicator's willingness and ability to pay more option money.

As an advantage for the seller, the seller retains the option money after the option period expires, since no forfeiture is involved (as is often attempted under liquidated damages provisions in some purchase agreements). Also, the seller is assured the syndicator will no longer have the right to acquire the property if the option period expires and the option is not exercised, even if the option is recorded.

Liquidated damages

A purchase agreement without contingency provisions allowing for cancellation exposes a syndicator to liability for money losses incurred by the seller for the syndicator's unexcused failure to close the transaction.

Usually, the only monetary loss a seller of income property incurs on a syndicator's failure to close the transaction is a decline in the resale value of the property at the time of the syndicator's breach to below the purchase price.

Money lost by the seller is generally reflected as a reduction in **net proceeds** received on a prompt resale of the property to below the amount they would have received had the syndicator not breached the transaction.

liquidated damages clause
A forfeiture provision in a purchase agreement purporting to fix the amount of money a seller is to recover from the buyer on the buyer's breach of the agreement.

liability limitation provision
A purchase agreement provision limiting the dollar amount of seller losses the syndicator is liable for in the event the syndicator breaches the agreement. [See **ft** Form 159 §10.8]

Two types of money damage provisions in purchase agreements address the seller's losses on the syndicator's wrongful cancellation or unexcused failure to close:

- a **liquidated damages clause**, also known as a **forfeiture provision**; and
- a **liability limitation provision**.

A *liquidated damages clause* sets out a fixed sum of money the syndicator will pay the seller in the event the syndicator breaches the purchase agreement. The syndicator agrees to pay the amount whether or not the seller lost money due to the breach.

While initially presumed valid, liquidated damages clauses are unenforceable by sellers in real estate transactions beyond recovering money *actually lost* due to the breach. Liquidated damages constitute a forfeiture unless equal or greater money losses actually exist. However, without actual money

Figure 1

Form 159

Purchase Agreement — Income Property

10. ACCEPTANCE AND PERFORMANCE:

10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within ______ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

10.3 On the inability of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.

10.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as ____.

10.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See ft Form 183]

10.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See ft Forms 171 or 172]

10.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

10.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to ☐ $____________, or ☐ the deposit receipted in Section 1.

losses, forfeitures are barred by law as an *unjustified windfall* to the seller. To enforce them would allow the seller to keep both their property and the deposit.[5]

To recover money losses on a wrongful cancellation or unexcused failure to close, the seller with a liquidated damages provision who is challenged by the syndicator needs to prove they sustained **actual money losses** (in the amount they intend to recover) as a result of the syndicator's breach. A liquidated damages clause literally states in plain words that a seller may claim money without having to prove they sustained any losses.

However, by law, the clause is unenforceable as written when contested by a buyer in a real estate transaction. Again, the seller may recover their *actual money losses*, using the deposit as a source for recovery.

*Editor's note — As a matter of risk management policy for brokers, **first tuesday** deliberately excludes liquidated damages provisions from its forms.*

Liability limitations

As an alternative to a liquidated damages clause, the syndicator and the seller may agree to limit the syndicator's liability in the event the syndicator breaches the agreement.

If agreed upon by both parties, the purchase agreement used will contain a *liability limitation provision* setting forth the maximum dollar amount of seller losses the syndicator is liable for. [See Figure 1, excerpt from **first tuesday** Form 159 §10.8]

With a **liability limitation provision**, the seller can recover their money losses incurred due to the syndicator's breach limited to the agreed-to ceiling amount.

5 CC §3275

Thus, if the property's value drops below the purchase price by the time the syndicator wrongfully cancels or fails to close escrow, the ceiling on the syndicator's liability has already been set, no matter how far the property value declined by the time of the syndicator's breach.

A purchaser's lien for the deposit's return

good faith deposit
A deposit made by a syndicator to evidence their good faith intent to buy when making their offer. Also known as earnest money. [See **ft** Form 401 §1.1]

A syndicator generally makes a cash deposit, called a **good faith deposit,** with their offer to purchase a property. Occasionally, the *good faith deposit* is in the form of a post-dated check or promissory note, payable into escrow at a future date, after due diligence contingencies are eliminated and the syndicator intends to close escrow.

If the syndicator deposits funds into escrow and later breaches the purchase agreement, they are entitled to recover the deposit, less money losses actually sustained by a seller due to the breach. Again, the seller's loss recovery can be limited by a provision placing a ceiling on recover of losses.

For example, consider a syndicator who breaches a purchase agreement at a time when the property's value is still equal to or greater than the price agreed to by the syndicator in the purchase agreement. Thus, the seller has not lost money due to a decline in property value at the time of the breach.

Since escrow is not going to close, the syndicator demands the return of their deposit. The seller refuses to authorize the release of the syndicator's funds, claiming the deposit is forfeited due to the syndicator's failure to close escrow.

As forfeitures in real estate transactions are barred by law and the seller will not return the syndicator's funds, the syndicator is entitled to place a **purchaser's lien** on the seller's property for the amount of the good faith deposit. The *purchaser's lien* is enforced by filing a judicial foreclosure action and recording a lis pendens on the property.[6]

6 CC §3050

Chapter 2 Summary

Real estate can be broken down into five basic categories for syndication purposes:

- existing residential and nonresidential income-producing properties;
- yet-to-be-built construction and subdivision projects;
- pre-builder developable land;
- agricultural land; and
- remotely located land with no present economic use.

Existing income-producing property is the most prudent type of property for real estate investment groups to own. The benefits of existing income-producing rental property include:

- an initial capital investment without the expectation of future additional contributions;
- minimal involvement by the investor;
- spendable income distributed periodically;
- equity buildup due to amortization of the mortgage principal;
- an increase in value resulting from consumer price inflation and asset appreciation; and
- tax benefits provided by depreciation deductions.

After entering into a purchase agreement to acquire property for syndication, the time period for closing escrow is best scheduled to be 120 days or more, comprised of the following periods of activity:

- First 30 days: The completion of a due diligence investigation of the property and clearance of contingencies regarding the property.
- Next 15 days: The completion of the investment circular (IC) with its exhibits, articles of organization (LLC-1) and LLC operating agreement.
- Next 45 days: The solicitation of investors and full subscription of membership in the LLC.
- Remaining 30 days: Extra time, if needed, to fund and close escrow.

For permission to conduct a due diligence review, syndicators often use a Letter of Intent. A Letter of Intent is used by the syndicator to request the seller provide information necessary for the syndicator to complete their due diligence investigation and determine its suitability for acquisition.

To control a property without unconditionally committing to its purchase without the use of a Letter of Intent, the syndicator has a variety of contract situations to choose from, including:

- a purchase agreement with contingencies;
- an option to purchase the property; or
- escrow instructions with contingencies, without first entering into an underlying purchase agreement or option to purchase.

Chapter 2 Key Terms

corporate securities risks .... pg. 6
existing rental property .... pg. 6
good faith deposit .... pg. 16
letter of intent .... pg. 9
liability limitation provision .... pg. 14
liquidated damages clause .... pg. 14

Chapter 3

The economics of income property

Learning Objectives

After reading this chapter, you will be able to:

- present an overview of the economic benefits an income producing residential or commercial property provides to syndicate investors;
- distinguish the four financial aspects of the ownership of investment income properties which generate annual returns for investors; and
- calculate the net spendable income and other financial analytics generated by an investment property's gross income, operating expenses, mortgage payments and depreciation schedule.

Key Terms

amortization

appreciation

equity buildup

gross operating income

inflation

Advantage in high-value property

The greatest benefits a syndicator and their group of investors are able to receive from an investment come from the ownership and operation of multi-million dollar, income-producing properties. All other investment fundamentals being constant, larger higher-valued properties are generally more efficient and thus yield greater returns over longer periods of time than do smaller lesser-valued properties.

Investing in a multi-million dollar property gives the syndicate an *economic advantage* over most investors working individually. Individual investors generally have less capital to invest, whereas a syndicator combines capital from several investors, called **pooling**. *Pooling* leverages the investors into property more valuable than most individual investors can afford by themselves.

Further, the syndicator's compensation for their activities is typically based on the price of the property acquired and its flow of rental income. Thus, the syndicator's compensation is far greater when their time and effort is spent on high-value properties which yield greater returns.

However, less experienced syndicators are advised to initially stick with low-value properties. Lesser-valued properties are less tricky to syndicate and their ownership provides good practical experience for syndicating larger, multi-million dollar income-producing properties in the future.

Multi-million dollar properties are more difficult to investigate and manage. Errors due to lack of experience and knowledge are dramatically compounded on larger, more expensive properties. Thus, the money and effort required to correct an error are more costly as the stakes are higher.

Earnings from income property

Residential or commercial income properties generate **annual returns** for investors based on four financial aspects of ownership, listed here in order of financial and economic importance:

- net spendable income;
- mortgage reduction;
- increased property value; and
- tax benefits. [See Chapter 10]

Net spendable income

gross operating income
The actual income from all sources that property operations can be expected to generate over a 12 month period, from which expenses are paid, mortgage payments are made and a profit is earned.

The rents actually received from tenants and equipment comprise a property's **gross operating income**. [See Chapter 22]

Gross operating income is the bottom-line income figure giving the anticipated bankable income from all sources that the property operations can be expected to generate over a 12 month period based on current operations and operations of comparable properties. From gross operating income, operating expenses are paid, mortgage payments are made and a profit is earned. Gross operating income is also sometimes called **GOI** or **gross revenue,** an equivalent bookkeeping term.

If rental income is insufficient to cover expenses and mortgage payments, syndicate members are called upon by the manager to contribute additional funds. This property condition is called **negative cash flow**.

Conversely, any income remaining after payment of operating expenses and mortgage installments is referred to as the property's **net spendable income**. When a property generates a *net spendable income*, the property is said to have a **positive cash flow**.

Spendable income is the primary source of cash for distributions to investors, called **cash-on-cash income** and analyzed as a percent return on cash invested. Further, spendable income acts as a cushion mitigating the risk of negative cash flow brought about by a drop in the property's **net operating income (NOI).**

NOI is the sum of the gross operating income less the property's total expected annual operating expenses. The NOI is the actual amount of *net revenue* generated by the property. NOI is used to set a property's market value and, and if clear of mortgages, the return on investment before tax considerations. [See Chapter 22]

Cash-on-cash spendable income

Spendable income generated by the investment is a return to the investor and the syndicator, calculated and referred to as a percentage of equity capital contributions (in contrast to and excluding borrowed capital by mortgage financing).

Spendable income is roughly comparable to interest received on money-market accounts (but without equity growth and appreciation gain) and more like dividends paid on common stock. Thus, returns vary from time to time due to inflationary/deflationary pressures on the pricing of goods and services and the Federal Reserve's (the Fed's) management of the money supply (monetary policy).

Further, other influences on rental income exist, such as local economic stability and demographic trends within the area.

The expectation of receiving a flow of spendable income without having to be involved in the day-to-day management of a property is a major inducement motivating investors to participate as contributing members in a limited liability company (LLC) investment program.

Mortgage reduction

The principal balance of a long-term real estate mortgage is systematically reduced by constant periodic mortgage payments, a financing process called **amortization.** Due to the systematic *amortization* of the debt built into a mortgage's payment schedule, the dollar amount of the annual principal reduction on a mortgage is another source of a return on invested capital, commonly called **equity buildup**.

> **amortization**
> The systematic reduction in the principal balance of a long-term real estate mortgage by constant periodic mortgage payments.

The amount of the mortgage reduction through amortization is commonly calculated for investors as a percentage yield on their cash investment, not a return of their borrowed capital (which is depreciation).

This mortgage reduction is a significant but secondary source of earnings. It functions as an *equity buildup* adding to the group ownership's net worth in the property. However, equity buildup is illiquid and cannot be distributed to investors until the property is refinanced or sold.

> **equity buildup**
> The process of mortgage reduction through amortized mortgage payments and any additional payoff of principal.

The annual debt reduction is best viewed as a reinvestment of the **return of capital** generated by the depreciation schedule as a bookkeeping deduction from NOI. The mortgage amount originally funded part of the capital the LLC used with the co-owners funds to purchase the property. Taxwise, the amount of the annual depreciation deduction represents the tax-free return of the total of all forms of invested capital, be they cash contributions or purchase-assist mortgage funds.

Typically, the depreciation deduction more than "shelters" from taxation an amount equal to that portion of the rental income used to reduce mortgage principal through payments for approximately two-thirds of the life of a 30-year mortgage.

Recapitalization and equity build up

The reduction in the mortgage amount through amortization increases the property's equity by an equal amount (a "build up" in equity) as long as the dollar value of the property remains at or above the original purchase price throughout the life of the mortgage.

Thus, a **recapitalization** of the investment occurs during each month of ownership when the amount of the mortgage principal is reduced by installments paid from rent (or additional contributions). While the property's value remains the same, the equity in the property increases by the amount of the monthly debt reduction, an ongoing restructuring of invested capital (principal debt reduction versus cash spendable withdrawn).

However, on resale of the property, the equity built up by the amortized reduction of debt is cashed out, generating taxable profits (unrecaptured gain due to depreciation deductions). Further, it is a tax-free return of capital for any mortgage reduction greater than depreciation deductions as no taxes are due on a return of capital.

Typically, the *investment circular (IC)* contains a yield schedule that charts the annual dollar amount of mortgage reduction over a ten-year ownership period. The annual equity buildup attributable to the mortgage reduction during each of the ten years is then presented as an average annual **percentage return on** the investors' original cash contributions. [See Chapter 20, 21 and 22; see **first tuesday** Form 371]

A property's net worth over time

The owner's equity in a property is the portion of the value remaining after deducting the mortgage principal from the property's value and represents the property's **net worth**. By extension, the property owner's net worth includes the equity in the property.

Equity is not equivalent to profits as it is related to the property's mortgage and unrelated to **cost basis.** Profits and cost basis pertain to the tax aspects of ownership, not the financial aspects.

Equity in a property is calculated as the difference between the property's fair market value (FMV) and the principal balance remaining on any financing or other monetary liens that encumber the property.

A group of investors' equity in a property is thus the result of:

- *cash invested* to purchase or improve the property, an amount that does not include cash contributed to cover any negative cash flow during the ownership of the property (unless used to reduce debt);
- *mortgage reduction* through amortized payments and any additional payments of principal; and

Sidebar

Know the bottom line for investment properties

Investors crowding into the market today all want to know the same thing: "Is this property going to pay off?"

A syndicator answers this question by discussing two simple formulas:

- *the* ***capitalization rate (cap rate)****; and*
- *the* ***net income multiplier (NIM)****.*

The ***cap rate*** *is pure income — the amount of money remaining after all of the property's operating expenses are deducted from the gross income produced by the property, before deductions for mortgage interest or depreciation — expressed as a rate, or percentage. Most real estate syndicators have a specific cap rate in mind when shopping for income-producing property.*

To find a property's cap rate, the syndicator first needs to gather the following data:

- *gross operating income (GOI) from the property (the rental amounts paid by the building's current tenants and the scheduled rent amounts for vacant units);*
- *property operating expenses (taxes, maintenance and repairs cost, etc.); and*
- *the purchase price for the property.*

Having obtained the above information, the syndicator needs to calculate the net operating income (NOI) of the property by subtracting all property expenses from the GOI:

GOI – operating expenses = NOI

Next, the syndicator finds the cap rate by dividing the NOI by the purchase price:

NOI ÷ purchase price = cap rate

Once the syndicator finds the cap rate, the syndicator decides if this cap rate is high enough and whether the cost of purchasing the property will satisfy the objectives of group investment. If the cap rate from the listing price is too low, the syndicator uses the inverse of the cap rate formula to find a purchase price more in keeping with their desired cap rate.

First, find the NIM; this is the reciprocal of the cap rate. Since a cap rate is expressed as a percentage, or fraction of 100, this is done by dividing 1 by the cap rate:

1 ÷ cap rate = NIM

Next, find the desired purchase price by multiplying the NOI by the NIM:

NOI × NIM = purchase price

A syndicator who knows how to find a property's cap rate and NIM cuts through a litany of expenses and variables to show their real estate investors an investment property's bottom line in the investment circular (IC).

- *increased market value* of the property due to inflation, appreciation or management, called **growth factors.**

An increase in property value

Real estate located in high-demand areas experiencing population and wage growth tends to increase in value over time. This increase is due to a combination of:

- *monetary inflation;*

- *local appreciation;* and
- other *growth factors*, such as the efficient management of income and expenses.

Meanwhile, expenditures on proper maintenance keep the physical aspects of the property unmarred by obsolescence and deterioration.

inflation
The price changes over time in consumer goods and services, quantified in consumer price index figures.

Inflation is a decline in the purchasing power of the dollar, measured by the federal government and reported through the consumer price index (CPI). Thus, over time, more dollars are required to purchase the same property in the same condition, which is an example of the results of monetary inflation.

Consumer inflation is a reflection of changes to the purchasing power of the dollar, not the rental power of the property. It is reported as the percentage of periodic increase in the dollar price paid for a bundle of consumer goods and services — the rental value of residential real estate — not in the logical alternative as a decrease in the quantity or quality of goods and services a dollar will buy.

Over the years, the dollar value of properly maintained real estate (a capital asset, not a good or service) tends to keep pace with consumer inflation, if:

- the location of the property has a static or increasing population and employment base; and
- the per capita income (earnings) of potential tenants increases annually at a rate no less than the rate of inflation.

To reap the "benefits" of real estate as a *hedge against inflation*, the manager of a property does not need to do anything more than maintain the property by:

- repairing it to remove wear and tear; and
- replacing fixtures and equipment to eliminate physical obsolescence.

Appreciation in property value

Periodically, property increases in value at an annual rate greater than the rate of inflation. The rate exceeding inflation is classified as **appreciation.** Appreciation in value is the result of events beyond the devaluation of the dollar that drive the additional increase in value.

appreciation
An increase in property value at an annual rate greater than the rate of inflation as the result of favorable economic conditions, such as increased demand for a location or increased wealth of the local population.

Appreciation in property values is the result of favorable local economic conditions, such as:

- rising consumer demand for housing or services in and about the location leading to an increase in the local population density; or
- increasing wealth and financial health of the local population.

It is the goal of a syndicator to acquire a property that is in an appreciable location. Thus, it is likely to increase in value from the time purchased beyond the annual rate of inflation to deliver to investors a **real return** on their investment.

To garner this future increase in the property's market value at a rate greater than the rate of inflation, the syndicator selects property located where conditions within its immediate vicinity will likely bring about an increase in local population density (or per capita income beyond the rate of inflation). Thus, the property will experience an increase in both demand and the rents paid for residential and commercial rental space.

Efficient management of the property

Finally, an even greater increase in property value beyond the effects of inflation or appreciation may be achieved by other growth factors such as the syndicator's **management capabilities** to reduce operating costs and increase rental income.

Efficient management and attention to the amenities of a property tend to increase a property's NOI. As a result, the value of the property also tends to increase since capitalization rates (cap rates) for setting a property's value are applied to the property's NOI.

Chapter 3 Summary

Residential or commercial income properties generate annual returns for investors based on four financial aspects of ownership:

- net spendable income;
- mortgage reduction;
- increased property value; and
- tax benefits.

The rents received from tenants comprise a property's gross operating income. Any operating income remaining after payment of operating expenses and mortgage installments is referred to as the property's net spendable income. When a property generates a net spendable income, the property is said to have a positive cash flow.

Net operating income (NOI) is the sum of the gross operating income less the property's total expected annual operating expenses. The NOI is the actual amount of net revenue generated by the property.

The principal balance of a real estate mortgage is systematically reduced by constant periodic mortgage payments, a process called amortization. The dollar amount of the annual principal reduction on a mortgage is akin to a return of invested capital. Thus, a recapitalization of the investment occurs during each month of ownership when the amount of the mortgage principal is reduced by installments paid from rent or additional contributions.

While the property's value remains the same, the equity in the property increases by the amount of the monthly debt reduction, an ongoing restructuring of invested capital.

A group of investors' equity in a property is the result of:

- cash invested to purchase or improve the property;
- mortgage reduction through amortized payments and any additional payments of principal; and
- increased market value of the property due to inflation, appreciation or management, called growth factors.

Chapter 3 Key Terms

amortization .... pg. 21
appreciation .... pg. 24
equity buildup .... pg. 21
gross operating income .... pg. 20
inflation .... pg. 24

Chapter 4

The reduction of investment risks

Learning Objectives

After reading this chapter, you will be able to:

- analyze the risks of loss unique to a group investment in real estate;
- discuss each market-related risk factor with an investor to address their fear of loss of their investment;
- structure the payment of reasonable cash fees to the syndicator for limited liability company (LLC) organization efforts, performing property management duties, and refinance and resale activities; and
- handle the disbursement of funds on acquisition, and during ownership from spendable income, refinance or sale of the property between Class A cash investors and the Class B syndicator.

Key Terms

equity financing	**parity distribution**
net operating income (NOI)	**watered stock**
note rate	

The investor's point of view

To analyze the **risk of loss** when investing capital, a prudent investor begins by judging the capabilities and competence of the syndicator organizing the group investment. Success is dictated by the outcomes of numerous technical factors, such as property selection, financing and management. Also consider that the greater the syndicator's experience, talents and commitment, the less the risk of loss for investors. [See Chapter 5]

To see an investment program through to fruition, the syndicator needs to have an evident sense of purpose, i.e., a known consistency of behavior, determination and focus. Without a showing of finely-honed competence for buying, owning and selling real estate over a long period of time, solicited investors will instinctively be put off by a syndicator's lack of experience. Here, investors will likely sense an increased risk of losing their capital due to the syndicator's lack of drive, dedication and experience.

Thus, a syndicator needs to be able to present evidence of themselves as a manager able to navigate the difficult stages of an investment program and emerge successful at the end — despite local economic upheavals that cyclically beset property.

Experience selling income properties, either on behalf of an owner or when acting as a principal, is evidence the syndicator understands the challenge of selling property. Operating a property month after month, then selling it during the short window of maximum liquidity for a resale opportunity in a real estate business cycle is a difficult task.

In application, the **price paid** for a property becomes the initial indicator as to whether a profit will likely be realized on its resale. Further, the **terms for payment** of that price — the financing — need to reflect the local economy's future stress on rental income and cash flow from the property, all of which affect the ability to retain ownership.

Timing the market

The **timing of a purchase** is best understood by a syndicator who has gone through at least one full real estate business cycle — from bust to boom and back, or vice versa.

This provides a personal grasp of the difference between the *concept* of historical equilibrium trends that ultimately control property values and the *reality* of price movement during a business cycle with its excessive rise and fall in real estate prices.

Selecting the correct phase of a business cycle — preferably the end of the recessionary phase after a bust but before the recovery fully sets in — as the ideal time to select and buy property to assure a profit on its resale is an absolute necessity for receiving an advantageous resale price.

The syndicater as a market maker

Few individual buyers are willing or able to acquire property at any price during recessionary lulls in the real estate resale market. During these periods of illiquidity when "cash is king," the perceptive syndicator functions as a "market maker" of sorts. To this end, the syndicator enters a depressed seller's market to buy at a time when few others (speculators) are willing or able to compete.

Here, the syndicator creates a buyer in the form of themselves and a limited liability company (LLC) full of cash investors who otherwise are unlikely or unwilling to individually buy property during a recession or early part of a recovery cycle.

Thus, a syndicator promotes the acquisition of property in a market following the height of foreclosure and real estate owned (REO) resale activity. Here, few sales exist, prices have adjusted to the mean price trend line and speculators are still sparse.

When timing acquisitions for long-term investment, the syndicator, having passed up acquisitions during a boom, takes advantage of the temporary (cyclical) dearth of buyers in the marketplace. It is then that sales volume troughs and begins to increase (based on fundamentals, not speculator activity) and at a time before prices start their long term assent. This is typically a *12-to-18 month window period* that begins shortly after a recession has formally ended.

During a well-developed buyer's market of greatly reduced sales volume and the off-loading of properties held by speculators, the syndicator is better able to negotiate a price and terms for payment that will help insulate against the risk of a loss of invested capital. To insulate against loss of value is the most likely method of creating wealth.

By taking advantage of market prices that drop below the equilibrium trend, a built-in profit is realized the instant the period of ownership moves into the **recovery phase** of the business cycle. Prices then begin to rise in a trajectory pushed upward ever faster by recovering demand fueled by increasing numbers of "fair weather" investors and the ever-recurring flow of tardy first-time speculators.

Priority as risk avoidance for investors

The primary financial purpose for the syndication of a property by a broker is to raise funds from passive investors for the down payment on the purchase of property that the broker and investors will co-own through an LLC entity. Thus, as the syndicator, the broker's fractional ownership interest in the property (via the LLC) is financed by a mortgage lender and equity capital investors, a double-leverage situation for the syndicator's ownership position.

However, the syndicator's percentage participation in ownership sometimes is not subordinated to the ownership interests held by the investors, called **parity participation**. Here, the syndicator's claim on the property's income and profits for their fractional ownership interest is junior only to the mortgage (as are the investors' ownership interests).

Without subordination of the syndicator's co-ownership interest to those claims on income held by the investors resulting from parity treatment, the dollar value of the investors' percentage of ownership on closing (if immediately resold at the purchase price) will be less than the down payment they have funded to acquire the property, a condition called **watered stock**.

watered stock
A condition that occurs when the dollar value of the investors' percentage of ownership on closing will be less than the down payment they have funded to acquire an investment property.

To eliminate this risk of loss created by parity treatment of the syndicator's ownership interest with that of the investors', the fractional ownership interest acquired by most syndicators is a *Class B subordinated ownership interest* (junior to the *Class A priority membership interests* held by the cash investors). [See Chapter 8]

Tertiary ownership

As a matter of practice, the syndicator's ownership is tertiary; subordinated and junior to both:

- the *mortgage financing* (the first claim on the property's value); and
- the *equity financing* provided by the cash investors (the second claim on the property's value).

This arrangement for the syndicator's ownership interest constitutes "double leverage," providing 100% financing for the acquisition of their ownership interest in the LLC.

Viewed from the aspect of income distributions, the syndicator's ownership claims, whether parity or subordinate, dissipate the **earning power** of the investors' cash contributions. The syndicator will participate in the property's spendable income as a co-owner, with different levels of participation based on parity or subordinated rights to the spendable income.

The investors' *risk of loss* of their investment is also analyzed based on the distinction between parity or subordination of co-owners' interests.

Dilution of earning power in profits

Investors are typically solicited by the syndicator to provide all of the equity financing needed to acquire the property. When doing so, the investors agree to the "watering down" of their share of participation in any future increase in the property value. They agree to receive less than 100% of the property's future increase in value in exchange for their claim to priority distributions of *spendable income* and *net proceeds* of refinancing or a sale before the syndicator has a claim on these proceeds.

Thus, the investors dilute the earning power of their cash by sharing future growth with a non-cash investor (the syndicator). However, they do reduce their risk of loss and do not create a moral hazard the syndicator will not perform by doing so.

Further, and as part of the dilution of the investors' earning power by sharing with the syndicator, on a resale of the property the syndicator **receives the first profits –** an increase in the property's value on resale over the price paid to acquire the property – limited to the dollar value given to the syndicator's Class B interest.

The investors under their priority distribution receive all their invested funds – based on the price paid for the property – before profits are disbursed. When subordinated to investor claims, distribution to the syndicator from sales proceeds is based solely on an increase in property value.

Depreciation and book value (adjusted *cost basis*) of the asset only plays a role in tax reporting, not the sharing of spendable income or net proceeds on a refinance or resale.

In contrast to profits, the priority return of the investors' cash contributions is distributed based on the price paid for the property, before considering any increase in the property's value. Also, any minimum annual yield owed to the cash investors, which may have accumulated unpaid due to insufficient amounts of spendable income in the past, has priority over any disbursement of sales proceeds to the syndicator.

After the initial disbursement of net sales proceeds to Class A and Class B members to return the dollar amount of their capital contributions with an annual minimum rate of return, any remaining sales proceeds are typically shared by all members on a *pro rata basis* — share and share alike. Thus, a Class A member's participation in the remaining profits is understandably diluted by the ratio of sharing between Class A and Class B members.

Avoidance of moral risk

Class A members need a priority return of their cash and a minimum annual return before the syndicator takes their share. With priority treatment, investors avoid the moral risk created by parity sharing that the syndicator will have insufficient incentive to pay attention to the value of the property.

The syndicator, through their Class B ownership, creates a dilution of the participation by Class A members in profits on a sale. However, in this trade-off for work performed, the investors enjoy a flow of income and full return of their cash contributions before the syndicator participates to receive cash for their original contribution of time, talent and energy to the acquisition of the property.

Funding the purchase, not the syndicator

Like mortgage financing, **equity financing** provided by cash investors is primarily meant to fund the purchase of property. Thus, *equity financing* is not generally considered a primary source of funds to compensate the syndicator for their acquisition activities. Instead, the syndicator receives an ownership participation in the LLC for these pre-syndication, acquisition efforts.

equity financing
Down payment funds solicited from cash investors by a syndicator for the purchase of an income-producing investment property to be co-owned by a group of investors. Contrast with mortgage financing.

However, if the syndicator is to **remain solvent**, they need to be reimbursed for all of their out-of-pocket expenditures related to the purchase of the property. Further, they need **reasonable compensation** for the organizational time and effort spent performing acquisition and syndication activities, such as:

- locating a suitable investment property;
- conducting a due diligence investigation;
- entering into a purchase agreement;
- preparing the investment circular (IC) [See Chapter 20 and 21];
- soliciting investors and forming the LLC;
- arranging for the assumption or origination of purchase-assist loans; and
- opening and closing escrow.

Of these, the real estate-related transactional activities warrant the receipt of consideration (a percentage of ownership) separate from a cash fee paid to the syndicator for those services rendered to form the LLC and locate investors.

Analyzing the economic risks of loss

Basic *market factors* common to all real estate transactions pose risks of loss no matter who owns the property or whether it is a single family residence (SFR), income property or vacant land.

Commonly acknowledged and understood market **risks of ownership** include:

- the purchase price;
- the down payment;
- mortgage financing;
- costs of ownership;
- the property's location;
- occupancy and rent;
- the maintenance of the property; and
- recovery of cash on a resale.

To provide a "comfort zone" sufficient for prospective investors to look further into the attractiveness of a syndicator's investment program, the syndicator needs to adequately address each of these market-related risk factors. The syndicator's analysis of these risks needs to be sufficient to address the initial *fear of loss* common to most individuals who consider a major financial move.

These market risks are the latent economic concerns of any rational investor. If not addressed by the syndicator, the typical candidate for group investment is probably unable or unwilling to ask questions on their own about real estate. Thus, an investor's gut reaction toward the investment will remain apprehensive, most likely barring a commitment to contribute as a co-owner.

Justifying the price and down payment

The first marketplace question that comes to the mind of every investor is whether the **purchase price** to be paid for the property is a proper amount that is compatible with their long-term investment objectives.

The syndicator needs to provide evidence the price is *below-market* if they are to entice investors to look further into the investment's profitability on a later resale of the property. An **appraisal report** prepared by a credentialed and licensed appraiser stating the property's fair market value (FMV) at a dollar amount greater than the price the syndicator has agreed to pay for the property is a significant advantage.

Logical explanations as to *why* a seller accepts a below-market price include:

- the lack of a brokerage fee (typically 6%) on the transaction;
- a price based on earlier sales (or an option acquired by the syndicator) at lesser prices when prices are trending upward; or
- a price reduction that was vigorously pursued by the syndicator through offers, counteroffers and inducements of a substantial down payment or cooperation in meeting the seller's tax goals.

A direct comparison by the syndicator to a recent sale on similar terms of a *comparable property* located in the immediate vicinity of the syndicated property provides evidence of good value in the syndicated property.

Since nearly all of the cash funds contributed by investors are going towards the **down payment**, an investor's instinct to avoid being "ripped off" is satisfied. The remainder of the cash funds, after a small amount is disbursed to the syndicator for their LLC organizational efforts and out-of-pocket costs, are held as **reserve funds**. This way, the investor reduces their innate concerns about creating a moral risk of a loss by a diversion to the syndicator of funds borrowed or contributed to the investment and not used to pay the purchase price.

The investor, aware of the percentage of ownership the syndicator is receiving, does not want to also pay the syndicator cash to help them acquire that ownership interest when the syndicator's percentage of ownership already dilutes the earning power of the down payment contributed by the investor.

Also, the greater the amount of the down payment as a percentage of the price, the less the risk of loss on the investment and the greater the amount of spendable income as a cushion against rental market failure during a recession. Further, a lender originating a mortgage with a lower loan-to-value (LTV) ratio offers better rates and payment schedules as the lender's risk of loss is also reduced due to the larger down payment.

Return of contributions on a resale

After a syndicator confirms the present worth of the property is equal to or greater than the investor's cash savings being transferred to the real estate investment (and the mortgage amount), the investor needs assurance the funds will be returned on a sale of the property.

Thus, the investor needs to be shown that **market trends** will support the original cash investment — and likely result in an increase in its value over the long term. To do so, a syndicator offers their **opinion of value** and expectations about future market trends, movements in property values and the availability of future buyers willing to purchase the property, as long as the syndicator has a reasonable basis for their opinion.

Documentation showing the direction of sales volume and prices of comparable properties during the six-month period preceding the purchase helps to demonstrate the trajectory of prices. Given the constant recurrence of business cycles and their effect on the volatility of real estate sales and prices, the syndicator can then rationally demonstrate what they believe will occur regarding an increase (or decrease) in the future willingness of buyers to buy, and the likelihood of a respective rise (or fall) in rents and prices.

Think long-term, as with a collectible

It is necessary to remind investors that the key to successful real estate investment is **long-term ownership**. To cash out on a resale of the property, the syndicate needs to wait for a peak in prices during a booming business cycle (accompanied by a profit for having acquired property at the right price following the end of a recessionary period).

The benefit of **monetary inflation** driving up nominal property values is recovered over time as the "hedge" in real estate ownership. Also taken over time are the additional profits from **property appreciation** brought about by growth in the local population and their wages.

These national monetary policies (inflation) and local demographic trends (population) drive up rental income over the period of a business cycle. With rising rents, the value of the property increases by a corresponding percentage if the capitalization rate (cap rate) for setting property values remains the same and operating costs do not rise faster than the rate of inflation.

An investor's fear of loss is best alleviated if the price paid for the property is less than the fair market value (FMV) of the property by at least the amount of the brokerage fees avoided on the purchase. Thus, if the property were to be immediately resold, the sale would generate net sales proceeds sufficient to return all the investors' funds — after payment of a full brokerage fee.

Purchase-assist mortgage financing

An investor's background experience with mortgages aids in the syndicator's persuasion inducing them to subscribe to an investment. However, the syndicator needs to explain why the rate of interest agreed to for purchase-assist financing is good for the investor's future ownership.

Investors need to be advised on the critical aspects of the purchase-assist financing, including:

- why a loan was arranged with a particular lender versus another; and
- what fees, charges and yield spread premium (YSP) the syndicator successfully avoided by negotiating the loan directly with the lender at the **par rate**.

Alternatively, if the interest rate is above the *par rate* at the time the mortgage is originated, the *spendable income* resulting from the investment is reduced — an unnecessary shift in wealth to lenders and loan brokers.

Further, when unnecessary loan fees, charges and YSPs are paid to a loan broker to negotiate the loan in lieu of direct lender negotiations by the syndicator, the amounts of both the debt underlying the down payment and the cash disbursed to others outside the investment group are inflated.

Here, the earning power of the invested cash is diluted and the risk of loss is greater than it needs to be.

Whether a *fixed rate mortgage* (FRM) or an *adjustable rate mortgage* (ARM), the rate on the mortgage financing needs to be no greater than the current rate charged by lenders in the secondary mortgage market, loan origination charges being at market rates.

Property values, and therefore prices, are inextricably linked to interest rates on mortgages. As mortgage rates rise or fall, the market value of all real estate moves in the opposite direction. This effect is comparable to the inverse movement of rates and pricing in the bond market, but with a delay when rates increase due to the stickiness of seller pricing of real estate (which dramatically reduces sales volume for up to 12 months for failure of prompt adjustment in price to the rise in mortgage rates).

Further, the type of interest rate selected to finance the acquisition has an impact on:

- the future worth of a property;
- the amount of spendable income remaining after monthly mortgage payments are made to the lender; and
- the ability of the LLC to retain ownership.

Fixed rate mortgages as manageable debt

As real estate prices trend downward due to a rise in fixed rates on purchase-assist loans, lenders and sellers duel in a trade-off for the dollars paid by the buyer for property. As interest rates rise, prospective investors acquiring income-producing property insist on an increased **rate of return** (cap rate) on their cash invested in the property (after the payment of operating costs and interest on the mortgage).

During these periods of rising interest rates, *cash is king,* as the saying goes.

Operating expenses are difficult to reduce and rents are unlikely to be substantially raised on acquisition of a property. Also, older investors will not likely invest in an income-producing property without an annual cash return from spendable income. This annual cash-on-cash return to investors is paid from the **net operating income (NOI)** which remains after mortgage payments have been made.

net operating income (NOI)
The net revenue generated by an income producing property, calculated as the sum of a property's gross operating income less the property's operating expenses and used to determine a property's value and pay mortgage debt. [See **ft** Form 352 §4]

When interest rates increase for new FRMs, a reduction takes place in the amount of mortgage money the property can carry. In turn, this also reduces the amount of mortgage money a syndicator can borrow to fund a purchase. Rises in cap rates keep property values down, if not reducing them.

Mortgage amounts are based on the NOI generated by a property. NOI is used to set the property's value for applying an LTV ratio and as the primary source for making interest and principal payments. The resulting loan amount (which is lower as interest rates rise), plus the down payment, establishes the maximum price a prudent syndicator will pay for a property, without concern for the price asked by the seller.

Lenders' real rate of interest

Over the next two or three decades, lenders will charge higher rates from time to time on new originations of mortgages and existing ARMs to cover their increasing cost of funds or widen their profit margins. Thus, the owner's property loses dollar value in a compensating amount.

This lost property value represents the present worth of the increase in consumer inflation or the *real rate of interest* earned by lenders. Thus, a shift in wealth from the owner to the new lender occurs during periods of rising rates — if the owner chooses to sell. Remember, capitalization rates rise and fall in sympathy with changes in mortgage rates.

Accordingly, prospective investors experience no short-term benefits from the reduced price for the property acquired. Likewise, for buyers there is no harm from the increased interest rates paid on the purchase-assist mortgage which helps fund the reduced price paid for the property. The LTV for mortgages remain the same as do the *debt-to-income (DTI)* ratios applied by the lenders. The price paid is the equalizer for the investor covering an increased mortgage rate.

Consider the fact that investors cannot lower and the seller cannot raise the price paid for the property once the purchase escrow has closed. Further, the lender funding an FRM cannot increase the principal balance or the rate of interest agreed to by the investors. Not so for ARM financing.

Adjustable rate mortgages

Using an ARM loan to finance a syndicated property complicates the syndicator's disclosures when advising investors on the adverse effects of ARM mortgage financing.

The syndicator will not be able to demonstrate that the ARM loan was selected by claiming the **note rate** on the ARM, being variable, will most likely decline in the future. Interest rates, particularly short-term rates used for ARM adjustments, will not go down during the foreseeable future of a real estate investment.

note rate
The interest rate agreed to between the buyer and the lender on a promissory note. Contrast with real interest rate.

Also, the ARM *note rate* is always greater than the initial teaser rate. Thus, by taking on an ARM, the syndicator is gambling the note rate will not drift higher. Further, it is economically problematic that rents, though likely due to consumer inflation, will rise sufficiently to cover payments at increasing ARM rates.

ARMs and short-term rates

ARMs are tied to an index of **short-term rates**, not long-term rates. *Short-term rates* are increased by the Federal Reserve (the Fed) to fight inflation, provide room for interest rate reductions when the next recession arrives and prevent present overheating of the economy. In doing so, the Fed causes ARM rates to rise and the domestic economy to slow with a parallel reduction in real estate sales volume, placing the nation in an informal and routine business recession.

Conversely, the Fed drops short-term rates to allow the economy to pick up through increased employment which spurs demand and in turn the production of more goods and services. All this activity generates more real estate sales and rental occupancy.

As short-term rates drop, so do ARM rates, eventually reducing the dollar amount of monthly ARM payments and producing more spendable income (or reducing the negative cash flow). Lowering short-term rates to or below inflation rates triggers increased sales volume and later prices.

When ARM financing is employed to fund the purchase of an income-producing investment property, the ARM eventually needs to be refinanced, replaced with an FRM to provide greater financial stability for the duration of the group ownership.

Analysis of operating costs

Operating costs incurred during the ownership of an income-producing property are generally not of concern to the typical passive investor in syndication. No formulas, rules of thumb or guidance exist for syndicate investors (or anyone else) to apply to expenses to make a quick analysis of value — just look at the wild variations of pricing in the *real estate investment trust* (REIT) stock market.

Further complicating an analysis of operating costs, each property is unique. Expenses for repair, maintenance and ongoing general care vary hugely from property to property, and owner to owner. Determining a property's operating costs is best understood by preparing a structural engineer's report or completing a due diligence investigation of the property. [See **first tuesday** Form 352]

However, if operating costs are temporarily increased to cure **deferred maintenance** and **accumulated obsolescence** or amenities, these costs are of great interest to investors as they benefit investors. The end result of curing deferred maintenance is increased value to the property through an increase in rents due to the one-time set of expenditures.

A one-time increase in operating costs on a newly acquired property to eliminate deferred maintenance, increase or upgrade tenant security or add facilities and amenities to keep and attract a better class of tenants generates increased rents.

In addition to reducing the investors' risk of loss, these activities tend to increase the NOI, and thus the spendable income distributions the investors will receive. Without a change in cap rates, the property's value will increase by the same percentage as the increase in NOI resulting from the enhancement of the property.

Raising below-market rents

Occasionally, rents are below-market and can be raised without significant change in the occupancy rate or operating costs. Here, a reasonable plan for executing any rent increases proposed in the IC needs to be prepared and presented to the investors for review before investing. [See **first tuesday** Form 371; see Chapter 20]

A detailed plan is especially necessary if scheduled income is forecast based on rents that are anticipated to be greater than the rents tenants currently pay. Some units will be on leases with rents that cannot be altered until expiration of the leases, thus interfering with the timing of the increases. Others are under rental agreements or expired leases that allow for increases after service of appropriate 30- or 60-day notices. Further complicating matters is the specter of *rent control* properties. [See **first tuesday** Form 570 and 574]

A timetable of rental increases needs to be prepared on a spreadsheet and presented to the investors. The time table lists:

- each unit;
- when and how much each tenant currently pays in rent; and
- the rent amount the tenant will be required to pay in the future. [See **first tuesday** Form 352-1]

Distributions based on priority returns

Consider a syndicator who enters into a purchase agreement as the named buyer and confirms the property's suitability for acquisition. The syndicator then places a dollar value of $100,000 on the assignment of their right to purchase the property to the LLC. [See **first tuesday** Form 370]

The valuation of a syndicator's assignment often represents roughly 6% of the present fair market value of the property, comparable to a brokerage fee in any other sale of the property. If the syndicator were to sell and transfer their contract right to purchase the property to another substitute buyer, that buyer will need to pay $100,000 for the syndicator's position. This amount is in addition to the price to be paid to the seller as agreed in the purchase agreement.

The price paid under the purchase agreement calls for a down payment of $250,000, approximately 17% of the purchase price. The syndicator intends to fund the down payment by raising $60,000 from each of five investors, a total of $300,000 in cash.

The $50,000 in surplus cash will provide funds for a $10,000 fee to be paid to the syndicator as compensation for organizing the investment group and $40,000 to be held by the LLC as **cash reserves** and additional working capital.

The syndicator will not be paid cash for assigning their contract rights under the purchase agreement to acquire the property. Instead, they will receive a $100,000 Class B interest in the LLC as a co-owner with the cash investors, who are Class A members.

Thus, the combined amount of all capital contributions ($400,000), comprising the cash raised from the investors ($300,000) and the value set for the assignment of the syndicator's purchase rights ($100,000), represents 100% of the capital contributions to the LLC.

Each co-owner's percentage **share of earnings** from rents and sale of the property is initially set as the percentage their contribution represents of the total dollar amount of all forms of contributions made by all co-owners, both Class A and Class B.

Thus, the investors will collectively hold a 75% co-ownership interest in the LLC as Class A members for their $300,000 cash investment. The syndicator will hold a 25% co-ownership interest as a Class B member for their contribution of their right to buy the property.

Initial parity distribution of funds unfair

Cash investors do not typically consider the syndicator's contribution of their purchase rights as equivalent to their after-tax cash contributions. Investors generally consider a syndicator's efforts as promotional, illiquid and untaxed since acquisition and organizational interests held by the syndicator have not been reduced to cash by a resale of the property.

Without restrictions imposed on the syndicator's share, LLC members will share earnings from spendable income and the proceeds of a sale (or refinance) equally. This is referred to as a **parity distribution** of funds.

parity distribution
An equal sharing between all members in a limited liability company (LLC) of earnings in the form of spendable income and proceeds of a sale or refinance.

Parity (equality) among all co-owners places the cash investors and the syndicator on identical footing. Thus, the investors' funds are in eminent danger of a partial loss if the property does not resell for a price exceeding roughly 10% more than the price the group paid for the property.

When sharing spendable income and sale proceeds, priority for the claim of cash investors as *Class A members* over the syndicator's claims as a *Class B member* needs to be a condition of the sharing arrangements. If not, it is unlikely the syndicator will attract investors since they may doubt the likelihood their cash investment will be returned.

Further, there is the moral risk created by parity allowing the syndicator to share no matter what happens to the property's value.

Front-end earnings for the syndicator's sake

Arguably, a syndicator's assignment of their contract right to purchase the property has a present cash value equal to the dollar amount of the membership interest they will receive in exchange.

Typically, the valuation of the syndicator's ownership interest is either:

- equal to a cash fee a seller's broker would receive on a sale of the property; or
- the difference between the reasonable fair market value of the property and the lesser price paid for the property.

Instinctively, investors hold feelings that the syndicator's participation on a parity basis (or for a sales fee as their agent) leaves the syndicator with *significantly reduced* incentives to properly structure the acquisition and manage the property.

Instead, the syndicator properly receives a fully subordinated share of earnings, redeemable when the property is sold at a profit.

If the syndicator receives an ownership interest with a participation in earnings equal to the cash investors' earnings, the syndicator has less motivation to:

- make the best selection of property and acquire it on the most advantageous financial terms;
- pay constant attention to the management of the property and tenants; and
- pick the most strategically beneficial time to sell the property at the maximum market value.

Shifting the risk of loss

To shift the risk of loss posed by the potential failure of the syndicator's motivation, the syndicator's interest needs to be *subordinated* to those of the investors to eliminate the unfair treatment resulting from parity distributions.

When subordinated, the syndicator first shoulders the **risk of loss** if the property does not live up to cash flow expectations. Further, the stated dollar value the syndicator's Class B membership will not be achieved on a resale if the property does not increase in value. When the syndicator acts to protect the value of their Class B interest in the investment, their own self-interest automatically provides protection for the financial interests of the investors in the property as well.

However, the syndicator's receipt of a cash fee in a small amount from the funds contributed by the investors on acquisition of the property is appropriate. Here, the syndicator has incurred operating overhead and personal expenses, and has organized and created the investment group, activities beyond the efforts to acquire the property.

A real estate broker in the business of creating investment groups to acquire property in which the broker takes an ownership position will soon be insolvent unless they generate cash during their first three or four years syndicating properties.

Services rendered in organizational efforts to form a group are separate from the efforts involved locating property, negotiating the purchase contract, and arranging to close escrow. Thus, the syndicator logically merits a cash fee for the organizational services rendered to the LLC and investors prior to closing.

Payment of monthly management fees

The payment of **management fees** to a syndicator is a proper diversion of a portion of the rental income to the syndicator. The syndicator's *management fees* are earned in the course of:

- managing the leasing of the property;
- overseeing the ongoing care and maintenance of the property; and
- rendering the services commonly expected by tenants to keep the property competitive and marketable.

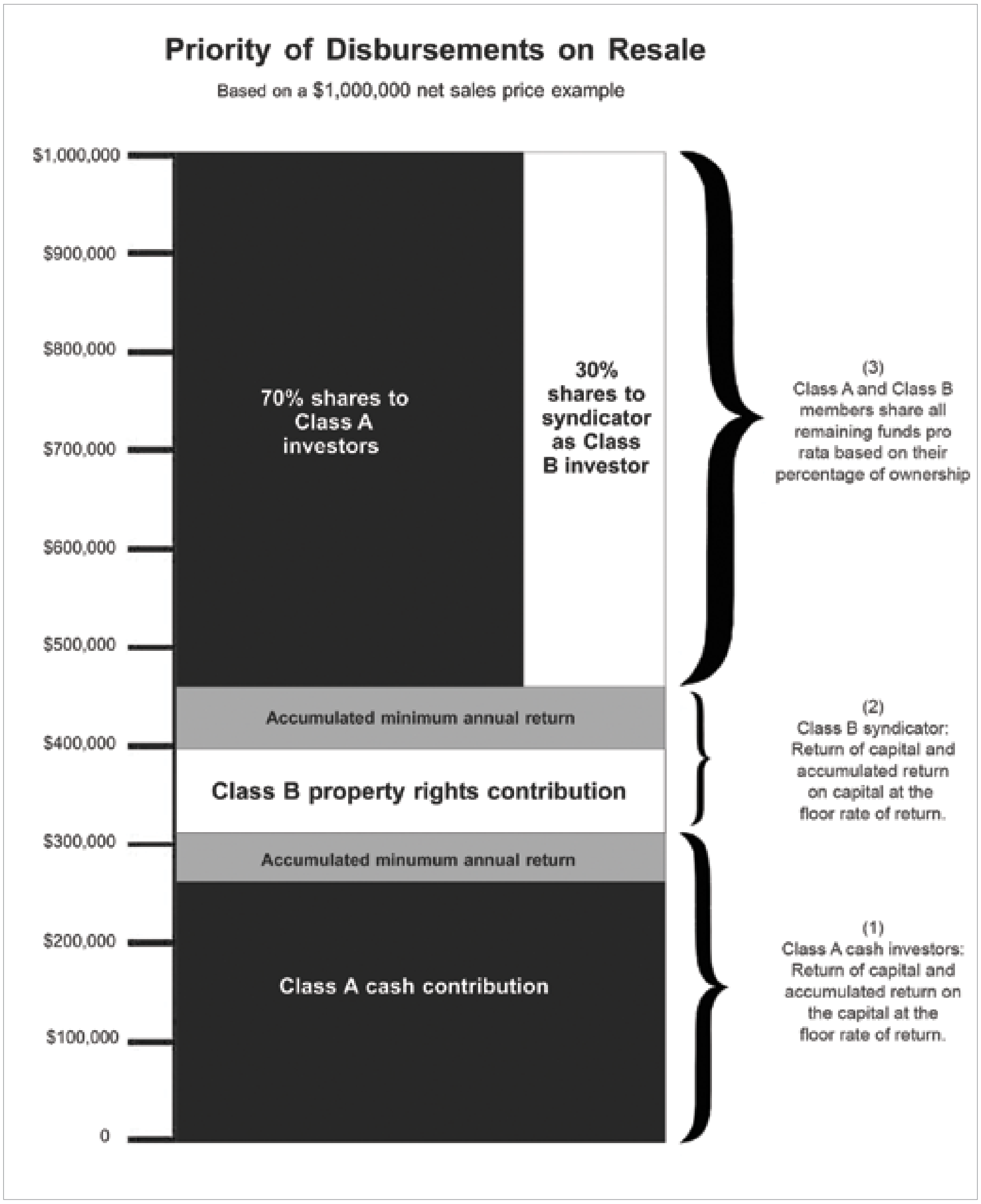


Figure 1

Priority of Disbursements on Resale

These management fees are necessary and proper, comparable to the payment of other operating expenses. A broker, other than the syndicator, with expertise in property management would otherwise be employed to manage the operations of the property, for which a fee would be paid.

Justification of fair and reasonable

In order for the syndicator who manages the property to legitimize the amount of their management fee, they need to show the fee is **fair and reasonable**. Justification is required as the syndicator has literally hired themselves to manage the property (and set the fee they will receive for doing so).

Further, the payment of a management fee before a return is distributed to investors has economic justification. The cost of supplies, labor and management are paid from income (rents) as expenses of ownership before funds remain for disbursement to the co-owners as spendable income (a *return of capital*, dividends, etc.).

As further justification, the syndicator who receives a management fee does not receive any portion of the spendable income for being a co-owner until the investors have first received a **minimum annual rate of return** on their invested capital. Only if distributable funds remain after priority disbursements to the investors can the syndicator share as a subordinated co-owner. [See Figure 1 accompanying this chapter]

Distributions to all during ownership

Typically, and the result of priority distributions, the minimum rate for the investor's primary annual yield on the capital invested is *cumulative*. If spendable income generated each year is not available for disbursement in the full amount of the minimum annual rate of return on investment, the unpaid amount accumulates. The unpaid accumulation will receive priority disbursement in later years when funds from any source become available for distribution.

After spendable income has been disbursed at the minimum rate of return to both the priority (Class A) and subordinated (Class B) co-owners, any spendable income remaining is distributed on a parity basis between all co-owners, Class A and B, disbursed without concern for priorities. [See Chapter 8]

Occasionally, a **ceiling rate of return** is set for the total annual participation in the spendable income by cash investors (Class A members). When a ceiling exists on earnings that limit their annual return from rents, the balance of spendable income is distributed to the syndicator under their Class B membership (never as a management fee which results in an adverse tax result).

The nature of the cash investors' Class A participation when a ceiling is placed on annual and lifetime returns is similar to the ownership of cumulative *preferred stock* issued by a corporate entity. The investors receive an annual rate of return. Any remaining earnings go to the common stockholders, represented here by the syndicator's subordinated Class B ownership interest in the LLC.

Further, the syndicator's rights often include **buy-out provisions** granting them options to acquire the Class A members' interests, or the property itself. [See Chapter 18]

Distribution of proceeds from a refinance or a sale

When the equity in a property is cashed out, in part or entirely, by a refinance or sale of the property, the net proceeds represent a **return of capital** to the co-owners. Funds from a refinance or sale are not operating income generated from rents. Any fees paid to a syndicator who acts as a loan broker in arranging a refinance or further encumbrance of the property, or negotiating the sale as a broker, is a proper diversion of proceeds that initially belong to all co-owners.

As always, the fee for brokerage activities received by the syndicator needs to be justified as both *necessary* and *reasonable* in amount. Here, the nature of the brokerage services provided are shown as necessary to the operation of the property. Further, the amount of the fee is shown as competitive and comparable to fees charged by other brokers who provide comparable services in the local market.

The net proceeds from a refinance or a sale, being a **return of capital**, are first disbursed to the cash investors as Class A members. The cash investors receive an amount equal to:

- their original cash investment; **plus**
- a minimum annual rate of return; **less**
- any amounts previously disbursed to them from any source, such as spendable income or the net proceeds of a prior refinance or sale of a portion of the property.

Remaining proceeds

Any proceeds remaining after the priority distributions to the cash investors are next disbursed to the syndicator. The syndicator receives:

- the dollar amount set as the value of their Class B ownership interest received in exchange for the assignment of their purchase rights; **plus**
- their minimum annual rate of return; **less**
- any amounts disbursed to the syndicator as a co-owner (not for service as a manager) from spendable income and net proceeds of a prior refinance or sale of a portion of the property. [See Chapter 18]

After all priority and subordinated co-owners have received a return of their original investment and the minimum annual floor rate of return on that investment, the remaining net proceeds are distributed to all co-owners on a parity basis, usually based on their percentage of ownership.

However, members may agree to a different ratio for sharing the remaining funds between Class A and Class B members, for example, 50% to Class A members and 50% to Class B members.

Occasionally, the parity claims of the investors are limited to their original investment and a maximum annual rate of return from all sources. Thus, the syndicator receives all sales proceeds remaining in excess of this maximum-ceiling annual rate of return for the cash investors.

Chapter 4 Summary

To analyze the risk of loss when investing capital, a prudent investor begins by judging the capabilities and competence of the syndicator organizing the group investment. Thus, a syndicator needs to be able to present evidence of themselves as a manager able to navigate the difficult stages of an investment program and emerge successful at the end.

Selecting the ideal time to select and buy property to assure a profit on its resale is a necessity. In timing acquisitions for long-term investment, the syndicator takes advantage of the temporary dearth of buyers in the marketplace at the time sales volume begins to increase but before prices start to pick back up again. This is typically a 12-to-18 month window period that occurs long after the current cycle's recession has ended.

Equity financing provided by cash investors is primarily meant to fund the purchase of property, not compensate the syndicator for their acquisition activities. Instead, the syndicator receives an ownership participation in the LLC for these pre-syndication efforts. However, the syndicator needs a reasonable fee for their organizational time and effort spent performing syndication activities.

To shift the risk of loss posed by the potential failure of the syndicator's motivation, the syndicator's interest needs to be subordinated to those of the investors to eliminate the unfair treatment resulting from parity distributions.

When subordinated, the syndicator first shoulders the risk of loss if the property does not live up to cash flow expectations. Further, the stated dollar value the syndicator's Class B membership will not be achieved on a resale if the property does not increase in value. When the syndicator acts to protect the value of their Class B interest in the investment, their own self-interest automatically provides protection for the financial interests of the investors in the property as well.

Chapter 4 Key Terms

equity financing .... **pg. 31**
net operating income (NOI) .... **pg. 35**
note rate .... **pg. 36**
parity distribution .... **pg. 39**
watered stock .... **pg. 29**

Chapter 5

The syndicator's professional services

Learning Objectives

After reading this chapter, you will be able to:

- understand how a broker license issued by the California Bureau of Real Estate (CalBRE) lends credibility and stature to a syndicator's investment program;
- effectively use a real estate broker's license to render professional services for a fee as a syndicator and manager of real estate; and
- appreciate the need for personal accomplishments and credentials a syndicator needs to possess to exhibit to investors a greater probability of success in an investment.

Key Terms

errors and omissions (E&O) insurance

investment circular (IC)

operating agreement

Licensing as a legitimizing force

Consider a licensed real estate broker who has been earning a decent living from the fees earned handling the sale of income-producing properties and the purchase of developable land for builders.

However, the broker's **net wealth** is minimal, consisting only of their home, two cars and a duplex. The broker acquired these assets with little or no down payment. Thus, all the broker's assets are encumbered with manageable debt. The broker has an excellent credit rating, maintains a minimal amount of consumer debt and has modest cash reserves.

The broker is concerned about building the future *net worth* needed to attain a better quality of living and a higher civic status. To accomplish these personal financial objectives, the broker needs to supplement the rate of fees presently earned. The broker determines this can be done by acquiring ownership of income-producing properties.

Being constantly exposed to income properties that come onto the market for sale, the broker begins to consider the possibility of owning and operating some of these properties for the broker's own account. To achieve this goal, the broker will initially need to co-own any income property with a group of investors who will put up all the cash needed to cover the costs of acquisition.

The broker is very experienced at locating property, conducting due diligence investigations and contracting for the acquisition of property. Rather than receiving a brokerage fee for locating and working up a package on a property for a client, the broker intends to act as a principal and acquire a percentage of ownership *in* a property in co-ownership with one or more investors who will provide all the cash.

Also, as an economic necessity, the investors will contribute enough funds to pay a modest front-end fee for the broker's efforts spent soliciting the investors and forming a limited liability company (LLC) to own the property.

The brokers acts as property manager

The broker will be designated as the manager — chief operating officer (CEO) — of the LLC. After acquiring a property vested in the name of the LLC, the broker will be the **property manager**. As the *property manager*, the broker will:

- oversee on-site resident managers;
- coordinate the solicitation of tenants;
- negotiate leasing arrangements; and
- arrange for the care and maintenance required to protect and improve the value of the property. [See Chapter 4]

The amount of the management fee will be based on a percentage of the **gross rental income** produced by the property. Thus, the broker has an incentive to attain the highest possible rents for the property. The greater the amount of rents, the greater the amount of management fees the broker will receive (and the more valuable the property will be).

As a co-owner, the broker will share in the **spendable income** produced by the property. If everything goes as planned, the value of the broker's **percentage ownership interest** will likely inflate and appreciate over time, similar to the interests of the cash investors.

During the tenure of the LLC's ownership of the property, the broker will receive fees for *brokerage services* rendered if the property is refinanced or sold, or if a co-owner decides to resell their fractional ownership interest. All these activities are fee-generating events.

Syndicating to build net worth

With this plan in place, the broker sees a way to accomplish both of their personal objectives in one activity: syndication for the acquisition of an ownership interest in income property with cash investors. Through the syndication of income-producing property, the broker will correspondingly build net worth and receive additional flows of income from fees for management services and distributions of spendable income.

Is it permissible for a broker, acting as a syndicator, to receive contingency or percentage-based fees for rendering real estate brokerage services to a group of co-owners when the broker becomes a co-owner of the property acquired, operated and eventually sold?

Yes! To do so, the syndicator needs to hold a valid real estate broker license issued by the California Bureau of Real Estate (CalBRE). A licensed broker acting as an asset manager on behalf of the co-owners or the LLC may charge fees that are **based on a percentage** and **contingent** on:

- the rents collected;
- the price received on a resale of the property; or
- the amount of any mortgage arranged.

As a co-owner who is a broker, the syndicator is not restricted to a salary or a fixed dollar amount paid periodically as compensation without regard to the amount of rents collected, mortgage principal or resale price.[1]

However, fees the syndicator expects to receive as payment for future services need to be agreed to in the LLC **operating agreement** and a written management agreement. These agreements are entered into when forming the LLC and disclosed in the **investment circular (IC)**. Here, a separate listing agreement is not used and is not needed for the syndicator to be entitled to fees. [See **first tuesday** Form 372]

Further, any compensation the broker will receive, whether acting as a principal in ownership or as a broker rendering services for the LLC, needs to be disclosed in the *IC* prepared to solicit investors. [See **first tuesday** Form 371; see Chapter 20 and 21]

An unlicensed person may manage the investment property for the co-owners with compensation based on a fixed monthly fee or salary. However, the *unlicensed manager* may not receive **incentive-based compensation**, such as a percentage-based fee tied to:

- the amount of rent collected;
- an occupancy rate;
- minimum spendable income; or
- other production-based formula.[2]

operating agreement
A form used by syndicators when setting up a limited liability company (LLC) to establish the procedures for operating the LLC and the rights and duties of its members. [See **ft** Form 372]

investment circular (IC)
A disclosure prepared by a syndicator and presented to potential investors explaining the nature of the investment program, significant features of the property selected for acquisition and the risks and financial consequences of the group investment, also known as a prospectus or memorandum. [See **ft** Form 371]

1 California Business and Professions Code §10131

2 Calif. Bus & P C §10133(a)(1)

The advantages of being licensed

A real estate broker syndicating group investments needs to analyze the long-term role syndication will play in their professional career. For brokers, syndication is a source of **mixed income**:

- part of their income will come from the wealth in ownership of fractional interests in real estate; and
- part of their income will come from fees for brokerage services rendered.

The broker negotiating the purchase of property and soliciting investors experiences an indirect benefit for having earned a license and the right to conduct business as a broker. They will be viewed by investors as having achieved the necessary credentials to make them capable of managing syndication.

Experience as a licensed professional

Members of the public who have accumulated cash savings and are considering investing generally understand that a person licensed as a broker has a high degree of experience in the real estate business and proven longevity. They presume the broker has attained an advanced level of technical training and education to qualify for a broker license — as they have.

When a prospective investor is solicited by a broker to participate in the co-ownership of an income-producing property, the investor also presumes the broker as a **licensed professional** has experience working with fellow licensees:

- locating property;
- negotiating purchase agreements;
- arranging financing and leasing; and
- managing property.

These points of expertise are frequently taken for granted as being part of the qualifications requisite to becoming a licensed broker. More germane, they are critical to successful syndication.

The silent power of a license

A broker has something tangible to lose if they are incompetent — or worse — fraudulent in their representation of the values and attributes of property.

A broker's exposure to loss of their license for improper conduct greatly reduces the investors' risk of the **moral hazard** of investing with a syndicator who does not invest their own cash and would not otherwise suffer if the investment fails for known, readily discoverable or avoidable defects.

errors and omissions (E&O) insurance
An insurance policy covering claims made on a broker or agent due to their negligence and the defense of those claims.

Further, prudent brokers carry professional *malpractice insurance*, called **errors and omissions (E&O) insurance**. Coverage for negligent misrepresentations, available to licensed broker syndicators, further places the investors' mind at ease about the integrity of the syndicator and the mitigation of risk. [See Chapter 4]

The *E&O* coverage provides a source of recovery beyond the investment if the investment is ill-fated for reasons of negligence in conducting:

- a due diligence investigation;
- providing management services; or
- tending to the care and protection of the property.

Holding a license also authorizes the broker to receive fees disbursed from the investors' initial contribution of capital, rental income, proceeds from the refinance or resale of the property, and for the professional services the broker provides.

Fulfilling expectations

The syndicator's task then is to live up to the **investors' expectations** by:

- negotiating the most advantageous price and terms for payment of the purchase price that are possible for the acquisition of income-producing property;
- fully analyzing the property and documenting every aspect of a competent due diligence investigation;
- preparing a thorough representation of the advantages and disadvantages of the property that affect its value for investor review; and
- having the prior management experience needed to operate the property as a reasonably well-informed and prudent owner would.

For a syndicator, a broker license lends credibility and stature to their investment program.

A capable syndicator

To successfully engage in the activities of a syndicator, a broker needs to have the proper aptitude and experience. Fundamentally, this includes the ability to select suitable property for the right *price*, on the right *terms*, at the right *time* and in the right *location*. However, more specialized capabilities are needed, such as the ability to:

- enter into purchase agreements;
- conduct a due diligence investigation and analysis of a property;
- arrange purchase-assist financing;
- determine the proper vesting for title;
- manage the landlord-tenant relationship;
- preserve the property's value by repair, maintenance and replacements; and
- account for income, expenses and mortgage payments.

Properly honed, the composite of these abilities represents an **expertise** sufficient to cope with the foreseeable challenges presented by the group ownership of income-producing real estate. The broker possessing these qualities demonstrates they are qualified to manage a real estate investment program either individually or for a group.

Without a background of education, training and experience in each the acquisition, financing, ownership and disposition of income property, a broker is not fully qualified to lead a group of unsophisticated investors into the co-ownership of income-producing real estate.

A local track record of achievements

The **personal achievements** of a syndicator also lend much credence to their syndication efforts.

Investors sense a greater probability of success in an investment selected and managed by an accomplished individual — one they perceive to have power — when their personal credentials include:

- at least three years' experience as a property manager, operating their own income-producing properties or managing properties on behalf of others;
- at least three years' experience as an appraiser or as a broker providing informed opinions of value;
- creditworthiness and lender confidence sufficient to qualify for loans themselves without relying on a co-signer or guarantor;
- cash reserves for emergencies, separate from funds used for investment;
- accumulated wealth, preferably in the form of equities in real estate;
- community service, such as involvement in civic affairs, both social and political;
- longevity of family as residence in the community;
- higher education and studies in real estate and business;
- licensing in related trades, such as real estate, construction, appraisal, and lending;
- personal accomplishments of notable merit; and
- existing income from sources other than up-front fees for the current syndication of property.

Chapter 5 Summary

Through the syndication of income-producing property, the broker will correspondingly build net worth and receive additional flows of income from fees for management services and distributions of spendable income.

For brokers, syndication is a source of mixed income:

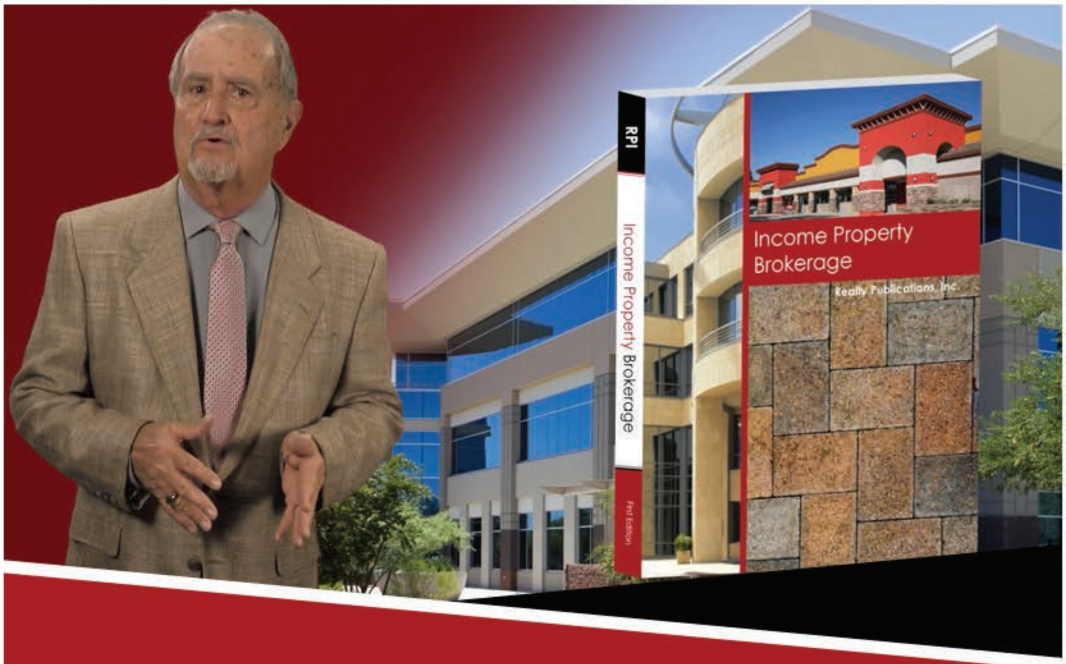
- part of their income will come from the wealth in ownership of fractional interests in real estate; and
- part of their income will come from fees for brokerage services rendered.

The broker negotiating the purchase of property and soliciting investors experiences an indirect benefit for having earned a license and the right to conduct business as a broker. They will be viewed by investors as having achieved the necessary credentials to make them capable of managing syndication.

Further, prudent brokers carry professional malpractice insurance, called errors and omissions (E&O) insurance. Coverage for negligent misrepresentations, available to licensed broker syndicators, further places the investors' mind at ease about the integrity of the syndicator and the mitigation of risk.

Chapter 5 Key Terms

errors and omissions (E&O) insurance ....**pg. 48**
investment circular (IC) ....**pg. 47**
operating agreement ....**pg. 47**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Chapter 6

Retaining a real estate attorney

Learning Objectives

After reading this chapter, you will be able to:

- locate, interview and retain an attorney to advise and render services in real estate disputes confronting syndicators; and
- anticipate what to expect when retaining a competent attorney.

Key Terms

initial conference **retainer agreement**

Choosing the right one

Oftentimes in syndication activities, it is necessary or advisable for the syndicator, the investors or the LLC as a group to seek the legal counsel of an **attorney**.

Consider a syndicator faced with a dispute arising out of their activities as a manger of a real estate syndicate. The syndicator requires advice from an *attorney* with legal expertise in the analysis and resolution of real estate management conflicts.

The syndicator has never sought out the professional advice of an attorney and does not know how to locate or select a qualified one.

Continue reading for a discussion of:

- what steps the syndicator takes to select a competent attorney to provide legal services;
- what law office attributes and procedures are to be considered by the syndicator when first meeting with an attorney; and
- what the syndicator can rationally expect to encounter when retaining a competent attorney.

Selecting an attorney

To initiate the attorney *selection process*, the syndicator first talks to several experienced real estate syndicators in the area where the subject real estate is located. The syndicators are solicited for the names of three or four real estate attorneys they have worked with and feel confident referring someone to for advice on real estate and agency matters similar to those confronting the syndicator.

The syndicator also inquires into the:

- different areas of real estate law each referenced attorney is engaged in;
- types of cases the attorneys handle; and
- competence demonstrated by the attorneys as observed by the solicited syndicators.

The recurrence of the name of one attorney who is *consistently recommended* by the syndicators contacted is generally a reliable indication of a more qualified attorney.

While **attorney referral services** and **media advertising** may be helpful in the initial selection stage, it is difficult to obtain objective recommendations or criticism from these typically biased sources.

It may even be necessary to locate an out-of-area attorney who specializes in the particular type of legal situation confronting the syndicator due to the sensitivity of local attorneys.

Regardless of locale, at least two or more attorneys are to be selected, with phone or office conferences arranged with each.

Before and after selecting an attorney, it is prudent for the syndicator to contact yet another attorney and hold a telephone conference as a "brainstorming session." This would provide a second opinion — and an additional or alternative advisor if the first attorney selected is determined to be unsuitable. The cost of conferencing with another attorney becomes a premium paid for the assurance the syndicator and the attorney they ultimately selected are on the right track, called **risk reduction**.

A syndicator's expectations

When meeting with an attorney, the syndicator considers many aspects of the attorney's law office and practice, including:

- the compatibility of the attorney's personality with the syndicator's;
- the efficiency and professionalism of the attorney's work habits;
- the law office's appearance and whether it appears to be well organized and adequately equipped;
- the attorney's conversational skills;
- the courtesy, productivity and helpfulness of the secretarial and office staff;
- how quickly and thoroughly the attorney or staff return phone calls and emails from the syndicator; and

Sidebar

Real Estate Attorney Database

*The **first tuesday Real Estate Attorney Database** is a community-generated list of California attorneys who specialize in real estate law. Use the Real Estate Attorney Database to recommend an attorney or use the database to find a real estate attorney in your area by going to:*

http://journal.firsttuesday.us/real-estate-attorney-database/

*Attorneys listed on the Real Estate Database are recommended by **first tuesday journal online** readers and are displayed based on:*

- *firm/attorney name;*
- *city and county of practice;*
- *website, phone number and email address; and*
- *area of specialization.*

***first tuesday** does not endorse or investigate any of the attorneys on this list.*

*The **California State Bar's Attorney Lookup** tool can be found at the address below:*

http://members.calbar.ca.gov/fal/MemberSearch/QuickSearch

- the competency of the attorney's law clerks or legal assistants to follow up on fact investigation, legal research, calendaring of events and related details.

The initial conference

During the **initial conference** with the selected attorney, the syndicator discusses their real estate dispute and interviews the attorney to determine their qualifications. This contact is the first step towards deciding whether the syndicator feels this attorney is the best attorney to retain.

initial conference
The first meeting between a syndicator and prospective attorney conducted prior to entering into a retainer agreement where the syndicator discusses their real estate dispute and interviews the attorney to determine their professional background, qualifications and compatibility.

Relevant topics to be discussed during the *initial conference* include:

- the attorney's professional background and the types of legal disputes which make up their practice;
- the attorney's previous experience with cases similar to the syndicator's;
- whether the attorney's practice regularly calls for their appearance in the court which will hear the syndicator's case;
- the attorney's initial grasp and assessment of the facts and laws controlling the case;
- whether or not, and why, the attorney believes they can obtain a favorable result for the syndicator;
- the different procedural stages, including negotiations, filing, discovery, trial and possible appeal;
- whether the dispute is covered by any insurance policies held by the syndicator;
- the potential liability exposure or other negative consequences on an adverse result of the litigation;
- whether the prevailing party can collect their attorney fees from the other party;

- the attorney's hourly fee and required retainer deposit (and the policies surrounding its refund on the termination of their representation);
- whether the attorney has a conflict of interest based on their other cases and clients;
- the estimated cost of handling the various stages in the resolution of the dispute;
- their attitude toward mediation or other settlement of a case; and
- the tax reporting permitted for the payment of the attorney fees.

Interviewing the attorney

Just as the syndicator is interviewing the attorney, the attorney will also be deciding whether or not they want to represent the syndicator.

The syndicator also needs to determine whether the attorney will handle the case themselves or delegate the analysis and decision-making process to a subordinate or partner. If the case is to be delegated, the syndicator needs to determine how closely the attorney will supervise the handling of the case. The syndicator will then also need to interview the associate attorney who will work on or actually handle their case. A prudent syndicator includes any associate attorney in the conference to avoid *double billing* for repeating the same discussion.

The syndicator will typically be billed for this initial consultation on a per hour basis. Attorneys' hourly rates generally range from $150 to $600 per hour, depending on their location and expertise. Any time spent counseling with the attorney or their staff will cost the syndicator money.

An attorney has the basic duty to respond promptly to any status inquiries by the syndicator. Further, the attorney is required to keep the syndicator reasonably well informed, monthly if possible, on matters relating to the case.[1]

If the attorney interviewed is not retained to represent the syndicator, the attorney still has the duty to maintain confidentiality of the information exchanged during the initial conference.[2]

Retainer agreements

retainer agreement
A contract entered into between an attorney and syndicator specifying the respective responsibilities of the parties and the hourly rate, deposit and other applicable fees charged for the attorney's legal services.

Once an attorney has been chosen, the syndicator will be asked by the attorney to enter into a **retainer agreement** employing the attorney. The attorney has a statutory right to collect a fee for their legal services.[3]

The attorney needs to fully explain the amount of fees or basis for their computation before the fee agreement is signed by the syndicator. To be enforceable, fee agreements for attorney services are required to be in writing when it is known the attorney fees will exceed $1,000.[4]

1 Calif. Business and Professions Code §6068(m)
2 Bus & P C §6068(e)
3 Calif. Code of Civil Procedure §1021
4 Bus & P C §6148(a)

Thus, written *retainer agreements* need to contain:

- the hourly rate, deposit and other rates, fees and applicable charges;
- the nature of the services to be provided; and
- the respective responsibilities of the attorney and syndicator in performance of the retainer agreement.[5]

All billings for services are itemized, stating the:

- name of the activity performed;
- amount due; and
- the hourly rate or basis of calculation used to determine the fees.[6]

The retainer fee

If a **retainer fee**, also known as a **contingency fee,** is negotiated, the agreement needs to be in writing and contain:

- a statement of the *retainer fee* rate;
- a statement addressing how disbursements and costs incurred in connection with prosecuting or settling the case will affect the amount of the retainer fee and the syndicator's recovery;
- a statement addressing what extent, if any, the syndicator could be required to pay attorney fees for related matters not covered by the retainer fee; and
- a statement the fee is negotiable and not set by law.[7]

A duplicate copy of the retainer fee agreement signed by the attorney and syndicator needs to be given to the syndicator. Failure to provide this information will render the retainer fee agreement voidable at the option of the syndicator.[8]

Later, if the syndicator has grounds and chooses to void the retainer fee agreement, the attorney will be entitled to collect a reasonable fee from the syndicator based on their time spent on the case.[9]

The retainer agreement may also be signed by and given to a representative of the syndicator, such as their office manager.[10]

Written fee agreements are confidential contracts between the attorney and their client, in this example, the syndicator.[11]

Deductibility of legal fees

Deductibility of legal fees for tax reporting is determined by the activity causing the expense. If not deductible, the legal fees are either:

- **personal losses;** or

5 Bus & P C §6148(a)(1-3)
6 Bus & P C §6148(b)
7 Bus & P C §6147(a)(1-5)
8 Bus & P C §6147(b)
9 Bus & P C §§6147(b), 6148(c)
10 Bus & P C §6147(a)
11 Bus & P C §6149

- a **capital investment** added to the cost basis of the property or ownership interest involved.

Legal fees fall into four federal tax reporting categories:

- personal expenses;
- business expenses;
- real estate rental (passive) expenses; or
- investment portfolio expenses.

Legal fees incurred for consultation on a broker's business-related matter are fully deductible as an expense of earning brokerage fees.

Legal fees incurred in the management, conservation or maintenance of income-producing real estate — rentals — or for the production or collection of rents, are *deductible* from rental income, a passive income category activity, as an expense.[12]

Capitalized legal expenses

However, some legal fees need to be capitalized, not expensed, including fees incurred in connection with:

- zoning battles;
- title defenses;
- condemnation; or
- acquisition.

These expenditures are added to the property's basis as they are considered **capital expenditures**, not operating costs.[13]

Legal expenses incurred to preserve ownership or defend title to an owner's personal residence are *nondeductible* personal expenses.

It is prudent for the syndicator to ask the attorney under retainer for their advice on the tax deductibility of their fees and, in contingency cases, the reporting of the attorney's share of any recovery.

Itemized billings

As a matter of prudent practice, the syndicator asks for and reviews a sample **billing statement** used by the attorney prior to entering into a retainer agreement.

The *billing statement* is generally itemized, describing:

- each legal activity or service provided by the attorney or their staff;
- the date the service was performed;
- the time spent rendering the service;
- the fee charged or the cost of each item;
- the amount due; and

12 26 United States Code §212

13 **Soelling** v. **Commissioner** 70 TC 1052

- the hourly rate or other basis for calculating the fees.[14]

The attorney is to provide a billing to the syndicator within ten days following the request.[15]

The syndicator is also entitled to receive invoices at intervals of no less than 30 days following their initial request for a billing statement.[16]

The attorney's failure to meet these requirements will render the fee agreement voidable at the option of the syndicator. However, if the syndicator elects to void the retainer agreement, the attorney will be entitled to collect a reasonable fee.[17]

Other factors influencing selection

Additional factors the syndicator wisely considers before selecting an attorney include:

- the attorney's familiarity with real estate law and how up-to-date they are on any statutory, case law and regulatory changes;
- whether the attorney will review the file on a monthly or other periodic basis;
- whether the attorney will automatically provide the syndicator with copies of all correspondence, documents and papers related to the case, and at what cost;
- whether the attorney will consult with the syndicator on any substantial issues which may arise before making a decision or taking action; and
- whether the attorney will review insurance policies to determine if legal fees are covered, such as homeowner's policies, business insurance or errors and omissions (E&O) insurance.

Covered by insurance

If the dispute is covered by insurance, the insurance carrier may reserve its right to choose the syndicator's attorney.

However, in some circumstances when the insurance company issues a *reservation of rights*, the syndicator is allowed to select their own attorney in addition to the attorney selected by the insurance carrier.

14 Bus & P C §6148(b)
15 Bus & P C §6148(b)
16 Bus & P C §6148(b)
17 Bus & P C §6148(c)

Chapter 6 Summary

Oftentimes it is necessary for a syndicator to seek the legal counsel of an attorney. To initiate the attorney selection process, the syndicator first talks to several experienced real estate syndicators in the area where the subject real estate is located.

When meeting with an attorney, the syndicator considers many aspects of the attorney's law office and practice, including:

- the compatibility of the attorney's personality with the syndicator's;
- the efficiency and professionalism of the attorney's work habits;
- the law office's appearance and whether it appears to be well organized and adequately equipped; and
- the competency of the attorney's law clerks or legal assistants to follow up on fact investigation, legal research, calendaring of events and related details

During the initial conference with the selected attorney, the syndicator discusses their real estate dispute and interviews the attorney to determine their qualifications. This contact is the first step towards deciding whether the syndicator feels this attorney is the best attorney to retain. Just as the syndicator is interviewing the attorney, the attorney will also be deciding whether or not they want to represent the syndicator.

Once an attorney has been chosen, the syndicator will be asked by the attorney to enter into a retainer agreement employing the attorney.

The attorney is to provide a billing to the syndicator within ten days following the request. The syndicator is also entitled to receive invoices at intervals of no less than 30 days following their initial request for a billing statement.

Chapter 6 Key Terms

initial conference ....**pg. 55**
retainer agreement ....**pg. 56**

Chapter 7

Selecting suitable investors

Learning Objectives

After reading this chapter, you will be able to:

- analyze investor character types for the selection and solicitation of qualified investors in a limited liability company (LLC) syndication program;
- identify traits of potential investors that are not accommodating or desirable in a small group investment environment; and
- understand a syndicator's need to associate with congenial investors who desire a long-term income and growth investment and appreciate the ownership risks in the cyclical real estate market.

Key Term

financial capacity

Profiling for investment longevity

Investors are generally cautious and selective when they consider entrusting a real estate syndicator with the on-going management of the capital they contribute. Before agreeing to invest, most perform some degree of background investigation into the professional history and character of the syndicator.

Likewise, a prudent syndicator collects information regarding the attributes of each potential investor they solicit for the purchase and joint ownership of the income-producing investment property.

An analysis of **character types** for selection and solicitation of qualified investors allows the syndicator to enhance their chances for long-term success in their investment programs.

Form 350

Client Profile

Page 1 of 2

CLIENT PROFILE

Confidential Personal Data Sheet

Prepared by: Agent ____________ Phone ____________
Broker ____________ Email ____________

NOTE: Use of this form assists in collecting information about an individual's personal traits, family obligations, composition of wealth, community integrity and accomplishments to better inform the Broker/Agent about the individual's wants and needs.

DATE: ____________, 20______, at____________________, California.

1. **Personal information:**
   - 1.1 Name ____________
     - a. Address ____________
     - b. City ____________ State ____________ Zip ____________
     - c. Phone ____________ Fax ____________ Email ____________
     - d. Age ______ General health ____________
     - e. Length of time in the community ____________
     - f. Personal achievements ____________
   - 1.2 Occupation ____________
     - a. Professional designations & licenses ____________
     - b. Business address ____________
     - c. City ____________ State ____________ Zip ____________
     - d. Business phone ____________ Fax ____________ Email ____________
   - 1.3 Marital status ____________
     - a. Spouse's name ____________
     - b. Spouse's occupation ____________
     - c. Children – names & ages ____________
   - 1.4 Membership in cultural or civic organizations ____________
     - a. Religious preference/time dedicated ____________
2. **Financial information:**
   - 2.1 Gross annual income . . . . $____________
   - 2.2 Interest income . . . . $____________
   - 2.3 Dividend income . . . . $____________
   - 2.4 Spendable income (real estate) . . . . $____________
   - 2.5 Approximate net worth (excluding home, car and furnishings) . . . . $____________
     - Cash on deposit . . . . $____________
     - Liquid stocks & bonds . . . . $____________
     - Net equity in real estate . . . . $____________
   - 2.6 Investor can make additional capital contributions in the annual amount of . . . . $____________
     - Source of funds ____________
   - 2.7 Cash value of life insurance . . . . $____________
3. **Investment background:**
   - 3.1 Stocks, bonds or commodities ____________
   - 3.2 Real estate owned other than residence ____________
   - 3.3 Investor involvement in partnership(s) ____________

PAGE ONE OF TWO — FORM 350

Personal information on potential investors is typically compiled by the syndicator over time. It is then retained on an investor profile form prepared on each potential investor. The completed forms are placed on file in a database of prospective investors. [See Form 350 accompanying this chapter]

How many investors to solicit?

Before soliciting investors for a particular property acquisition, the syndicator needs to set a limit on the *number of members* they would like to participate in the program. Though the exact number of participants is up to the syndicator, three to six cash investors is generally the preferred range.

— PAGE TWO OF TWO — FORM 350 —

4. **Investment needs (explain briefly):**
   4.1 Tax benefits ____________________
   4.2 Spendable income, loan reduction or increased value ____________________
   4.3 Short-term investment goals (less than 5 years) ____________________
   4.4 Long-term investment goals (five or more years) ____________________
5. **Investor's advisors:**
   5.1 Accountant ____________________
   5.2 Insurance broker ____________________
   5.3 Banker ____________________
   5.4 Attorney ____________________
   5.5 Stockbroker ____________________
   5.6 Real estate broker ____________________
6. **Educational background:**
   6.1 Degrees and majors ____________________
   6.2 Real estate or law courses studied ____________________
7. **Investor's special interests (hobbies, clubs, etc.):** ____________________
8. **Personality traits:**
   8.1 Positive and decisive? ☐ Yes ☐ No
   8.2 Negative and evasive? ☐ Yes ☐ No
   8.3 Passive and compliant? ☐ Yes ☐ No
9. **Relationship with broker:**
   9.1 Brief description of previous relationships (business, social, civic) with investor: ____________________

FORM 350 03-11

Form 350

Client Profile

Page 2 of 2

The more investors brought into a group, the more likely there will be difficulties:

- communicating with each member;
- managing co-ownership issues when they arise; and
- brokering a meeting of the minds.

To maintain *equilibrium of influence* within the group, the amount contributed by each investor is structured to be nearly the same amount as contributed by each other investor. Thus, no one investor has implicit undue influence to dominate the conduct of group activities.

Further, a general rule suggests no one investor is to have more than twice as much invested capital as any other single investor. Ideally, all investors make identical amounts of cash contributions to the investment. As a result of this balance of interests, all investors will be more likely to treat each other equally.

Financial capacity and longevity

financial capacity
An investor's general financial strength based on their assets and liabilities and their ability to absorb losses of their own funds or borrowed funds without major personal disruption. [See **ft** Form 350]

When soliciting investors, the syndicator considers each individual's **financial capacity** and long-term **propensity to stay** with an investment in real estate. If a prospective investor has cash but is not creditworthy, the investor is likely unreliable as a long-term participant due to potential future demands on their invested capital by creditors.

Also, if additional contributions are later needed to carry the limited liability company (LLC) through a cyclical negative cash flow period, the financially unstable investor may be unable or unwilling to further contribute.

An individual's negative creditworthiness condition usually results from a failure to look ahead, a prelude to lost opportunities for all connected with them in an investment program. Especially trying for some erstwhile investors is the stress of the local economy moving through a cyclical recessionary period when properties underperform.

When selecting prospective investors, syndicators are advised to be skeptical of any investor who appears to be disinclined to compensate the syndicator for their promotional and administrative activities. This indicates the potential investor likely mistrusts the syndicator and views the investment as suspect.

As a contributing member in an LLC, the suspicious investor is more likely to later blame the syndicator for an adverse shift in local market conditions and be unwilling to remain in the investment or contribute additional capital as necessary on a call from the syndicator. Trolls do exist as investors, and it is best to weed them out before they are let in and cause disruption.

The selection of investors

The syndicator selects investors who are:

- **objective and rational** in their approach to problem solving and not prone to act on their emotions;
- **goal-oriented** when analyzing the syndicator's expectations for ownership of the property and looking forward into the economic future for the property;
- **willing to commit** their capital and share earnings (or losses) of ownership as a group, an acknowledged joint effort from the start;
- **willing to leave** the day-to-day management of the program to the syndicator, as authorized by the operating agreement and the property management agreement [See **first tuesday** Form 372 and 590]; and
- **willing to provide** the syndicator with a fair and competitive amount of compensation in ownership and cash for their organization and management efforts.

A group of investors from *comparable backgrounds* is more likely to produce a smooth running investment program in spite of cyclical shifts in the economy. Socioeconomic similarity between investors safeguards against inconsistent investment attributes and expectations.

Sidebar

Wealth from other nations

The geographic location of the investor is a consideration in choosing an investor. However, in the increasingly global economy, investors from different locations may also have the required temperament, experience and other characteristics necessary to undertake California real estate investments.

No restrictions exist which prohibit domestic or foreign nonresidents from owning a membership interest in California real estate syndicates. There are, however, additional tax considerations when involving nonresident members in an LLC. *[See Chapter 10]*

Investors uniformity

To ensure investor uniformity, a syndicator also considers the following:

- location of their residence (preferably within the same community);
- age group — younger investors are more likely to accept and absorb high risk investments, whereas older, more stable investors who have accumulated their net worth over a long period of time are less likely to take such risks;
- extent of their personal achievements;
- economic standards (similar personal net worth, annual income and family needs);
- business background, occupational experience and creditworthiness;
- level of formal education;
- longevity of their family in the community; and
- prior investment, civic and social activities.

Investor characteristics to avoid

Some prospective investors possess characteristics that are not accommodating or desirable in an LLC syndication program.

The syndicator accordingly avoids prospective investors who demonstrate:

- an *improper emotional makeup* to remain in a long-term investment, based on an evaluation of an individual's anger, disgust or surprise, and whether they are tense, nervous, stressed or upset;
- a suspicious or nit-picking (micro-managing) *attitude that conflicts* with the profit-sharing, joint-venture culture of a group investment program, manifested by asking detailed questions about the syndicator's day-to-day operations of the property that appear designed to "catch" them in inconsistent explanations rather than honestly trying to better understand the long-term risks of loss the real estate or the economy may present for the investment; or
- an *excessive concern for the modus operandi* of the syndicator, not the economics of the investment opportunity presented, making inquiries with what seems like an intention to learn enough from the syndicator about the process of their property selection, analysis and acquisition, and the organizational requirements for forming an investment group to enter the real estate investment field themselves.

Chapter 7 Summary

A prudent syndicator collects information on the attributes of each potential investor they solicit for the purchase and joint ownership of income-producing investment property. An analysis of investor character types allows the syndicator to enhance their chances for long-term success in their investment programs.

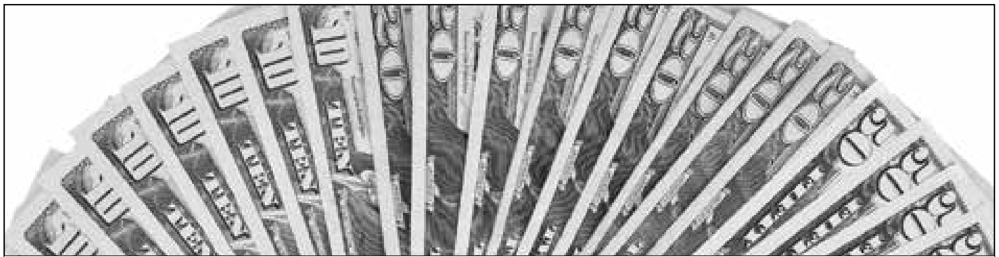
Before soliciting investors, the syndicator needs to set a limit on the number of members they would like to participate in the program. Three to six cash investors is generally the preferred range.

When soliciting investors, the syndicator considers each individual's financial capacity and long-term propensity to stay with an investment in real estate. Further, the syndicator selects investors who are:

- objective and rational and not prone to act on their emotions;
- goal-oriented;
- willing to commit their capital and share earnings or losses of ownership as a group;
- willing to leave the day-to-day management of the program to the syndicator; and
- willing to provide the syndicator with a fair and competitive amount of compensation in ownership and cash for their efforts.

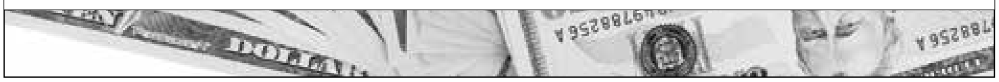
Chapter 7 Key Term

financial capacity ....pg. 64



Chapter 8

The distribution of income



Learning Objectives

After reading this chapter, you will be able to:

- determine each member's ownership share in the limited liability company (LLC) as the percentage their capital contribution represents of the total amount of all forms of member contributions; and
- manage the disbursement of spendable income from property operations and net proceeds from a refinance or sale between Class A cash investors and any Class B members, such as the syndicator.

Key Terms

cash-on-cash return

reserve account

parity distribution

Contributions set share of ownership

Consider a limited liability company (LLC) that is initially capitalized at $500,000 consisting of:

- $400,000 in cash contributed by a group of investors; and
- $100,000 in the value of the syndicator's contribution by assignment of their right to purchase the property acquired by the LLC.

The cash investors receive **Class A priority membership interests** in the LLC set at $400,000. In contrast, the syndicator receives a **Class B subordinated membership interest** in the LLC set at $100,000 for the purchase rights to real estate they assigned to the LLC.

Each member's share of ownership in the LLC is set as the percentage each member's contribution represents of the total of all contributions to the LLC.

Thus, the Class A members collectively hold an 80% participation in ownership. The syndicator as a Class B member holds a 20% participation in ownership.

Allocation of cash contributions

Continuing our previous example, the vesting of ownership to the property purchased will be in the name of the LLC, not the members or the syndicator. The members own the LLC, not the real estate. However, the stated purpose of the LLC may be to hold title in trust for the members who as *tenants-in-common* are the actual co-owners of the real estate.

From the $400,000 in cash contributions, $340,000 is used as a **down payment** to fund the acquisition of the property — funds the LLC needs in order to close the purchase escrow and acquire title.

reserve account
An account established by a limited liability company (LLC) to cover miscellaneous transactional costs incurred to create the LLC and purchase the property, and for unexpected operating expenses. [See **ft** Form 371 §13]

$30,000 from the cash contributions is placed in a **reserve account** the LLC maintains.

From the *reserve account*, the LLC pays:

- miscellaneous closing costs;
- attorney fees;
- accounting fees;
- printing costs; and
- other out-of-pocket **transactional expenses** incurred to create the LLC and purchase the property.

The balance remaining unused in the reserve account serves as a **contingency fund** for unexpected *operating expenses* that typically confront all new owners of property.

The remaining $30,000 is paid to the syndicator as a fee to compensate them for their time and effort spent soliciting investors and organizing the LLC. The $30,000 cash fee paid to the syndicator is for services rendered. This compensation is separate from the 20% subordinated Class B membership interest the syndicator received in exchange for the assignment of their right to purchase the property.

The syndicator's contribution and share

Typically, a syndicator is not also a cash investor though they may be.

The dollar amount given the *Class B membership share* the syndicator receives in the LLC is set by the syndicator. The amount set is based on the dollar value the syndicator places on the contract right they hold to purchase the property. In exchange for the assignment of the purchase rights to the LLC, the syndicator receives the set dollar amount of Class B subordinated interest in the LLC. This dollar sum is a prerequisite to establishing their percentage share of membership.

The cash investors — one of whom could be the syndicator if they also chose to contribute cash — hold *Class A* memberships. As cash contributors, Class A investors receive a *priority distribution* of earnings under the LLC operating agreement, including:

- **spendable income** from property operations; and
- **net proceeds** from the refinance or resale of the property. [See **first tuesday** Form 372; see Chapter 4]

For example, the operating agreement entitles the Class A members to first receive a distribution of annual spendable income generated by the property. Only then may the syndicator (and any other Class B members) receive spendable income. This priority distribution to Class A members is limited in amount to an annual percentage on their cash contribution, a **cash-on-cash return** comprising a return of capital (due to depreciation deductions) and ordinary income.

cash-on-cash return
Spendable income stated as a percentage of total member contributions to equity capital, represented by operating income remaining after all expenses and mortgage payments have been paid and before depreciation deductions or income taxes.

The spendable income the syndicator receives as their Class B *subordinated distribution* is the same annual percentage return on the dollar amount of their contribution as the Class A investors receive on theirs.

Any spendable income remaining after minimum distributions is next distributed among all the members on a pro rata basis, based on the percentage share they hold in the LLC. This distribution is without concern for priorities or subordination, called a **parity distribution**.

parity distribution
An equal sharing between all members in a limited liability company (LLC) of earnings in the form of spendable income and proceeds of a sale or refinance.

However, a different ratio of sharing between classes is occasionally established by the syndicator for these *parity distributions*. For example, the spendable income remaining after priority distributions might be distributed 50% to Class A members and 50% to Class B members.

When the syndicator's percentage share of excess spendable income is larger than their pro rata ownership, the syndicator has greater incentive to increase the spendable income generated by the operations of the property. This self interest in maximizing spendable income in turn increases the property's value due to management increasing rental income or reducing operating costs, or both.

Over time, and due to inflationary increases in rents and thus spendable income, these alternative percentages for sharing can shift great future wealth to the syndicator.

Distribution on a refinance or sale

Distribution of the net proceeds from a **refinance** or **sale** of the LLC property follows a similar priority format for sharing.

The Class A members receive the first distribution of proceeds from a refinance and sale up to the dollar amount of their original contributions, plus any unpaid minimum annual distributions.

Any portion of the annual minimum rate of return not available for distribution during prior periods of ownership accumulates and is distributed as funds from any source as they become available.

Next, the Class B syndicator receives a distribution from the refinance and resale proceeds up to the dollar amount of their capital contribution. Added to this is any annual minimum rate of return not previously available for distribution that has accumulated unpaid.

Any refinance or sales proceeds then remaining are typically distributed on a parity basis to all members. For example, the agreement may call for the remaining funds to be distributed to all members based on their percentage of membership, or on a different ratio, such as a 50-50 split between the Class A and Class B members, or any other ratio agreed to.

Finally, the manager, as a licensed real estate broker, may receive a fee for their management, refinance, and sale of the property.

The right to a fee for services rendered to the LLC is contracted for in the operating agreement. As payment for services, the distribution of brokerage fees has priority over distributions to capital investors. [See **first tuesday** Form 372]

Chapter 8 Summary

Cash investors in a limited liability company (LLC) receive Class A membership interests. Thus, Class A investors receive a priority distribution of earnings under the LLC operating agreement, including:

- spendable income from property operations; and
- net proceeds from the refinance or resale of the property

This priority distribution to Class A members is limited in amount to an annual percentage on their cash contribution, a cash-on-cash return comprising a return of capital (due to depreciation deductions) and ordinary income.

In contrast, the syndicator receives a Class B subordinated membership interest in the LLC. The dollar amount of the membership share the syndicator receives in the LLC is based on the dollar value the syndicator places on the contract right to purchase the property they assign to the LLC. The spendable income the syndicator receives as their subordinated distribution is the same annual percentage return on the dollar amount of their contribution as the Class A investors have received on theirs.

Any spendable income remaining after minimum distributions is next distributed among all the members on a pro rata basis, based on the percentage share they hold in the LLC. This distribution is without concern for priorities or subordination, called a parity distribution. However, a different ratio of sharing between classes is occasionally

established by the syndicator for these parity distributions. For example, the spendable income remaining after priority distributions might be distributed 50% to Class A members and 50% to Class B members. Here, the syndicator has greater incentive to increase the spendable income generated by the operations of the property.

Distribution of the net proceeds from a refinance or sale of the LLC property follows a similar priority format for sharing.

Chapter 8 Key Terms

cash-on-cash return ....pg. 69
parity distribution ....pg. 69
reserve account ....pg. 68


HOLLYWOOD
PRODUCTION VRC
DIRECTOR firsttuesday
CAMERA
DATE SCENE TAKE
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Chapter 9

Sharing earnings through services and capital contributions

Learning Objectives

After reading this chapter, you will be able to:

- identify the compensable activities of a syndicator;
- analyze the numerous arrangements for sharing income and profits with the co-owners of a limited liability company (LLC);
- avoid the moral hazards which exist when a syndicator shares in the net sales proceeds on a parity basis with the investors; and
- discuss the various methods for payment of a syndicator's compensation.

Key Terms

conflict of interest

equity financing

moral hazard

net operating income (NOI)

The tradeoff in priority distributions

An income-producing property generates an annual **net operating income (NOI) (or loss)** during any given period of time, no matter how well managed it may be.

net operating income (NOI)
The net revenue generated by an income producing property, calculated as the sum of a property's gross operating income less the property's operating expenses and used to determine a property's value and pay mortgage debt. [See **ft** Form 352 §4]

During the same period, the property will experience an annual rise or fall in the dollar amount of its fair market value (FMV). Value fluctuations are triggered by a multitude of factors, some with no correlation to the management of the property, including:

- national consumer price inflation;
- monetary policy of the Federal Reserve (the Fed);
- construction starts;
- local politics of zoning, code enforcement and infrastructure; and
- increased or decreased local demographics of population density and wages which influence the appreciation of property.

A zero-sum game

For the owners of the property, the *NOI* and any rise in value constitutes the sum of the earnings generated by the property during the period of ownership.

When an income property is co-owned by investors and a syndicator, vested in the name of a limited liability company (LLC), the earnings produced by rental income and rising property value are shared. Any increase in one co-owner's share of the earnings, such as the syndicator's share, produces an *equal decrease* in the earnings remaining available to the other co-owners, such as the investors.

This is a perfect mathematical illustration of a **zero-sum game**.

In the environment of a syndicated investment, that portion of the property's earnings (NOI and value) taken by the syndicator reduces the amount of rental income and property value available for disbursement to cash investors.

Alternatively, a *priority allocation* for distribution of spendable income and net proceeds from refinancing and the sale of the property to cash investors draws down the earnings available for distribution to the syndicator. Thus, all co-owners share, under one formula or another, in an absolute and finite sum of dollars represented by the NOI remaining after interest expenses and any build-up or rise in the property's equity value.

Share and share alike

Consider a syndicator who negotiates a $300,000 down payment for the purchase of a property. The down payment is funded by contributions of $50,000 from each of six investors who join with the syndicator to co-own the property. The syndicator receives an equal share in ownership for locating the property and contracting to purchase it. The total capital contribution from all members and in all forms is $350,000.

Any percentage of the income and profits the syndicator is to receive for their share of ownership reduces the earnings available to the cash investors who funded the down payment made to acquire the property.

Here, the cash investors put up 100% of the funds needed to buy the property, but receive only 6/7 (86%) of the ownership. The syndicator's $50,000 co-ownership valuation represents 1/7 (14%) of the total $350,000 capitalization of the investment group. Thus, the purchasing power of the investor's cash has been diluted by the percentage of ownership held by the syndicator, referred to as **watered stock**. [See Chapter 4]

The property is acquired by the group at its current FMV. Further, the syndicator receives no part of the down payment from the seller or anyone else. Here, the syndicator receives no compensation or benefits for their efforts, other than the 14% of co-ownership they were able to justify as the value of their purchase rights assigned to the limited liability company (LLC) to acquire the property.

As a result, the investor will receive 14% of all distributions of income and net sales proceeds.

The moral hazard in parity sharing

Continuing our previous example, consider the sale of the same income property by the group one year later.

The price received reflects an increase in value equal only to the transactional costs incurred to sell the property. Thus, the net proceeds from the resale are $300,000, the same amount as the original down payment.

On distribution of the net sales proceeds to the investment group composed of the syndicator and the six investors, the syndicator receives $42,857, 14% of the $300,000 net proceeds. The investors will receive the 86% remainder of the proceeds, $257,143. Thus, each of the investors who funded the entire down payment will receive $42,857 as the return of their $50,000 investment, resulting in a cash loss on the sale exceeding $7,000 apiece.

Since the investors acquired **parity ownership** with the syndicator, the syndicator shares with the investors each dollar of net proceeds from the resale. This sharing creates the inherent **risk of loss** known as a **moral hazard.** The syndicator will receive cash on any sale without concern for the quality of the property selected, the day-to-day operations, care of the property or the effective marketing of the property to obtain the highest resale price.

moral hazard
An investment situation in which the risk of loss is borne primarily by a group of investors, not the syndicator, structured to discourage the syndicator from working for results that exceed minimum performance standards and motivate the syndicator to take unacceptable risks.

The compensation a syndicator receives when they share net sales proceeds on a *parity basis* with the investors is not contingent on their performance or subject to a priority return of the investors' cash contributions. The risk of loss situation created by parity participation allows the syndicator to merely sit and wait for a sale in order to benefit financially from their initial syndication efforts. [See Chapter 4]

The likelihood of a financial return

Investors need to be given a reasonable likelihood their invested capital will be returned together with the income and profits they have been led to anticipate on their investment.

To attain these objectives, the investment program needs to include a mix of:

- cash distributions based on a formula of priorities, subordination and parity participation between all co-owners;
- front-end reimbursement of the syndicator's out-of-pocket expenditures for acquisition (transactional) costs, LLC organizational expenses and purchase agreement deposits;
- participation by the syndicator as a co-owner in lieu of a cash payment for the assignment of their purchase rights to the LLC;
- fees for services performed by the syndicator to form the LLC, prepare an investment circular (IC), locate investors and for property management duties during ownership of the property;

Sidebar

Conflicts in a real estate syndication

conflict of interest
When a broker or agent has a positive or negative bias toward a party in a transaction which is incompatible with the duties owed to their client. [See **ft** Form 527]

*A **conflict of interest** arises when a broker or their agent, acting on behalf of a client, has a competing professional or personal bias which hinders their ability to fulfill the fiduciary duties they have undertaken on behalf of their client.*

In the context of syndication, a conflict of interest exists when a syndicator has a professional or personal bias toward others which interferes with their ability to arrange the acquisition and management of an income-producing investment property on the most advantageous terms for a group of investors.

*A potential conflict of interest exists when a broker **manages multiple LLCs** which own like-type properties in the same market area.*

For example, consider a syndicator entrusted with managing two investment groups which own similar apartment projects located within the same market. The two projects thus compete for the same prospective tenants. The syndicator is paid a management fee by each investment group based on a percentage of the rents received.

When contacted by a prospective tenant, the syndicator is initially faced with the dilemma of which apartment building to refer the tenant to, and thus which investment group will benefit from the tenant's occupancy.

A similar conflict of interest results from parallel transactions by multiple LLCs managed by the same syndicator that are actively competing to sell or buy property within the same marketplace.

A potential conflict of interest of this nature needs to be disclosed to the investors before they agree to participate as members in an LLC the syndicator manages.

*This disclosure is contained in **first tuesday** Form 371, Investment Circular provision 6d, which states:*

> ***Conflicts of Interest**: The Manager has numerous other business responsibilities and ownership interest which will demand some or most of his time during the LLC's ownership of the property. The Manager's other interests include ownership of projects comparable to the property purchased in this transaction. To the extent his time is required on other business and ownership management decisions, he will not be involved in monitoring or marketing of the LLC's property. [See **first tuesday** Form 371]*

*With this disclosure, the **syndicator's allegiance** to multiple projects and investment groups is transparent and is be taken into consideration by all investors at the time they receive the Investment Circular from the syndicator – before investing and consenting to the risk.*

- cumulative minimum annual earnings on contributions;
- separate classes of ownership for the different tiers of sharing arrangements; and
- fees earned by the syndicator based on graduated percentages for achieving higher levels of income and profit.

Investors are less likely to invest in programs that include:

- parity participation between the investors and the syndicator in distributions [See Chapter 4]; and
- up-front fees to the syndicator which exceed the reimbursement of their out-of-pocket costs for LLC organization and transactional costs of property acquisition.

As a prerequisite to structuring the sharing of earnings and wealth flowing from a property, a dollar value needs to be placed on the syndicator's participation in ownership.

Once the dollar value of the syndicator's co-ownership is set, the *percentage* of each co-owner's contributions to the total of all contributions made establishes the basis for pro rata participation in income, profits and the return of capital.

Preliminarily, the dollar amount the syndicator sets for their co-ownership interest needs to be based on the value of the purchase rights they contributed by assignment to the LLC and justified as:

- reasonable; and
- based on objective standards of evaluation.

The phases of a syndicated investment

The following outline chronicles in three phases the *syndicator's participation* during the life of a syndicated investment program:

- the **pre-acquisition period**;
- the **ownership period**; and
- the **disposal period**.

Phase 1. The pre-acquisition period

1.1 **Search** for and locate suitable property.

1.2 **Select** a property that appears suitable to acquire based on unconfirmed seller disclosures.

1.3 Enter into a **Letter of Intent** or an agreement to purchase the property (at a price reduced by the amount of a brokerage fee, say 6%). [See **first tuesday** Form 185]

1.4 Complete a **due diligence investigation** into the property and either terminate negotiations and cancel the agreement, or proceed to perform the purchase agreement. [See **first tuesday** Form 159]

1.5 Dictate and execute **escrow instructions** to process the closing of the purchase agreement. [See **first tuesday** Form 401]

1.6 Deposit **good faith money** in escrow and arrange mortgage financing if it is required.

1.7 Prepare an **IC**. [See **first tuesday** Form 371]

1.8 Prepare the LLC **operating agreement**, setting the ratios and formulas for investor and syndicator participation in earnings. [See **first tuesday** Form 372]

1.9 Solicit **commitments** from investors to contribute cash and subscribe to the LLC.

1.10 **Record** the LLC articles when the investment is fully subscribed.

1.11 **Assign** the syndicator's right to purchase the property to the LLC. [See **first tuesday** Form 370]

Phase 2. The ownership period

2.1 The syndicator receives a share of ownership in the LLC in exchange for an **assignment of their purchase rights** to the LLC. In turn, the investors receive a share for their **cash contributions**.

2.2 **Manage** the property.

2.3 Experience **equity buildup** due to the amortization of the loan amount through monthly payments.

2.4 Distribute **spendable income** generated from the operations of the property to the co-owners.

2.5 **Refinance** the existing loan and distribute any **net loan proceeds** and any resulting increase in spendable income to the co-owners.

2.6 **Buy out** the investors on a **right of first refusal** or **purchase option** held by the syndicator.

Phase 3. The disposition period

3.1 Facilitate a vote of the co-owners authorizing the **sale** of the property, when the time is right to sell.

3.2 Employ the syndicator as the seller's broker to **list** the property for sale and **locate** a buyer.

3.3 Prepare a **marketing package** for delivery of disclosures and representations about the property to prospective buyers. [See the **first tuesday** Income Property Brokerage suite of forms]

3.4 Enter into a **purchase agreement** to sell the property to a buyer and open escrow. [See **first tuesday** Form 159]

3.5 Cooperate and assist the buyer in their **due diligence investigation** of the property and close the sale.

3.6 **Disburse brokerage fees** to the syndicator from the net sales proceeds.

3.7 Distribute the remaining net sales proceeds to the **co-owners**.

3.8 Record the **dissolution of the LLC**.

The syndicator's earnings

Throughout this chronology of events, an analysis is needed that focuses on the economic nature of the syndicator's activities as **capital events** or **services rendered**. This economic analysis is necessary when the syndicator accepts a co-ownership interest, sets priorities, parities or accumulation of earnings and collects fees all received out of the property's rental income and rise in value. The distinctions have financial and tax consequences for the syndicator.

To begin an analysis of the aspects of sharing, the syndicator's activities which generate earnings during each phase of real estate syndication are broken down and categorized based on their nature as:

- *capital contributions* to the LLC; or
- *services rendered* on behalf of the LLC.

Each are taxed differently; the income from capital contributions at passive income category rates, the services rendered at trade or business category rates.

Differentiated activities

The syndicator's activities are differentiated as follows:

1. **The syndicator's ownership activities when acting as a principal:**
   1.1 *Acquisition phase:*
      a. Enter into a **purchase agreement** in their own name as the syndicator. [See **first tuesday** Form 159]
      b. **Open escrow** to purchase the property in their own name.
      c. Fund the **good faith deposit** into escrow.
      d. **Transfer** the rights to purchase the property by an assignment to the LLC. [See **first tuesday** Form 370]

   1.2 *Ownership phase:*
      a. **Participate as a member** who co-owns a share in the LLC.
      b. Participate in the **equity buildup** in the property by the monthly amortized reduction in debt.
      c. Share **spendable income** generated from the operations of the property when it is distributed to co-owners.
      d. Share the **net proceeds** from a refinance on their distribution to co-owners.
      e. Exercise the **right of first refusal** or **option to buy the property** or fractional ownership interests granted to the syndicator by the investors.

   1.3 *Marketing and resale phase:*
      a. Vote as a co-owner to **sell** the property.
      b. Enter into a **purchase agreement** and escrow to sell the property.
      c. Share the **net sales proceeds** on their distribution to co-owners.
      d. Complete the **dissolution of the LLC**.

2. **The syndicator's services rendered to the LLC acting as a broker:**
   2.1 *Acquisition phase:*
      a. Prepare an IC to mar**ket LLC shares**. [See **first tuesday** Form 371]
      b. Arrange to assume or originate **mortgage financing**.
      c. **Solicit investors** to contribute capital and enter into an LLC operating agreement. [See **first tuesday** Form 372]
      d. **Form the LLC** by preparing, signing and recording the LLC-1 Articles of Organization.

2.2 *Ownership phase:*

a. **Manage the property** under a property management agreement with the LLC. [See **first tuesday** Form 590]

b. Arrange any **refinancing or further encumbrance** of the property.

c. Locate **substitute co-owners** on resale of an existing co-owner's fractional interest.

2.3 *Marketing and resale phase:*

a. Market the property for sale and **locate a buyer** under a listing agreement.

b. **Prepare a marketing package** to deliver property disclosures to prospective buyers. [See the **first tuesday** Income Property Brokerage suite of forms]

c. Cooperate and assist the buyer in their **due diligence investigation** of the property and close the sale.

Rationale for sharing profits

As discussed above, when a syndicator proceeds with the acquisition of an investment property on the completion of their due diligence investigation, the IC is prepared. The IC is used for marketing fractional ownership interests when soliciting contributions from cash investors. [See **first tuesday** Form 371; see Chapter 20 and 21]

The IC includes an LLC operating agreement that authorizes the employment of the syndicator to manage the day-to-day operations and management of the property, including handling refinancing and resale of the property. It further authorizes the syndicator to distribute the earnings, profits and capital from these activities to the co-owners of the LLC. [See **first tuesday** Form 372]

However, before preparing the operating agreement, the syndicator determines the nature of their participation in the income and the extent of sharing in earnings generated by the property and their management.

To spur interest in the investment opportunity among prospective investors, the syndicator needs to demonstrate that the formulas for sharing the earnings will, as a matter of priority distributions, deliver to the investors:

- a return of their invested capital;
- minimum annual spendable income; and
- an acceptable portion of any increase in value on a refinance or resale of the property.

Collectively, the property's physical condition and co-owner income-sharing formulas need to be sufficiently attractive and transparent to induce prospective investors to commit the funds needed to fully capitalize the investment, called **equity financing**.

equity financing
Down payment funds solicited from cash investors by a syndicator for the purchase of an income-producing investment property to be co-owned by a group of investors. Contrast with mortgage financing.

Avoiding a moral hazard

For the risk of loss in an investment to be acceptable to prospective investors, the syndicator needs to use substantially all the cash contributions to fund the down payment for the purchase of the property.

To avoid creating *moral hazards* for investors in the form of the syndicator's decisions, the syndicator's fees and earnings need to be structured to encourage the syndicator to work for results that exceed **minimum performance standards**. To accomplish this, the syndicator's ownership interest is subordinated to priority disbursements to the investors from spendable income and net proceeds from a refinance or sale of the property.

Similarly, the syndicator needs to disclose the fee they will be paid for their **organizational services** to form the LLC, solicit investors and bring together the co-owners is fair to the investors. Thus, the fees need to be competitive with the fees charged by others who provide similar services, such as attorneys.

Further, the **property management fee** the syndicator has bargained for needs to be shown as fair for the quality, quantity and reliability of their services. To do so, the fee needs to be consistent with the charges for like services provided by competitive property managers actively operating in the area. [See **first tuesday** Form 590]

To avoid a moral hazard, it is the syndicator who will initially absorb the investment's risk of loss from any decline in rental income or property value, not the investors. This is a result of the provisions for *priority distributions* to the investors.

Floors and ceilings on returns

Earnings are shared between the syndicator and the investors under various formulas.

Sharing arrangements take into consideration:

- priority and parity sharing;
- ratios for sharing;
- a minimum annual return that accumulates if unpaid;
- contingency fee arrangements;
- the dollar value of the syndicator's contribution; and
- buy out options. [See Chapter 4]

Collectively, these arrangements **place a ceiling** on the total return the cash investors are able to receive over the life of the investment.

Arrangements for sharing

The following outline analyzes the various arrangements for sharing:

1. **Structuring an LLC's capitalization and sharing by co-owners:**
   1.1 *The investors' contribution of cash provides for:*
      a. A **percentage of ownership** in the LLC as **Class A members**.

Arrangements for sharing, cont'd

b. A **periodic distribution** of spendable income between Class A and Class B members.
   1) Initial priority distribution to Class A members.
   2) Initial distribution as a minimum rate of return.

c. A **supplemental distribution** of remaining **spendable income**.
   1) Parity distribution to members of all classes of any spendable income remaining after initial distributions to Class A and B members at the minimum rate of return.
   2) Parity sharing by all LLC members is based on percentage of ownership or another agreed ratio, such as 50:50 between classes.
   3) Distribution of spendable income to Class A members may be capped at a maximum annual rate of return.
   4) Spendable income remaining after distributions to Class A members at the maximum annual rate is distributed to Class B members.

d. An initial distribution of the **net proceeds** from a refinance or sale of the property.
   1) Priority distribution to Class A members.
   2) Initial priority distribution to Class A members limited to the dollar amount of their contributions and a minimum annual rate of return, less all distributions they have previously received.

e. **Supplemental distribution of net proceeds** remaining from the refinance or sale of the property after initial priority distributions.
   1) Parity sharing between classes is based on percentage of ownership or another agreed ratio, such as 50:50.
   2) Distribution of the remaining net proceeds to Class A members may be capped at a maximum annual rate of return on their original capital contributions, such as a rate equal to the *consumer price index (CPI)* for the term of the investment and an annual percentage rate, such as 4% or 6%.

1.2 *The syndicator's contribution of purchase rights provides for:*

a. A dollar amount of ownership in the LLC as a **Class B member**.
   1) The dollar value the syndicator places on their Class B membership received for their contract right to purchase the property establishes in relationship to all contributed capital the syndicator's percentage of ownership in the LLC.

b. A **periodic distribution** of spendable income to Class B members.

Arrangements for sharing, cont'd

1) Distribution is subordinated to the annual floor rate of return initially distributed to Class A members.
2) The distribution is initially limited to an annual floor rate of return identical to the rate of return for priority distribution of spendable income to Class A members.

c. A **supplemental distribution** of remaining **spendable income**.

1) Parity sharing of spendable income between all member classes.
2) The ratio for parity sharing is based on percentage of ownership or another agreed ratio, such as 50:50.
3) The parity distribution of spendable income to Class A members may be capped at a maximum annual rate of return.

d. A distribution of all **remaining spendable income**.

1) After initial and parity distributions to Class A and B members, any remaining undistributed spendable income is distributed solely to Class B members.

e. A **subordinated distribution** of proceeds from a refinance or a sale of the property.

1) Distribution to Class B members is subordinated to the initial priority distribution to Class A members.
2) Distribution to Class B members is limited to the dollar amount of their contributions and an annual minimum rate of return identical to the rate of return for priority distributions of proceeds to Class A members, less all distributions Class B members have previously received.

f. **Supplemental distribution of net proceeds** remaining from the refinance or sale of the property.

1) Parity distribution of proceeds between classes may be based on percentage of ownership or another agreed ratio, such as 50:50.
2) The amount of the parity distribution of proceeds to Class A members may be capped at an annual ceiling rate of return on their original capital contributions, such as a rate equal to the CPI for the term of the investment and an annual rate of return, such as 4% or 6%.

g. A distribution solely to Class B members of net proceeds remaining undistributed after priority and parity distributions to Class A and Class B members.

1.3 *Buy out provisions represent:*

a. A **right of first refusal** granted to the syndicator in the operating agreement to acquire, at a formulated price, a co-owner's fractional interest on the co-owner's withdrawal, death, expulsion by court order or by all remaining members, etc.

Arrangements for sharing, cont'd

b. An **option** granted to the syndicator in the operating agreement to acquire the interests of the Class A members at a formulated price, comparable to a preferred stock arrangement by which a corporation pays off the stockholder. Alternatively, an option may be granted to the syndicator to buy the property from the LLC.

2. **Fees and benefits for services rendered to the LLC by the syndicator:**

2.1 *Acquisition fee or listing fee:*

a. Paid directly to the syndicator by the LLC out of cash contributions for **brokerage services** rendered by the syndicator to negotiate the purchase, or less prudently, paid indirectly to the syndicator by the seller of the property out of the down payment.

b. Received by the syndicator **in lieu of a percentage of ownership**.

2.2 *Organizational or formation fee:*

a. Received by the syndicator from the LLC for services the syndicator rendered to **prepare** an IC, **solicit** cash investors and **form** the LLC entity.

b. Paid on the LLC's **acquisition of ownership** from cash contributions.

2.3 *Property management fees:*

a. Paid to the syndicator as a licensed broker at the end of each month in an amount based on a **percentage of the rents collected**.

b. Received by the syndicator as a licensed broker rendering services under a **property management agreement**. [See **first tuesday** Form 590]

c. Payment of the management fee may be **contingent on the sufficiency of rents** to cover operating expenses and mortgage payments.

d. Payment of the fee may be **further subordinated** to the distribution of a minimum annual rate of return to the Class A members and, if the fee is unpaid, will accumulate and be payable in later years when spendable income is available.

2.4 *Loan brokerage fee:*

a. Received by the syndicator as a licensed broker for arranging the **refinancing or further financing** of the property.

2.5 *Miscellaneous income and financial benefits:*

a. Income received by the syndicator as reimbursement for expenses incurred in the **management of the LLC and the investors**, other than the management of the property.

Arrangements for sharing, cont'd

b. Income received by the syndicator for providing services which are **not obligations of the LLC** under the leases. These services are paid for by tenants separate from the rent through common area maintenance fees (CAMs), a tenant association, laundry equipment and supplies or vending machines.

c. Profits from a **maintenance company**, controlled by the syndicator that provides services for the care and maintenance of the LLC property. [See **first tuesday** Form 519]

d. **Rent-free** or **rent-reduced occupancy** of vacant space by the syndicator for their personal or business use, whether or not it is coupled with the management of the property.

2.6 *Sales fees or listing fees*

a. Received by the syndicator as a real estate broker from the net proceeds on a sale of the property, paid by the LLC.

3. **A master lease held by the syndicator on the property acquired by the LLC:**

3.1 *Rent paid to the LLC:*

a. Rent under the **master lease** is the sole source of a periodic return on the co-owners' invested capital.

3.2 *Right to buy:*

a. Rights of **first refusal, buy-out options** and **options to purchase** the property at a gain for the investors (in addition to rent) are granted to the syndicator to buy the property or buy out the cash investors. [See Chapter 18]

Chapter 9 Summary

An income-producing property generates an annual net operating income (NOI) (or loss) during any given period of time. For the owners of the property, the NOI and any rise in value constitutes the sum of the earnings generated by the property over a period of ownership.

When an income property is co-owned by investors and a syndicator, vested in the name of a limited liability company (LLC), the earnings produced by rental income and rising property value are shared. Any increase in one co-owner's share of the earnings, such as the syndicator's share, produces an equal decrease in the earnings remaining available to the other co-owners, such as the investors.

Investors need to be given a reasonable likelihood their invested capital will be returned together with the income and profits they have been led to anticipate on their investment.

To attain these objectives, the investment program needs to include a mix of:

- cash distributions based on a formula of priorities, subordination and parity participation between all co-owners;
- front-end reimbursement of the syndicator's out-of-pocket expenditures for acquisition (transactional) costs, LLC organizational expenses and purchase agreement deposits;
- participation by the syndicator as a co-owner in lieu of a cash payment for the assignment of their purchase rights to the LLC;
- fees for services performed by the syndicator to form the LLC, prepare an investment circular (IC), locate investors and for property management duties during ownership of the property;
- cumulative minimum annual earnings on contributions;
- separate classes of ownership for the different tiers of sharing arrangements; and
- fees earned by the syndicator based on graduated percentages for achieving higher levels of income and profit.

A syndicator who shares equally in the net sales proceeds is on a parity basis with the investors. Parity allows the syndicator to share and share alike with the investors all the net cash on the resale, creating a risk of loss known as a moral hazard. Here, the syndicator receives cash on any sale without concern for the quality of the property selected, the day-to-day operations, care of the property or the effective marketing of the property to obtain the highest resale price.

To avoid creating moral hazards for investors in the form of the syndicator's decisions, the syndicator's fees and earnings need to be structured to encourage the syndicator to work for results that exceed minimum performance standards. To accomplish this, the syndicator's ownership interest is subordinated to priority disbursements to the investors from spendable income and net proceeds from a refinance or sale of the property.

Further, the syndicator needs to show the fees they will be paid for their organizational and management services are:

- reasonable;
- based on objective standards of evaluation; and
- competitive with the fees charged by others who provide similar services.

Chapter 9 Key Terms

conflict of interest ....pg. 76
equity financing ....pg. 80
moral hazard ....pg. 75
net operating income (NOI) ....pg. 73

Chapter 10

The tax treatment of a syndicator's earnings

Learning Objectives

After reading this chapter, you will be able to:

- understand the taxation of a syndicator's gains and earnings received for acquiring property and forming a limited liability company (LLC) for group investment; and
- maximize your earnings from syndication activities while minimizing their negative tax impact.

Key Terms

cost basis **return on capital**

Property rights, services or both

A distinction exists for tax reporting between the income a syndicator derives from:

- their **contribution of capital** to a limited liability company (LLC); and
- **services rendered** by the syndicator on behalf of the LLC.

The difference in the amount of taxes the syndicator will pay on earnings from *contributions* versus taxes on *services rendered* and when they will be due exemplifies the contrasts.

The syndicator's personal tax objective when structuring various syndication activities is to maximize their earnings from syndication activities while minimizing the negative tax impact they have.

For instance, the **profit taxes** the syndicator pays on the sale of property owned by an LLC in which they hold a membership interest, when the LLC

return on capital
An annual yield on invested capital, stated for group investment purposes as a percentage of equity capital contributed by group members to fund the costs of acquisition and improvements of a property, represented by the property's net operating income (NOI) less interest paid on mortgage debt, also called return on investment (ROI).

acquired the property under **purchase rights** assigned to the LLC by the syndicator, are limited to 20% (28% on any depreciation recapture) of the syndicator's portion of the net sales proceeds.

In contrast, the **ordinary income tax** on compensation the syndicator receives for *services rendered* while acting as an agent of the LLC max out at 35%, plus 15.3% in self-employment taxes and 9.31% in California state taxes –– an aggregate of 60% in taxes for 40% net proceeds after taxes.

As a result of the huge distortion in tax consequences, the syndicator's tax goal is to *contractually structure* their activities to attain the lowest allowable tax. The income they receive during the life of the investment program, from inception to resale of the property, is given the most favorable tax treatment if it is structured as a **return on capital** (profit), and not **payment for services** (ordinary income).

Rights created and exchanged

A syndicator locating a property and packaging an investment opportunity for the LLC establishes **property rights** when they enter into a binding contract to buy, finance or develop real estate. To contract for acquiring property, the syndicator uses a variety of documents, including:

- purchase agreements [See **first tuesday** Form 159];
- options to buy [See **first tuesday** Form 161 and 161-2];
- loan applications and commitments to finance acquisition or construction;
- construction permits; and
- escrow instructions. [See **first tuesday** Form 401]

Property rights created by the syndicator when acting as a principal are considered **capital interests**. Services rendered acting on behalf of another produces self-employed business income. Self-employment occurs when a syndicator negotiates a purchase agreement entered into in the name of the LLC as the buyer and signed by the syndicator on behalf of the LLC as its manager.

When a syndicator assigns to an LLC a contract right they previously negotiated, created and hold in their name to purchase a property, that right *exchanged* by assignment to the LLC for a membership interest in the LLC is a *tax-exempt transaction*. Thus, the value of the syndicator's property rights is not taxed at the time the right to buy is transferred to the LLC.[1]

In exchange for the syndicator's contribution of their purchase rights by a tax-free assignment, the syndicator may receive an ownership interest in the LLC classified as:

- **priority**;
- **parity**; or
- **subordinated**.

Tax consequences of a tax-deferred exchange

The tax consequences of a tax-deferred exchange of a *capital interest* for any interest in ownership of the LLC remain the same. However, the syndicator's contributions of their promotional or organizational services for which they will be compensated, *spent on behalf* of the LLC for a participation in ownership, are not tax exempt. Priorities are thus a critical concern when contributing services and expending time, talent and effort on behalf of an LLC.

Consider a syndicator who enters into a purchase agreement in the syndicator's name, acting as a principal, to purchase property. The purchase agreement allows the syndicator to later assign their contract rights to purchase the property to an LLC to be organized by the syndicator.

Escrow instructions are prepared and signed, naming the syndicator as the buyer. [See **first tuesday** Form 161 and 401]

On the syndicator's completion of their due diligence investigation and satisfaction of contingencies regarding the property's condition, the syndicator forms the LLC that will acquire the property. Through escrow, the syndicator then assigns their purchase rights to the LLC. In exchange, the syndicator will take a *percentage of ownership* in the LLC.

The percentage of ownership the syndicator receives in the LLC is based on the dollar value the syndicator places on the contribution of their right to buy the property by assignment. The dollar amount placed on their contribution then represents a percentage of the total of all forms of capital contributions to the LLC.

Here, the syndicator's receipt of a membership share in the LLC in payment for their assignment of purchase rights is a *tax-exempt exchange transaction*.[2]

Contribution of valuable property rights

Consider another property rights example. A syndicator-developer controls *ground leases* and *loan commitments* under contracts entered into in their own name as a principal. Before beginning the construction of improvements on the property, the syndicator forms an LLC and assigns it all the syndicator's rights to purchase the leases, obtain the construction loan and develop the property.

The ground leases and loan commitments were the syndicator's assets, part of the net worth the syndicator developed for themselves since they were previously created or controlled in the syndicator's name, not the name of the LLC.

Here, the syndicator's contribution of these valuable property rights for an ownership interest in their newly formed LLC is a tax-free exchange.[3]

Editor's note — A syndicator may purchase and assign property rights to a named LLC before the LLC is created.[4]

Services rendered for a participation

Services rendered to the LLC include the syndicator's **time and effort** spent on behalf of the LLC to:

- locate property; and
- solicit investors to fund the purchase and co-ownership of the property.

Generally, the syndicator providing services to an LLC negotiates the purchase of property and enters into a purchase agreement or option — all in the name of the LLC. The syndicator signs the purchase agreement as the **manager** of the LLC.

The syndicator then sets a dollar value on their time and effort rendering services on behalf of the LLC. The syndicator's services rendered are exchanged for a membership interest in the LLC with an equal dollar amount. The syndicator does not act in their own name as a principal for their own account at any time, thus remaining behind the liability shield provided to a manager of an LLC at all times.

Here, the receipt of the membership interest is compensation characterized and taxed as *ordinary personal income* received for the syndicator's time and effort spent rendering services as an agent of the LLC.

Taxable contributions of services

Contributions of services to the LLC in exchange for a membership interest are not tax-free transactions. The syndicator's *compensation for services* does not receive the same tax-exempt treatment that is given to the exchange of the syndicator's **contract rights** for a share of ownership in the LLC.[5]

The *cash value* of the LLC membership interest received by the syndicator in exchange for the brokerage and organizational services the syndicator renders on behalf of the LLC (or the seller as a listing agent) is reported to the Internal Revenue Service (IRS) and the Franchise Tax Board (FTB) as part of the syndicator's brokerage business income. [See IRS Form 1040 Schedule C]

The dollar figure given to the membership interest the syndicator receives for their services is the amount they receive as their fee. However, for tax purposes, the syndicator reports as their business income from their services the **cash-equivalent value** of the membership interest they receive, not the dollar figure they set as their contribution.

The *cash-equivalent value* of the membership interest the syndicator receives for their services is taxable in the year received, unless it is **subordinated** *to the cash investors*.

To be classified as *subordinated*, the syndicator's membership interest needs to be so lacking in **parity** with the interests held by the cash investors that its cash value is entirely speculative. Thus, their membership interest cannot be determined to have a present value other than zero.

When the syndicator receives an **unsubordinated** interest in the LLC, the syndicator is on a *parity* basis with the cash investors. An *unsubordinated* membership interest received by the syndicator for promotional and organizational services is treated as equivalent to the syndicator's receipt of cash.

Thus, the dollar amount set for the syndicator's parity co-ownership interest will be taxable in the year the syndicator receives their co-ownership interest. The amount is reported as ordinary income for their professional services at the dollar figure placed on their membership interest.

Class A or Class B memberships

However, a Class B subordinated interest received by the syndicator in exchange for services rendered has no present value. Subordination limits their membership participation to *future income and profits* that may be generated by the property acquired by the LLC.

The cash investors holding Class A membership interests receive a **priority return** of their capital investment. They share first in the income and profits generated by the operations of the property before distributions of any remaining income or profits to a Class B member, i.e., the syndicator.

The taxable value of their services will not be established until the syndicator:

- sells their interest; or
- the property is sold and their interest is liquidated.[6]

For example, a syndicator receives a subordinated Class B membership interest in the LLC in exchange for services the syndicator rendered acquiring property as the manager of the LLC. The membership interest the syndicator receives in the LLC need not be reported and taxed until the syndicator receives funds on a resale or refinance of the property, or the syndicator sells their subordinated interest.

The syndicator's services are not taxed when the syndicator initially receives a **subordinated interest** in the LLC, even though the share of ownership the syndicator receives represents ordinary income for services the syndicator rendered on behalf of the LLC to locate and acquire property.[7]

In a related example, a syndicator receives a subordinated interest in the LLC in exchange for their promotional or organizational time and effort spent establishing the LLC. Later, before the LLC sells the property, the syndicator sells their interest.

On the transfer of their subordinated interest, their time and effort — services previously rendered but not previously reported and taxed — are given cash value equal to the dollar amount the syndicator received for transferring their ownership interest in the LLC.[8]

*Editor's note — While the above **Vestal** and **Diamond** cases relate to limited partnerships (LPs), the treatment is fully applicable to LLCs. LLCs automatically qualify with the IRS for partnership reporting.*[9]

Here, the cash received on their sale of the fractional interest the syndicator received for services is taxed at ordinary income rates since no prior value was reported and taxed to convert it to capital under Internal Revenue Code (IRC) §83.[10]

Editor's note — 26 United States Code (26 USC) is the Internal Revenue Code (IRC).

For either a pre-existing LLC or a yet-to-be-created LLC, the alternative to the contribution of time and effort performing brokerage services is the exchange of property rights as discussed above, created or controlled by the syndicator in their name for an ownership interest in the LLC.

Converting services to capital

The subordinated ownership interest received by a syndicator for their services has no ascertainable cash value at the time of closing. Thus, their earnings for the services rendered are not taxed at the time of closing since what the syndicator received as compensation has a value of zero.

However, when the property or the syndicator's Class B interest is sold, the money the syndicator receives is then taxed at ordinary income rates for services the syndicator previously rendered.

This adverse taxation at **ordinary income rates** can be avoided if, at the time the ownership interest was received, an *election* was made to convert it to capital from its income-for-services status.

The syndicator may elect to place a value — albeit small as it is only a fraction of the value placed on their Class B contribution — on the ownership interest the syndicator receives for their services. This minimal value is reported as earnings received. The syndicator pays the income tax due on the declared earnings as their business income.

cost basis
The cost incurred to acquire and improve an asset subject to adjustments for destruction and depreciation, used primarily for tax reporting.

The value the syndicator gives the ownership interest as the amount received and reported for their services under the election becomes the **cost basis** for their ownership interest. When the interest is liquidated by a sale of the interest in the property or the property itself, the price received is reported as the sale of a capital asset at a profit — the *cost basis* having been set by the income election valuation. Thus, capital gains rates, not ordinary income rates, apply to the sale. (Consider at this point an IRA contribution of the membership interest received for services rendered.)

IRS §83(b) Election Statement

To accomplish the election, an **§83(b) Election Statement** is filed with the IRS within 30 days after the close of escrow on the purchase of the syndicated property (and receipt of the Class B subordinated ownership in exchange for services instead of an assignment of property rights).

Another copy is addressed to the LLC since it issued the Class B interest for the services. A copy is also later attached to the syndicator's IRS 1040 tax return for the year.

The **§83(b) Election Statement** describes:

- the interest received;
- the terms of the subordination (restrictions);
- the value placed on it for the election (even though the interest has no present cash value); and
- any amount paid for the interest (such as including the value of the property right assigned together with the services).[11]

Exchange of both services and rights

To further clarify their intentions to create and assign property rights, a syndicator will:

- contribute their purchase rights to acquire property in exchange for a membership interest in the LLC; and
- render services for the promotion and formation of the LLC that the LLC will pay for in cash.

Services rendered include the time and effort spent forming the LLC and soliciting investors to provide equity financing for the acquisition of property.

Conversely, **property rights** held in the name of the syndicator, embodied in the purchase agreement or option to purchase the property, are assigned to the LLC for a membership interest. The property rights exist as a capital interest even when their sole purpose in contracting to buy the real estate is to syndicate the equity financing and assign their purchase rights prior to closing escrow. No holding period exists in tax-free exchanges.

Exclusive of contracting to buy property, the task of syndication — forming the group investment — includes:

- originating the LLC entity [See Chapter 16];
- creating the investment circular (IC) [See Chapter 21];
- soliciting investors [See Chapter 7]; and
- gathering the investor's funds.

These efforts are on behalf of the LLC, not part of the negotiations with the seller and investigations into the property's conditions. Arguably, the syndicator is selling shares in an LLC which the syndicator created and owns, constituting a short-term capital gain or inventory of their business. These are both taxed at ordinary rates but with an additional *self-employed tax* (15.3%) on the business earnings.

An all-services tax challenge (or an arbitrary partial allocation) by the IRS arising out of the syndicator's exclusive use of the IRC §721 tax exemption to report all of their front-end earnings in a syndicated transaction may be avoided. To do so, the syndicator needs to separate their contract rights from their compensation for services and evaluate them individually.

To establish the value of each before closing, a syndicator:

- receives a cash fee for their organizational services, reported and taxed in the year the LLC acquires the property; and
- assigns their purchase rights to the LLC for a membership interest, an exchange that is a tax-exempt transfer of their contract rights.

Reduction of risk of loss of tax-exempt treatment

Consider a syndicator-developer who has maps, engineering reports and plans prepared for a property they have under contract as the buyer. To close escrow and take title to the property, the syndicator forms an LLC to equity finance the acquisition. The syndicator contributes the subdivision plans to the LLC in exchange for a membership interest in the LLC.

Here, the plans are considered **property** the syndicator produced for themselves, not the product of **services** rendered on behalf of someone else (the LLC). The value created by the development of maps, engineering and plans the syndicator contracted for and owns in their name is not taxed when assigned to the LLC.

In addition to creating the real estate maps and plans in their own name when acting as a principal for their own account, the syndicator performs services on behalf of the LLC such as the preparation of the IC and solicitation of investors. The syndicator is compensated for these organizational services in cash. Thus, the value of the services — cash — will be reported as business category income in the year received.[12]

By delivering to the LLC services and property rights, and setting the value of each in agreements prior to closing, the syndicator's receipt of cash for their services greatly reduces the risk of losing a portion of the IRC §721 tax-exempt treatment allowed on the transfer of their contract right to acquire real estate in exchange for a membership interest in the LLC.

Self-employment taxes

In addition to paying income tax, the syndicator will pay 15.3% self-employment taxes on the income the syndicator receives for services rendered forming the investment group and the LLC.

Sidebar

LLC annual fee based on apportionment of gross income

For purposes of calculating the annual limited liability company (LLC) fee due to the Franchise Tax Board (FTB) from a multi-state LLC doing business in California, the calculation of gross income is made by:

- *electing to be taxed under a single sales factor; or*
- *making no election, resulting in the LLC being taxed under property, payroll and double sales factors.*

If a multi-state LLC elects to be taxed under a single sales factor, the gross income upon which the annual fee is based is apportioned to California for:

- *services received in California;*
- *the sale of intangible property used in California;*
- *the sale of marketable securities if the buyer is in California;*
- *the sale, lease, rental or licensing of real property located in California; and*
- *the rental, lease or licensing of tangible personal property located in California.*

If a multistate LLC does not make an election to be taxed under a single sales factor, the gross income upon which the annual fee is based is apportioned to California for:

- *income-producing activity performed in California; or*
- *the greater proportion of income-producing activity which is performed in California, based on performance costs. [Revenue and Taxation Code §25136]*

Self-employment taxes are imposed on the net income produced by the syndicator in their **trade or business**, namely, on monies paid to the syndicator less expenses for forming and funding the LLC and for their ongoing property management services.[13]

The share of spendable income the syndicator receives on a distribution to all members — including themselves — is **rental income**. The self-employment tax is not imposed on earnings generated for members by the operation of the LLC's real estate. Rental income is **passive category income**, not trade or business category income.[14]

The ownership and operation of a rental property is **not a business**, even though the ownership is structured as an LLC, which is a business entity.

Members are not liable for self-employment tax on rental income since the LLC has no trade or business income — unless it owns land which it holds for development in a resale program (dealer property).

Also, the self-employment tax is imposed on the income of the owner-operator of a hotel, motel or vacation rental, since the average occupancy is for a period of **30 days or less**. Thus, similar to dealer property, income from transient occupancy establishments constitutes business category income for material participants.[15]

In contrast, the earnings generated by the owner-operator of income-producing real estate are reported as rental income or losses in the *passive income category* if the average occupancy of all tenants is **more than 30 days**.

Accordingly, the manager escapes the self-employment tax for any distributions based on their pro rata ownership interest acquired in the LLC for services rendered. However, the manager's income for services rendered under a **property management contract** with the LLC or its members is considered trade or business income subject to the self-employment tax. [See **first tuesday** Form 590]

Chapter 10 Summary

A distinction exists for tax reporting between the income a syndicator derives from:

- their contribution of capital to a limited liability company (LLC); and
- services rendered by the syndicator on behalf of the LLC.

The syndicator's personal tax objective when structuring syndication activities is to maximize their earnings from syndication activities while minimizing the negative tax impact they have.

The income a syndicator receives during the life of the investment program, from inception to resale of the property, is given the most favorable tax treatment if it is structured as a return on capital (profit), and not payment for services (ordinary income).

A syndicator locating a property and packaging an investment opportunity for the LLC establishes property rights when they enter into a binding contract to buy, finance or develop real estate. Property rights created by the syndicator when acting as a principal are considered capital interests.

Services rendered acting on behalf of another produces self-employed business income. Self-employment occurs when a syndicator negotiates a purchase agreement entered into in the name of the LLC as the buyer and signed by the syndicator on behalf of the LLC as its manager.

When a syndicator assigns to an LLC a contract right they previously negotiated, created and hold in their name to purchase a property, that right exchanged by assignment to the LLC for a membership interest in the LLC is a tax-exempt transaction.

The receipt of the membership interest is compensation characterized and taxed as ordinary personal income received for the syndicator's time and effort spent rendering services as an agent of the LLC.

Contributions of services to the LLC in exchange for a membership interest are not tax-free transactions. The syndicator's compensation for services does not receive the same tax-exempt treatment that is given to the exchange of the syndicator's contract rights for a share of ownership in the LLC.

In addition to paying income tax, the syndicator will pay 15.3% self-employment taxes on the income the syndicator receives for services rendered forming the investment group and the LLC.

The share of spendable income the syndicator receives on a distribution to all members is rental income. Rental income is passive category income, not trade or business category income.

Members are not liable for self-employment tax on rental income since the LLC has no trade or business income.

However, the manager's income for services rendered under a property management contract with the LLC or its members is considered trade or business income subject to the self-employment tax.

Chapter 10 Key Terms

cost basis ....**pg. 92**
return on capital ....**pg. 88**

Chapter 10 Cites

1. 26 United States Code §721
2. **Ungar** v. **Commissioner** (1963) 22 TCM 766
3. **United States** v. **Stafford** (1984) 727 F2d 1043
4. **02 Development LLC** v. **607 South Park, LLC** (2008) 159 CA4th 609
5. 26 USC §721
6. **Campbell** v. **Commissioner of Internal Revenue** (1991) 943 F2d 815
7. **Vestal** v. **United States** (1974) 498 F2d 487
8. **Diamond** v. **Commissioner of Internal Revenue** (1974) 492 F2d 286
9. 26 USC §7701(a)(2)
10. 26 USC §83
11. 26 USC §83(b)
12. **United States** v. **Frazell** (1964) 335 F2d 487
13. 26 Code of Federal Regulations §1.1402(a)-1
14. 26 CFR §1.1402(a)-4
15. 26 CFR §1.1402(a)-4(c)


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Chapter 11

Tax benefits for co-owners

Learning Objectives

After reading this chapter, you will be able to:

- apply income tax reporting rules to the limited liability company (LLC) co-owners' capital investment and their share of operating income or losses during ownership; and
- understand how to use rental operating losses to offset income and profits within other income categories.

Key Terms

adjusted gross income (AGI)	**return of capital**
passive category income	**suspended losses**

Capital recovery, operating income and losses

Income tax aspects for owners of real estate is merely an incidental source of additional earnings. The incentive of tax relief is minor in amount and of lesser importance when compared to earnings generated by the property, including:

- spendable income;
- loan reduction; and
- growth in property value.

An investment analysis based on a property's fundamentals historically used to set its market value does not include the external income tax consequences of its ownership. Income tax consequences of ownership do not impact the analysis of a property. The taxes a co-owner of a limited liability company (LLC) pays depend on the tax status of the co-owner and not the property, except for the duration of its depreciation schedules.

The major income tax benefit derived by an owner of improved real estate is the annual **tax-free return** of a portion of the owner's invested capital, called a **depreciation deduction allowance**. The *deduction* provides an accounting method for the recovery of the owner's invested capital — the cash down payment and funds from a purchase-assist loan or debt assumed — without incurring a tax when the capital is returned.

The return of the invested capital

return of capital
The annual return of funds originally contributed to the investors or, in the case of a real estate investment, that portion of the net operating income (NOI) annually sheltered from taxes by a depreciation deduction, as well as any net proceeds from a refinance or resale of the property, cumulative up to the amount of the original contributions, also known as return of investment. To be distinguished from a return on capital.

In theory, the **return of capital** recovered tax-free from the property's rental income is justified. The recovery of the annual loss in value of the improvements due to deterioration, obsolescence and wear and tear brings the improvement to a statistically useful end after a period of 27.5 to 40 years.

However, the experience of ownership in most of California demonstrates that well-maintained property actually increases in value over time. This increase tracks the growth of the local population and increase in its personal wealth. Thus, the annual tax-free recovery of capital from rents is a windfall for most property located in well-populated areas of California if it is adequately maintained.

The tax-free *return of capital* is the result of the annual depreciation allowance an investor is permitted to write off. The allowance is based on the cost of improvements acquired as part of the real estate. The annual amount of depreciation allowed is deducted from the property's **net operating income (NOI)** before arriving at the amount of the rental income that is reported by the ownership and subject to income taxes.

The rental income sheltered by the depreciation allowance is often calculated for investors over the initial ten-year period of ownership as an annual yield on their cash contributions. Technically, the amount sheltered from taxes by the depreciation deduction is not a **return on** the capital invested (from rental income), but properly a **return of** the invested capital (originally contributed).

Consider an income-producing property with an annual gross operating income of $120,000 and operating expenses of $40,000. The property's *NOI* is the difference in these amounts, $80,000.

To determine the annual reportable operating income or loss for the ownership of the property, the interest paid on mortgages and the depreciation allowance are then deducted from the NOI. **Interest** is the ownership's cost of borrowing *additional capital* to fund the purchase of the investment. **Depreciation** is the owner's recovery of all of their invested capital allocated to improvements. [See **first tuesday** Form 352]

Suppose the annual interest payments amount to $60,000 and the depreciation deduction is $20,000. Thus, the property has no reportable operating income (or loss), since the total amount of interest paid and depreciation deductions ($80,000) equals (or exceeds) the NOI ($80,000).

Depreciation deduction shelter

In a separate analysis, the NOI includes **spendable income**, the colorful title given to the amount of rents remaining after deducting mortgage payments of principal and interest from the NOI. Here, principal and interest (PI) payments amount to $67,000 annually, which is paid out of the $80,000 NOI. Thus, the remaining $13,000 is spendable income and is distributable to the co-owners of the LLC.

When determining the amount of spendable income a property produces, depreciation is not a factor as depreciation is not an operating expense incurred by the property. Taxwise for the owner, spendable income comprises a return of capital or ordinary income (or a mix of both) depending on the amounts of the depreciation deduction and principal reduction on mortgages, neither of which relate to operating the property.

Here, the property does not produce reportable income, but does generate spendable income. Since the owners borrowed capital to buy the property, no part of the spendable income is taxed in the first year of ownership –– the results of interest and depreciation deductions. The amount of spendable income (and debt reduction through the payment of principal) is "sheltered" by the depreciation deduction. Technically, the spendable income is classified as a tax-free return of invested capital, not as income or profit.

However, rents sheltered by depreciation deductions are often casually viewed as an additional source of income for the investors — as though it were a yield on the original investment — even though rental income, to the extent it is offset by depreciation, is a return of capital, not a yield at all.

The rationale that allows the return of capital to be viewed as income is that real estate market values are not perceived to be negatively affected by the deterioration and wear of improvements. This dismissal of an improvement's aging seems justified due to the offsetting effect on value brought about by inflation, appreciation, maintenance and proper management of income and expenses.

Losses offset income in three ways

For each LLC co-owner member, a rental property's reportable losses from annual operations are first applied to offset any reportable income the co-owner member may have from other rental properties and passive business investments. Both sources of income are reported as **passive category income** in Schedule E of each co-owner's Internal Revenue Service (IRS) 1040 tax return. [See IRS Form 1040 Schedule E]

passive category income
Profits and losses from rental real estate, operations and sales, and from non-owner-operated businesses.

However, **rental operating losses** (including the allowance for depreciation) greater than the co-owner member's income from all *passive category income* investments do not just disappear. The annual operating losses from the property may then be reported by each co-owner on their IRS 1040 tax return to offset income and profits within other categories.

adjusted gross income (AGI)
The total of the taxpayer's reportable income and losses from all three income categories.

suspended losses
A capital loss incurred as a result of passive activities on a property that is not realized in a given tax year and carried forward for use in future years to offset income or profits from the property incurring the loss.

Depending on the co-owner's level of involvement in management, their **adjusted gross income (AGI)** and whether the LLC files a return, the co-owner may offset their income from other categories in one of the following ways:

1. If the co-owner qualifies as being in a **real estate related business** and further qualifies as a **material participant** in the management of this property, the amount of the loss on Schedule E *lowers* the amount of the co-owner's *AGI*.
2. If the co-owner qualifies as **active management**, the amount reported as the loss on Schedule E is *deducted from* the co-owner's **AGI** to determine their taxable income, called the **$25,000 rental loss deduction**.[1]
3. If the co-owner does not qualify for the adjustment to AGI or the *rental loss deduction*, the amount of the loss on Schedule K-1 or E is carried forward by the co-owner for use in future years to offset income or profits from the property incurring the loss, called **suspended losses**.

Services rendered as a material participant

For a co-owner to qualify to write off their share of the property's operating loss (as passive category income) offsetting their income from trade or business category or portfolio category income and reduce their AGI, they must be classified as a **material participant** by rendering services in real estate related business activities.

Businesses where a co-owner may be involved in rendering real estate related services include:

- the acquisition, development or construction of real estate;
- the management of income properties in which they own an interest (as a landlord); and
- any real estate brokerage services performed on behalf of others as a real estate licensee.

When a co-owner is involved in real estate related businesses and intends to write off their rental operating losses by reducing their AGI, they need to also qualify as a **material participant** in those businesses by:

- spending at least 750 hours per year rendering real estate related services; and
- providing real estate services for more than half of all their time spent rendering services of all types, including other types of professional, business or investment services.

The syndicator acting as both the manager and a co-owner generally qualifies as a *material participant* in real estate related businesses since they usually do not render any type of service other than those that are real estate related, such as acquisition, management and sales of real estate, for themselves or for others in this and other properties.

1 26 United States Code §469(i)

As for the other co-owners, they need to be involved in real estate businesses, other than their investment in the syndicated property, in order to qualify to write off the property's operating loss against sources of income other than passive business-opportunity investments and rental properties and reduce their AGI.

The $25,000 rental loss deduction

Consider a co-owner who does not qualify as a material participant in a real estate related business. They cannot directly offset income from other categories and use it to reduce their AGI by the amount of their share of the operating loss.

Here, the co-owner may qualify to *deduct* the operating loss from the AGI (instead of reducing the AGI), called the **$25,000 rental loss deduction**. To do so, the co-owner must be *actively involved* as an owner who authorizes the syndicator to act as the property management under contract with the co-owner.

For a co-owner to avoid automatic disqualification as an **inactive co-owner**, the LLC or tenant-in-common (TIC) vesting cannot file a partnership return. Thus, the co-owner will not receive or file a K-1 Schedule with their IRS 1040 tax return. It is the K-1 that identifies a co-owner as an inactive co-owner of the real estate. Instead, they will file a Schedule E with their IRS 1040 tax return to report their share of the operating loss.[2]

An LLC may avoid filing a partnership return with the IRS under the small partnership exemption when:

- ten-or-less co-owners (husband and wife are counted as one) are involved; or
- the co-owners are TIC co-owners and do not number more than 35. [See Chapter 14]

Limitations under the $25,000 rental loss deduction

Several limitations are placed on an LLC co-owner's use of the operating loss under the **$25,000 rental loss deduction**. These limitations include:

1. The co-owner's fractional ownership interest needs to be a minimum of 10% of all interests in the LLC.[3]
2. The co-owner cannot report a rental loss above $25,000.
3. For each dollar the co-owner's AGI exceeds $100,000, there needs to be a 50% reduction in every dollar of the deductible operating loss amount, which eliminates any deduction of a rental operating loss if the co-owner's AGI exceeds $150,000.[4]
4. A co-owner needs to personally enter into the property management agreement (with the other co-owners) which employs, for a period not in excess of one year, a property manager to enter into leases with tenants. The LLC's operating agreement must also state the LLC's

2 26 USC §469(i)(6)(C)
3 26 USC §469(i)(6)(A)
4 26 USC §469(i)(3)

purpose is to hold title on behalf of the co-owners, all of whom are classified as TIC co-owners, and operate the property in the name of the property manager, not the LLC. [See **first tuesday** Form 590]

When a co-owner is unable to use the operating loss under the $25,000 rental loss deduction (or as a real estate related business), the losses are retained on the co-owner's books as **suspended losses**. *Suspended losses* are carried forward to be used in future years when reportable operating income is generated by the property or a profit is taken on a sale of the property.

Chapter 11 Summary

Income tax aspects for owners of real estate is merely an incidental source of additional earnings. The incentive of tax relief is minor in amount and of lesser importance when compared to earnings generated by the property.

An investment analysis based on a property's fundamentals historically used to set its market value does not include the external income tax consequences of its ownership. The major income tax benefit derived by an owner of improved real estate is the annual tax-free return of a portion of the owner's invested capital, called a depreciation deduction allowance.

The tax-free return of capital is the result of the annual depreciation allowance an investor is permitted to write off. The allowance is based on the cost of improvements acquired as part of the real estate.

For each limited liability company (LLC) co-owner member, a rental property's reportable losses from annual operations are first applied to offset any reportable income the co-owner member may have from other rental properties and passive business investments.

However, rental operating losses (including the allowance for depreciation) greater than the co-owner member's income from all passive category income investments do not just disappear. The annual operating losses from the property may then be reported by each co-owner on their tax return to offset income and profits within other categories.

For a co-owner to qualify to write off their share of the property's operating loss offsetting their income from trade or business category or portfolio category income and reduce their AGI, they must be classified as a material participant by rendering services in real estate related business activities.

The syndicator acting as both the manager and a co-owner generally qualifies as a material participant in real estate related businesses since they usually do not render any type of service other than those that are real estate related, such as acquisition, management and sales of real estate, for themselves or for others in this and other properties.

A co-owner who does not qualify as a material participant in a real estate related business cannot directly offset income from other categories and use it to reduce their AGI by the amount of their share of the operating loss. However, the co-owner may qualify to deduct the operating loss from the AGI, called the $25,000 rental loss deduction, by being actively involved as an owner who authorizes the syndicator to act as the property management under contract with the co-owner.

For a co-owner to avoid automatic disqualification as an inactive co-owner, the LLC or tenant-in-common (TIC) vesting cannot file a partnership return.

Chapter 11 Key Terms

adjusted gross income (AGI) .... **pg. 102**
passive category income .... **pg. 101**
return on capital .... **pg. 100**
suspended losses... **pg. 102**


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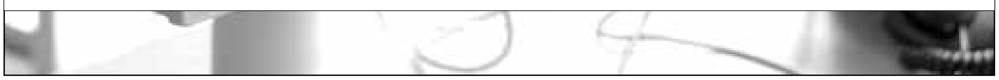
Chapter 12

Tenants in common or tax partners



Learning Objectives

After reading this chapter, you will be able to:

- distinguish between the co-ownership of property and having a co-ownership interest in an entity that owns property;
- identify the arrangements an owner of a fractional interest in a real estate investment is to undertake to qualify their separate sale or purchase of that individual co-ownership interest as §1031 property; and
- understand the advantages of using a wholly owned, one-man limited liability company (LLC) or limited partnership (LP) to hold title to their fractional ownership interest as a tenant in common (TIC) with all other co-owners.

Key Terms

alienation

disregarded entity

Subdivided Lands Act (SLA)

§1031 fractional ownership issues

The profit taken on the sale (or exchange) of an ownership interest in real estate may qualify for an exemption from income taxes under **Internal Revenue Code (IRC) §1031**.

For a seller to use the exemption, the interest sold must be an *ownership in property* that together combine to qualify as **like-kind property**, commonly called *§1031 property*.

Following in tandem to complete a §1031 reinvestment plan, the ownership interest acquired in the replacement real estate needs to also be §1031 property.

Thus, in any §1031 reinvestment plan, both "legs" of the plan — the property sold and the property acquired — must qualify as the investor's *ownership* of §1031 property. §1031 property is initially classified as property held either for **investment** or **productive use** in a business.[1]

Editor's note – 26 United States Code (26 USC) is the Internal Revenue Code (IRC).

The §1031 tax-exempt transaction

When an entity such as a limited partnership (LP) or limited liability company (LLC) sells a parcel of real estate held either for investment or productive use and replaces it by purchasing another parcel it will hold for investment or productive use, the entity has completed a §1031 tax-exempt transaction.

The co-owners of the partnership or LLC then separately report their pro rata share of the gain passed through to them on the §1031 transaction as exempt from taxes — **non-recognition of profits**. The group moved their collective ownership from one property to another as an entity — selling and buying ownership in like-kind properties as *one person*.

In contrast, an investor's fractional ownership interest in a group does not qualify as §1031 property if their interest is a **co-ownership interest** in an entity, such as a(n):

- LP;
- LLC;
- corporation; or
- tenants in common (TICs).

In all instances, it is the entity that owns the real estate.

An investor's sale of their percentage of co-ownership in the entity, independent of the sale of the real estate held by the group, does not qualify for the §1031 exemption. The individual co-owner's reinvestment plan includes the sale of a fractional ownership interest in an entity classified as a **tax partnership**.

Tax partner in co-ownership

Further, a co-owner vested as a *TIC* with a group of co-owners is considered a **tax partner** in the co-ownership of §1031 property if they have *agreed to restraints* on their common law rights as a TIC to freely manage their interest in the property — independent of control by other co-owners and as they see fit.

When classified as a *tax partner* for income tax reporting, the TIC investor is considered a co-owner of an interest in a *tax partnership*, not a co-owner holding an ownership interest directly in the real estate (even though title to the real estate is vested in their name with others).

1 26 United States Code §1031

As a result, the tax partnership is treated as the sole owner of the §1031 property for tax purposes. The TIC co-owners are partners who merely own a personal property interest in the partnership, not the real estate.

When a TIC co-owner, by agreement or by definition, is a tax partner with others, none of the profit taken on the separate sale of their fractional interest qualifies as exempt from taxes.

To avoid being a tax partner on the sale or purchase of a fractional interest in a group which presently owns §1031 real estate, the fractional interest sold or acquired needs to be an **independently manageable** ownership interest held by each investor directly in the real estate, not the investor's mere ownership of an interest in a TIC partnership. A partnership operates separate from each TIC co-owner. It is the partnership that controls the ownership rights in the real estate for all co-owners.

A tax partnership vs. a California partnership

The **coordinated conduct** of co-owners in the exercise of ownership rights to operate the investment real estate they co-own is viewed differently under federal income tax law than under California partnership law.

Basically, when co-owners of property located in California share the income — profit and losses generated by a joint investment in real estate — and operate under an unincorporated ownership arrangement such as a TIC, California partnership law classifies the profit-sharing group as a partnership.

Thus, California imposes agency obligations on each co-owner to act in concert for *the mutual benefit* of the group. These agency obligations arise the first moment discussions about a syndicated investment occur. As a result, anarchy within the group of co-owners is legally avoided as public policy in California.

Conversely, federal tax law as a contrivance places emphasis on common law TIC rules to establish co-owner rights, but solely for the purposes of tax reporting. TIC ownership does not rise to tax partner status unless the co-owners are operating as:

- a declared partnership (general or limited);
- an LLC which has not elected to report as a corporation; or
- a cooperative TIC.

Avoidance of federal tax partnership status

To avoid federal tax partnership status, each co-owner vested as a TIC needs to have the unrestricted common law right by agreement to independently *alienate* their fractional interest without the prior consent of the other co-owners. Further, each co-owner also needs to have the unrestricted right to independently block any **alienation** of the entire property co-owned by the group.

Alienation of the entire property refers to its sale, further encumbrance or lease for a period exceeding one year.

alienation
The transfer of an interest in real estate from one person to another.

Taxwise, the ownership of a TIC interest that retains its common law right of alienation in real estate is viewed by the Internal Revenue Service (IRS) as being the §1031 ownership of a fractional interest in the real estate itself, rather than merely the owner of an interest in a partnership which controls ownership activities. Thus, California state law is not considered by the IRS for tax reporting purposes since California will treat the same TIC as a California partnership when a dispute arises.

Cooperation among co-owners

Further, §1031 TIC co-ownership arrangements may provide for **cooperation** among the co-owners in the ongoing management and operation of the property. Operating the property by centralized management does not violate the IRS requirement of unanimous approval for sale, encumbrance or leasing (alienation) of the entire property by the group. Thus, the alienation rights inherent in ownership are distinguished by the IRS from the day-to-day operations of the property. Not so under California treatment of TIC ownerships of real estate.

An understanding of the distinctions between federal tax law (which defines §1031 property investments as excluding fractional interests held by tax partners) and California's partnership law (which controls joint ventures and profit sharing ownerships that are not entities) is critical to individuals involved in investment groups.

These individuals include:

- **syndicators** structuring the ownership for acquisition of property by an investment group they are forming;
- **investors** acquiring or withdrawing a fractional interest from a syndicated real estate investment; and
- **brokers** (or other advisors) representing a person who is buying into or withdrawing from a real estate syndicated investment.

Knowing the parameters for activities that establish a partner under California partnership law versus activities that establish a tax partnership for federal income tax reporting avoids unintended and unexpected results under either set of laws, or worse, the loss of a transaction because of insufficient knowledge.

We cooperate in California

Consider a group of investors who acquire income-producing property located in California. Title is taken as *TICs*, naming each investor and stating their percentage or fractional share of **undivided ownership** in the property.

The property is occupied by tenants under short-term leases and periodic rental agreements that provide for the landlord to care for and maintain the premises.

The co-owner investors orally agree to:

- divide annual operating income (or losses) and resale profits on a pro rata basis in accordance with their percentage of ownership;

- grant each other a *right of first refusal* on a resale of their fractional TIC interests; and
- grant the syndicator the option to purchase the property at its fair market value (FMV).

The broker who organized the group is also designated to manage the property with authority to:

- locate tenants;
- enter into short-term lease and rental agreements;
- collect rents;
- contract for the repair, maintenance, utilities and security to be provided by the landlord under the lease agreements;
- pay operating expenses and mortgage payments; and
- distribute spendable income to the co-owners quarterly.

Are the co-owners conducting themselves as partners under California partnership law despite the TIC vesting placing each co-owner on title?

Yes! Co-owners of California real estate vested as TICs, when engaged in the business of *jointly operating* the property on terms calling for them to *share income and profits*, are conducting themselves as partners. Thus, they are considered *agents of one another*, charged as fiduciaries with the duty to cooperate in the ownership of the property.[2]

A TIC vesting does not control the **possessory rights** of the co-owners when the co-ownership conduct in fact constitutes a California partnership. For example, a partner may use or possess partnership property only on behalf of the partnership, while a common-law TIC co-owner (as viewed by the IRS) may use, possess or lease the property themselves, without regard to any other co-owner.[3]

Partners who co-own their partnership

Further, TIC co-owners who conduct themselves as **joint operators** of a property, such as occurs with a rental property, are not co-owners of the real estate. They are partners who co-own their partnership. Thus, the partnership owns the property without concern for the type of vesting — title holding vehicle — the group of investors has chosen.

As a *partner*, the vested co-owner does not hold a right to an interest in the property that they can independently possess or separately transfer by leasing the property to a tenant without concern for the other co-owners.

The only **transferable interest** the TIC co-owner has is their **fractional interest** in the partnership. The partnership interest entitles them to share profits and receive distributions. Thus, the co-owner's fractional interest, vested as a TIC interest, is no more than a **personal property** share of ownership in a California partnership.[4]

2 Calif. Corporations Code §§16202(a), 16202(c)(3)
3 Corp C §16401(g)
4 Corp C §16502

Trustees for one another, by law

Although title to an income-producing property held by co-owner investors for profit is vested in the names of all the co-owners, each co-owner actually *holds title as a trustee* on behalf of all the TIC co-owners, collectively called a **partnership**.[5]

As co-owners and operators of a rental property, they have formed a partnership, holding title in the most troublesome of all California co-ownership vestings: a TIC.

Thus, the conveyance of a co-owner's TIC interest to another person conveys nothing more than the co-owner's interest in the partnership's **equitable ownership** of the property. The partnership's title to the property is *held in trust*, in the name of each co-owner for the benefit of all co-owners.

The defining acts of partners

Prior to California's 1949 enactment creating **tenancies in partnership**, TIC co-owners who owned rental property requiring centralized management did not constitute a partnership. Before 1949, no agency relationship existed between TIC co-owners to protect the common interests of the co-owners to share profits. The federal tax law defining TIC interests remains the same today as the prior California law controlling TICs.[6]

Since 1949, a California partnership exists when two or more investors join together to carry on a business for income and profit in California. A California business includes every trade, occupation or profession.[7]

While landlord and property management activities are not classified as a trade or business activity for federal income tax purposes (since the property is a passive rental operation or a portfolio asset), landlord and property management by a syndicated group is an *occupation* under California partnership law. A co-ownership is a California partnership if the co-owners are involved in *sharing earnings and profits* from rental operations, refinancing and resale of the property they own.[8]

Also, the receipt of income (from operations) and profits (from a sale) by co-owners from their joint investment is considered evidence of a California partnership, unless the earnings are received by a co-owner in payment:

- of an installment note, including one given in consideration for the sale of goodwill or property;
- for wages or rent due the co-owner;
- on an annuity to a surviving spouse or representative of a deceased co-owner; or
- as interest on a loan.[9]

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5 Calif. Civil Code §682; Corp C §16404(b)(1)

6 **Johnston** v. **Kitchin** (1928) 203 C 766

7 Corp C §16101(1)

8 Corp C §§16202(a), 16202(c)(3)

9 Corp C §16202(c)(3)

The TIC partnership

With a TIC vesting, the sharing of income and profits earned by each co-owner's separate use of the property — such as occurs with the extraction of minerals from the property by each co-owner for their own separate use — does not in itself create a California partnership. It takes more than the sharing of use and possession by co-owners to constitute conduct on the level of a partnership.[10]

It is the *interaction and coordinated conduct* of the co-owners while directly or indirectly managing or operating the investment that determines whether a state law partnership relationship exists between them. Once the conduct of co-owners in a coordinated ongoing operation of the property constitutes a joint and mutually beneficial activity, an agency relationship exists between the co-owners.

With the agency relationship comes fiduciary duties owed to partners, which obligates each prospective or actual co-owner to act in the best interest of the group, not to act independently on the investment opportunity before them.[11]

Interaction and coordinated conduct among co-owners

Thus, TIC co-owners of rental property who act collectively to manage the property or authorize a property manager to operate the property on their behalf hold ownership to the real estate under what has been best entitled a **tenancy in partnership**. Each co-owner is a tenant in partnership with all other co-owner investors.

By the sharing of income among co-owners who are vested as TICs, a *tenancy in partnership* is established.

Each co-owner is subjected to the rights and obligations of a partner, such as:

- the duty to hold title to the real estate as a trustee for the benefit of the partnership;[12]
- the right of each co-owner to use and possess the real estate — but only for group purposes;[13]
- the nontransferable right to use and possess the real estate unless all co-owners collectively transfer the partnership's right to possession of the property;[14] and
- the protection of the co-owned property as not being subject to attachment or execution on a judgment against an individual co-owner, only on claims against the partnership.[15]

Even when co-owners do not characterize their mutual working relationship in a profit-sharing investment as a partnership, they are still obligated to *act on behalf of the group* as though they were partners in a partnership.[16]

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10 Corp C §16202(c)(1)
11 Corp C §16404; **Leff** v. **Gunter** (1983) 33 C3d 508
12 Corp C §16404(b)(1)
13 Corp C §16401(g)
14 Corp C §§16203, 16501
15 Corp C §§16201, 16501
16 Corp C §16202(a)

Under state law, TIC co-owners hold no interest in the real estate they co-own that they can legally transfer, voluntarily or involuntarily, independent of the rights of the resulting California partnership.[17]

However, federal tax law for determining the tax partner status of TICs disregards state law to the contrary.[18]

A tax partner's profits disqualified

The penalty for a TIC co-owner who is federally classified as a tax partner in the ownership of either the property sold or the property acquired in a **§1031 reinvestment plan**, is the loss of the entire **§1031 tax exemption** for profit taken on the property sold.[19]

Thus, the arrangements or activities a co-owner, other co-owners, a property manager, a syndicator or a lender agree to between themselves, which makes a co-owner a tax partner, may become, if not already, of great concern to investors in syndicated real estate investments programs.

When a co-owner of investment real estate is classified by the IRS as a partner, the real estate is considered to be owned by a tax partnership. Classified as a partner, the co-owner's ownership interest is that of a share in a partnership and does not qualify as §1031 property.

Thus, an investor with after-tax cash they have accumulated or §1031 money to reinvest, who makes a capital contribution to a group being formed to jointly own and operate an income-producing parcel of real estate, needs to be certain no co-owner is sharing in any income from tenants other than rent.

Co-owners establish tax partner status if they:

- occasionally provide tenants with business or professional services (such as linen service, maid service, meals, etc.) for a fee separate from rent; or
- share in the income received by others providing services to tenants that go beyond the customary services required under a lease.

Co-owners or partners

Tax partner status is of no concern to a co-owner, unless and until the co-owner:

- withdraws from a group to separately and independently invest on their own; or
- desires to exchange their sole ownership in real estate (or the cash from its sale) for a fractional ownership in a replacement property.

To understand the **federal distinction** between a co-owner's non-partner status and tax partner status in the co-ownership of an investment in real estate, it is instructive to know the purposes behind the different income

17 Corp C §16502

18 Revenue Procedure 2002-22

19 26 USC §1031

categories. Each category has been established to report and account for income, profits and losses from the ownership and sale of real estate, put to different uses by the owner.

Three income catergories

Three income categories have been established for reporting income. The source or nature of the income, profit or loss determines the income category in which the income, profit or loss will be reported. This includes:

- **trade or business income category**, which includes real estate occupied and used by the property owner for a business they own and operate, including residential housing with an average occupancy of less than 30 days, such as motels, hotels, vacation rentals, and other transient housing and boarding facilities that provide occupants with services unrelated to the care and maintenance of the property;
- **passive income category**, which includes residential and commercial rental properties with an average occupancy of 30 days or more, but with a tenancy less than a triple net (master or ground) lease, during which the owners provide the tenant with the repair, maintenance, security, utilities and management of the property typically provided or required by state law in exchange for rent; and
- **portfolio income category**, which includes income-producing real estate subject to long-term lease agreements which shift the responsibility for the care, maintenance, repair and operation of the property and the payment of expenses of ownership such as property taxes, assessments and insurance premiums to the tenant, and includes other like-type flows of management-free income such as bonds, stocks, interest on loans (trust deed investments) and vacant, unimproved real estate held for profit on a resale (not as dealer property).

Thus, income-producing real estate *held for investment* and leased to tenants is classified as either:

- **rental (passive income) property** requiring **management services** related to the tenancies; or
- **portfolio income property** requiring no **tenant-related services** to be provided by management.

Land held for investment that does not require any management services, except for the annual payment of taxes, assessments, insurance premiums and the like, is classified as *portfolio property*. However, land held for development, subdivision and resale by the owner or a co-owner is trade or *business category inventory*.

Passive income vs. portfolio income

Stated another way, rental (passive income) property and portfolio income property are not business property. On the other hand, a motel or hotel is a business property since services unrelated to rental property operations are provided and the tenancies are generally less than 30 days.

And as a further distinction, the co-ownership arrangements relating to the management of rental or portfolio properties consists of services customarily provided for tenants by a landlord directly, or through an agent. The **landlord's services** provided for tenants are not business-related services, such as maid services, food, laundry pickup and delivery, towels or linens, which are provided to more transient occupants of trade or business category property, such as hotels, motels, transient housing or vacation rentals.

Thus, negotiations with prospective tenants to lease units or space within the property, limited to providing customary landlord services, such as the collection of rent, evictions, repairs and maintenance of the property, utilities, security and other real estate related services typically included in the rent, is not a business. Obviously, the property is not a business income category asset which provides **business-related service**, as an operator of a hotel, motel, boarding house or vacation rental property does.

Without being coupled to a business service, the capital contribution of a co-owner and the landlord services the co-owner provides in the form of rental property operations for the care and operation of the property as a rental or portfolio asset do not make the co-owner a tax partner.

Here, none of the co-owners are involved rendering *additional services* to the tenants through a business, enterprise or joint venture in which one or more of the co-owners share profits or losses in trade or business services offered to tenants.

A property manager and their authority

Co-owners may join together to own and operate income-producing property and will not be considered tax partners when they hire a broker (who may be a co-owner) as an independent property manager. The manager may be given all the authority they need to do all acts necessary to provide services for tenants which are customary under regular leasing arrangements.

However, the manager may not be given the authority to enter into long-term leases (more than one year), sell or encumber the property. These are the *rights of alienation* held by each co-owner which must remain unrestrained and require unanimous approval by all co-owners to be exercised.

The authority co-owners may give a property manager without becoming tax partners is extensive, and includes the authority to:

- act on behalf of the co-owners to negotiate and enter into leases and rental agreements with prospective or current tenants [See **first tuesday** Form 550 and 551];
- collect deposits, rents and other amounts due from tenants and deposit them into a common bank account maintained for (but not in the name of) the co-owners;
- contract for all services customarily provided to tenants under similar circumstances as part of the rent, including normal repair and maintenance of the property, utilities, trash pickup, an on-site resident manager and security;

- pay from rents (and additional funding by co-owners made necessary due to insufficient rental income) the charges for all services the manager contracts for as authorized, including the payment of property taxes, assessments, insurance premiums, mortgage payments and management fees;
- disburse to the co-owners, at least every quarter, their share of spendable income; and
- prepare annual statements for each co-owner setting forth their share of income, expenses, interest and depreciation.[20]

The customary property manager and income property owner relationship

Thus, co-owners are merely limited to the classic relationship between a property manager and an owner of income-producing property. No co-owner, directly or indirectly through another person, will carry on or share profits in a trade or business which will provide additional services to the tenants beyond those customarily provided under common leasing arrangements in exchange for rent.

However, each co-owner will be considered a tax partner who is carrying on a trade, business, financial operation or venture in a tax partnership if:

- they render the additional **business-related service** to tenants; or
- the property manager renders the additional business services and one or more co-owners (including the co-owner manager) share in the income the manager receives for providing the business-related service to the tenant.

Thus, the **tax partnership** includes the person rendering the business-related services whose income for those services provided is shared with one or more of the co-owners of the real estate. It does not matter that the person rendering the services (such as the property manager) may have no claim to the:

- spendable income from the rental operation;
- proceeds from a refinance; or
- net proceeds from its resale.

Property manager qualifications

The property manager hired by the co-owners:

- may not be a tenant; and
- may only be on a short-term management agreement, not to exceed one year, which may only be extended or renewed for a period not to exceed one year, and only by a unanimous vote of the co-owners (or by a failure to vote). [See **first tuesday** Form 590]

The property manager's pay needs to be comparable to the property management fees reasonably paid to brokers in the area for managing similar properties and providing similar real estate related management services.

20 IRS Revenue Ruling 75-374

While the manager may not be a tenant, a pre-existing or unanimously agreed long-term lease may provide for a **lessee** to care for, operate and incur at their expense all the typical services (sub-)tenants may need to occupy the premises, including the right to sublet the property, an arrangement called a **master lease**.

Further, the property manager may be granted an option to purchase the property. However, the price to be paid for the property on exercise of the option needs to be set as the **FMV** of the property at the time of purchase.

The devolution of TIC control

Some flexibility exists regarding the annual unanimous consent of the TIC co-owners to renew property management agreements and the extent of authority they may grant management to enter into long-term leases of portions of the property.[21]

Each long-term lease exceeding one year needs to be unanimously approved by all TIC co-owners to qualify each individually owned fractional ownership interest as §1031 property. This unanimous approval is satisfied by an **annual unanimous approval** of a set of long-term leasing guidelines for management. Management then follows the guidelines in the exercise of the leasing authority unanimously given by the property management agreement. [See **first tuesday** Form 590]

Thus, the authority given in the leasing guidelines is viewed as a method by which each TIC co-owner retains direct control over their right to disapprove and bar entry into a proposed lease. In effect, the parameters set in the guidelines place a limit on management's flexibility in the discretionary leasing of the property.

Guidelines for leasing

The IRS example for leasing guidelines include the typical standards any landlord sets for qualifying prospective tenants and structuring the terms and conditions of lease provisions. Guidelines for leasing include the landlord's authority to:

- care for and maintain the property;
- select tenants for the property;
- verify tenant creditworthiness;
- establish a range of rent amounts to charge tenants; and
- structure the term of the lease and the content of lease provisions.

Interestingly, the syndicator managing the property is allowed, as outlined in the IRS letter ruling, to bar any TIC co-owner from altering the guidelines during the year following their approval since the unilateral change is less than unanimous approval.

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21 IRS Private Letter Ruling 2005-13010

Until the next annual approval of leasing guidelines occurs, each TIC co-owner agrees not to alter the guidelines by exercising their ownership rights to lease the property, themselves or through a competitive leasing agent, on conflicting and possibly more advantageous long-term arrangements.[22]

Also, while the requirement for unanimous annual approval of the property management agreement is an anarchic condition detrimental to current management, apparently automatic one-year approval by **mere silence** at the time of the annual renewal is deemed a sufficient exercise of a TIC co-owner's right to approve or disapprove the renewal of an annual contract with management.

Co-owner objections

For example, a TIC operating agreement entered into by all TIC co-owners calls for **automatic annual renewal** of the property management agreement. If all TIC co-owners **fail to object** to any provisions submitted by the management team in a **notice of renewal** of the management agreement, management is approved for another year — by silence.

Thus, a TIC co-owner exercises their right to control their interest in the property by objecting to the renewal. However, if they do object, they will be penalized.

The conduct of management permitted in the IRS letter ruling gives co-owners who agree with management the right to buy out the objecting co-owner's interest. If not bought out, the objecting co-owner is limited to hiring their own property manager. However, for doing so, they will alone bear the cost of the manager they hire. Further, their manager will only be an advisor to the current management, unable to exercise any objection they or their employing co-owner may have.

Option for a buyout

As a final detriment for objections to the current management's unaltered or continued involvement, a co-owner's objection triggers an option for a buyout of the objecting co-owner's TIC interest (without a corresponding option to buy out their non-objecting co-owners' interests if they do not purchase their interest).

The option price to be paid for the objecting co-owner's TIC interest is their fractional portion of the property's FMV (set by an appraiser chosen by a majority vote of TIC co-owners). The buyout provision places a co-owner at risk of a loss on their investment if they object to the renewal in a down market, which is not justified when disputes arise solely for reason of recessionary vacancies.

Normally, a co-owner objecting to management has a reasonable basis for doing so, namely that management procedures and policies are deteriorating the future worth of the property, requiring new management to take corrective action to preserve and build up equity in the property.

22 PLR 2005-13010

Hence, the property's present FMV at the time of a co-owner's objection, especially in syndicated property which attracted §1031 monies, is an amount less than the price paid by the group to acquire the property (usually from the syndicator or a related entity) since poor management has deteriorated its worth.

Accordingly, if the non-objecting TIC co-owners exercise their option to purchase the objecting TIC co-owner's co-ownership interest, they will most likely be able to pay an amount less than the price paid by the objecting co-owner when the objecting co-owner initially acquired their fractional interest in the property.

Resale by an individual TIC as §1031 property

Consider a syndicator who seeks to bring together several property owners and cash investors to form a group to co-own an income-producing property located by the syndicator. They will take title as TICs, each for their fractional share of undivided ownership, based on the pro rata value of their contribution to the purchase price.

The entire property will be leased to a single tenant. The tenant will be either a single user of the property or a master tenant with the right to sublet portions of the premises. Either way, the lease is a triple-net lease which imposes no responsibility on the co-owners for maintenance of the property or the supplying of any tenant services. [See **first tuesday** Form 552-2]

The co-ownership agreement places no restrictions on each co-owner's ability to sell or encumber their individual TIC interest. Also, *no voting* is established to sell, release or encumber the whole of the property.

Thus, any alienation of the entire ownership of the real estate requires **unanimous approval** of all the co-owners — the essence of the conduct required for a TIC ownership to avoid the status of a tax partnership.

Based on these co-ownership arrangements, the syndicator requests of the IRS an **advance ruling** stating the arrangements for the TIC investment do not establish the investors as tax partners or members in an entity.

On receipt of the IRC ruling, the fractional interest of a co-owner vested as a TIC may be acquired or sold as like-kind property.

Thus, an investor's acquisition of a fractional interest in a TIC investment group (with §1031 monies), which is the subject of an IRS advance ruling that the group is not a tax partnership, allows the profits an investor realizes on the sale of their property to qualify for the §1031 profit tax exemption by buying like-kind replacement property.[23]

23 Rev. Proc. 2002-22

The advance ruling for audits

To receive an IRS *advance ruling*, the syndicator of a TIC co-ownership arrangement needs to, as a minimum, present extensive documentation to the IRS. In particular, the syndicator needs to demonstrate the following conditions exist:

1. Title will be vested in the name of all co-owners as TICs to their fractional or percentage ownership based on their proportionate contribution to the purchase of the property.
2. The co-owners will share in the income, profit and losses based on their percentage ownership.
3. No more than 35 participants will be co-owners, with husband and wife considered one participant.
4. The co-owners will not file a joint partnership return nor operate the property under a common business name and the co-ownership agreement will not classify the co-owners as shareholders, members or partners.
5. The co-ownership agreement may provide for a right of first refusal to anyone (co-owner, manager, syndicator or lessee) to acquire a co-owner's fractional interest if the co-owner decides to sue for a partition and sale of the property. The fractional interest will be sold at a price set as the FMV of the property at the time the right to purchase is exercised.
6. Any sale, encumbrance, lease, management or release agreement may only be entered into by unanimous approval of all co-owners (and no one related to the investment may hold a co-owner's power of attorney to act on their behalf). [See **first tuesday** Form 447]
7. Each co-owner may sell, encumber or lease their fractional ownership interest in the real estate without any prior restraints or approvals needed to permit the transfer. If a transfer occurs, a right of first refusal may exist in favor of any co-owner, the syndicator or the tenant to purchase the fractional interest transferred (based on the current FMV of the entire property).
8. Any advances made by any other co-owner, the syndicator or the manager to cover a co-owner's failure to meet a call for additional funds must be recourse and due within 31 days.
9. A co-owner may grant an option to purchase their interest to anyone. The price to be paid is the co-owner's fractional share of the whole property's FMV on the date the option is exercised, however, no guaranteed buyout (put option) may be held by a co-owner to sell to anyone involved in the investment or the property.
10. A property manager may be hired for a period of no more than one year, with the contract renewable by unanimous agreement of the co-owners. The property manager selected may be anyone except a lessee of the property, may collect rents, pay expenses incurred for the services to be provided to tenants as part of the rent, make distributions to co-owners from one bank account, prepare annual profit and loss statements for each co-owner's proportionate share of income, expenses, interest and depreciation, place insurance, negotiate leases to be executed only by unanimous approval of the co-owners and

receive a fee in an amount comparable to fees received by competitive property manager brokers. This fee cannot be based on a percentage of distribution to co-owners.

11. No lender providing funds for the investment program may be a related person to any of the co-owners, syndicator, manager or lessee.
12. The syndicator may not sell any co-owner an interest in the property for less than the fractional interest's proportionate share of the whole property's FMV (and services rendered by the syndicator to form the group), and no promotional fee or contribution by a co-owner may be contingent on the financial success of the investment program.[24]

Limited IRS guidance beyond an advance ruling

However, in spite of all these threshold arrangements to obtain an advance ruling, the IRS provides *no rules or guidelines* for the syndicator's actual formation of a group of co-owners outside the confines of a ruling. Further, the IRS provides *no guidance* for their audit on a co-owner's sale or exchange of a fractional co-ownership interest which is not the result of an advance ruling. The IRS only provides a procedure for requesting an advance ruling by a syndicator based on a very limited set of facts.

As a legal complication, an investment program designed to qualify for an advance ruling from the IRS and sold to investors in California likely creates a risk of loss for the co-owners which is controlled by **California's securities law** and the **Subdivided Lands Act (SLA)**. [See Chapter 13]

Ironically, both laws require more protection for investors than is required by the IRS for the TIC to qualify for an advance ruling regarding the non-partner status of a fractional co-ownership interest sold or acquired in a §1031 reinvestment plan.

The dilemma of an entity

An LLC or LP entity is typically used in **real estate syndications** to structure the co-ownership by investors of real estate. The use of an entity is both a more practical and prudent title holding arrangement than the previously discussed TIC vesting.

For example, California's property tax laws cause a *reassessment* of the property vested in an LLC or LP only when more than 50% of the ownership of the LLC or LP is assigned to another person by the original members of the LLC or LP.[25]

Conversely, when title for the same co-owners is vested as TICs, each co-owner who conveys their TIC interests to others (including other co-owners), triggers **reassessment** of the fractional portion they conveyed. Thus, property taxes rise on each conveyance of a fractional interest, not just the 100% reassessment when a change of the original ownership in an LLC or LP with more than 50% ownership received by one person occurs.

Subdivided Lands Act (SLA)
A law administered by the California Bureau of Real Estate (CalBRE) which protects purchasers of subdivided land consisting of five-or-more parcels or condominium and apartment projects containing five-or-more units (with exceptions) from fraud.

24 Rev. Proc. 2002-22

25 **Ocean Avenue LLC** v. **County of Los Angeles** (2014) 227 CA4th 344

Also, a **voluntary conveyance** or encumbrance by a co-owner of their interest in the property (as required to be allowed without restraint to receive federal non-partner status) may not concern other co-owners. However, a judgment lien imposed by a creditor on a vested co-owner's interest in title and a foreclosure by way of a judicial sale of the interest becomes an **involuntary conveyance** of the co-owner's interest to another person. [See Chapter 17]

The foreclosing creditor or another party will acquire the debtor's co-ownership interest in the property. On acquisition as the highest bidder, they will in all likelihood file for the partition and eventual sale of the entire property –– a forced sale by a creditor which an LLC or LP vesting fully avoids.

Another issue for vested co-owners is the release of their names to tenants as required on acquisition or change of management, unless they appoint an *agent for service of process*. An LLC or LP vesting avoids the **public release** of their names since the co-owners are secreted behind a title holding entity they have formed — the LLC or LP vesting — to either own or simply hold title in trust for the co-owners.

Most important, the co-owner is *shielded from liability* for operations of the property by the use of an entity for any uninsured obligation they may incur as an owner of the property. In contrast, TIC co-owners are directly liable as vested owners.

Thus, LLC or LP vestings are preferable for those co-owners not concerned about managing their profit tax avoidance when they invest or withdraw their investment from the group.

Acquiring a fractional interest

Consider an investor who sells their ownership interest in §1031 real estate. The investor is either the sole owner of the property or the owner of a fractional interest in property co-owned by a group. The investor has located a replacement property with an equity far greater than the net proceeds from their sale.

The seller of the replacement property is unwilling to sell on terms consisting of a purchase-money note carried back for the balance due to the seller after a down payment. Further, the investor is unwilling to commit additional cash funds themselves.

However, the investor has solicited another investor who will become a co-owner with them and contribute the additional funds needed to cash out the seller's equity and purchase the property.

A purchase agreement is entered into to acquire the property. On closing, the two investors take title to the property as TICs, each to an undivided fraction of the title in proportion to their contribution of cash toward the purchase.

They enter into a co-ownership agreement to spell out the arrangements they have agreed to between themselves regarding:

- the **management and operation** of the ongoing rental of the property; and
- the management of their **ownership interest** in the property to sell, encumber or lease (long-term) their interests or the entire property.

Arrangements for management

Continuing our previous example, the co-ownership agreement addresses their **arrangements for management** of the entire property, as well as each individual's management of their fractional ownership interest, as follows:

1. Title will be vested as a TIC.
2. The property will be managed by one of the investors (or a broker) as the property manager for a one-year period.
3. The co-owners will share income, profits and losses in proportion to their fractional ownership share in the property.
4. Each co-owner will maintain separate tax reporting for their share of operating data and cost basis in their ownership interest and depreciation deductions. Each will report their income and losses on their IRS 1040 Schedule E with no partnership return to be filed.
5. Any sale, encumbrance, long-term lease or property management contract for the property will be unanimously approved by the co-owners.
6. The right of each co-owner to sell, encumber or partition their fractional ownership interest in the property will be unrestrained by any approval or consent by the other co-owner.

No business relationship with tenants or sharing third party income

An **option to purchase** either another co-owner's fractional interest or the whole property may be granted to a co-owner or the syndicator who packaged the investment program.

Also, a **right of first refusal** may be granted to co-owners (or the syndicator) to be exercised on another co-owner's decision to sell, encumber or partition their fractional interest in the property.

The price paid on the exercise of the purchase rights is a pro rata amount of the FMV of the entire property based on the co-owner's fractional ownership interest in the property.

Does the co-ownership agreement establish a *tax partnership* which disqualifies the sale of a co-owner's TIC interest from use of the §1031 profit tax exemption?

No! Neither co-owner is entering into a *business relationship* with any tenant by providing services unrelated to the rent paid for the property, nor are they sharing income received by a third party who is operating a business providing tenants with services unrelated to operating the rental, such as laundry, food, maid service or towels and linens.

Further, as TIC co-owners, they **unanimously approve** the hiring of a property manager who has authorization to carry out only those managerial steps necessary to operate the rental property, including customary landlord services.

Thus, the co-owner has not relinquished their common law right of a TIC to act independently of the other co-owner to sell, encumber, enter into long-term leases and partition the property. No trade name, no joint operating (bank) account and no partnership agreement have been used or entered into to coordinate any sale, further encumbrance or long-term lease of the property.

The only "pooling" by the co-owners is the capital investment and its income, operating expenses and mortgage obligations of the ongoing ownership. Each co-owner has retained the ultimate property right to unilaterally withdraw from the investment by sale, encumbrance or partition without the consent of the other co-owner.

A disregarded entity holds title

An alternative available for the vesting of a co-owner's fractional interest is the use of a wholly owned, one-man LP or LLC. Title to their fractional ownership interest is held in the name of their LP or LLC as a TIC with all other co-owners. Such a vesting for their undivided fractional interest is considered by the IRS as title held by a **disregarded entity**.[26] [See **first tuesday** Form 372-5]

disregarded entity
A sole proprietorship separate from its owner for liability purposes, such as a single member limited liability company (LLC) or limited partnership (LP), where the owner reports business income on their personal tax returns, also called a pass-through entity.

As a *disregarded entity*, an individual co-owner's use of their solely-owned LLC for the vesting of their fractional share of ownership would have absolutely no tax impact on the *non-partner status* of the co-owner's undivided interest.

If title to the entire property is vested in an entity such as an LP or LLC, the co-owners' arrangements needs to be limited so the entity is merely *holding title* for each individual co-owner, as TICs. Further, the entity and the co-owners will not file a partnership return (as ten or less are already excused from doing so).

The **operating agreement** for the LP or LLC needs to establish the entity holding title has no ownership interest in the property, and is acting solely as a trustee holding title for the co-owners.[27] [See **first tuesday** Form 372-5]

A vesting change to benefit a partner

Consider a multi-unit income property owned and operated by an investment group as an unincorporated association structured as an LP or LLC. A broker operates the property as the property manager.

26 26 Code of Federal Regulations §301.7701-3
27 Rev. Rul. 79-77

The investment group consisting of ten or less members does not file an IRS 1065 return and a K-1 information statement on annual operating income, expenses, interest, and depreciation is not handed to the co-owners, since these filings are not required.[28]

Each co-owner separately reports their fractional share of each year's rental operations on Schedule E of their return based on information provided to them by the property manager.

One of the co-owners now intends to sell their fractional interest to another co-owner or an outside person.

The price or value the co-owner receives for their fractional interest exceeds their adjusted cost basis remaining in this investment. Thus, the co-owner will take a profit on the sale or exchange, which for tax purposes needs to be reported, unless *exempt* or *excluded*.[29]

While the co-owner desires to get out of the investment, they do not want to report the profit and pay taxes. They need all the net proceeds from the sale, undiminished by taxes, to invest in their personal trade or business.

The selling co-owner locates other property which they will acquire for their own account to house their business. Thus, the property they will acquire qualifies as §1031 property since it will be *held for productive use* in their trade or business.[30]

Editor's note — If the property acquired in the investors' names is rented to the co-owner's corporate business, it will then be a rental classified as §1031 investment property, not §1031 business property.[31]

To structure the sale of their fractional co-ownership interest in the investment group as the first leg of a §1031 reinvestment plan, the LLC or LP will convey to the co-owner by grant deed an undivided interest in the real estate equal to the co-owner's percentage share in the partnership. [See **first tuesday** Form 404]

Thus, a **liquidation** of the co-owner's interest in the partnership occurs as a **distribution in kind** of the partnership asset — conveyance of their pro rata share in title, a non-taxable event. As a result of the conveyance, the partnership becomes a TIC with the prior partner who now holds title to a fractional interest in the real estate as a TIC. As a TIC, the co-owner by the TIC agreement is given all the rights to alienate their TIC interest, unrestrained, while agreeing to the centralized management of the property's maintenance and customary tenant-related services for a short period of time (not more than one year).

28 Rev. Proc. 84-35
29 26 USC §1001
30 26 USC §1231
31 IRC §1221

Continuously invested and unliquidated

Continuing our previous example, the co-owner, as owner of a TIC interest in real estate and no longer a partner in the partnership, immediately sells (or exchanges) and conveys by grant deed their newly acquired TIC interest to a third party. The cash receipts of the sale are used to acquire the real estate they have located as the replacement property to complete the second leg of their §1031 reinvestment plan.

Has the co-owner held ownership to the TIC interest for a sufficient length of time and for the right reasons to qualify the TIC ownership for the §1031 profit tax exemption?

Yes! The co-owner acquired ownership of the TIC interest with *no intention of liquidating* their investment in real estate by "cashing out." Thus, the co-owner held the TIC interest, unrestrained by the need for prior consent from the co-owners on the co-owner's sale of their interest. The co-owner's only intent is to make money by remaining *continuously invested* in real estate.

The duration of the co-owner's ownership in any one particular property, such as their ownership of the TIC interest, is not of concern. The only critical fact is that the ownership is held either for productive use in a trade or business or for investment. Since it was held for productive use, the continuation of their investment after a sale by acquiring an ownership interest in replacement property (regardless of whether it is for a long or short period of time) demonstrated the intent required to *remain unliquidated* in real estate investments. [32]

Editor's note — For property used in a trade or business to qualify as §1031 property, ownership must be retained for a period of one year.[33]

The §1031 by a twist of Schedule E

A lack of understanding seems to exist among taxpayers, certified public accountants (CPAs) and drafters of IRS forms regarding the consequences of IRC partnership classification for fractional ownership interests, IRS 1065/K-1 co-ownership reporting forms, the exemption from filing by partnerships comprising ten or less members and Schedule E filing by co-owners.

Thus, an **unintended application** of the §1031 exemption from profit tax reporting permits the profit taken on the sale of a fractional interest in a group investment which would otherwise be classified as a *tax partnership* to go unreported.

For example, when co-owners in an investment group file their individual returns, they report the operating data for rental properties on Schedule E, attached to their annual IRS 1040 return. The partnership does not file a return nor provide an IRS 1065/K-1.

Schedule E lists the co-owners' proportionate share of income, expenses, interest and depreciation separately. No reference is made (unless volunteered) to the aggregate data generated by the combined ownership of the real estate described in Schedule E.

32 **Bolker** v. **Commissioner** (9th Cir. 1985) 760 F2d 1039

33 26 USC §1231(b)(1)

The property data itemized by the individual co-owner on their Schedule E are but an *undisclosed fraction* of the income, expenses and deductions of the property identified on the co-owner's Schedule E.

But on the sale of the ownership interest in real estate listed in Schedule E, the IRS does not know (without an audit or a gratuitous disclosure) whether the interest sold is:

- an ownership **interest in a tax partnership** and thus excluded from tax-free treatment;[34] or
- a TIC ownership **interest in the asset** itself which, if unrestrained in its alienation rights, qualifies as §1031 property.

Thus, Schedule E fails to request information from the taxpayer on whether:

- the property ownership is connected by arrangement to additional tenant services paid for that are separate from rent; or
- the interest listed is a fractional ownership interest.

Likewise, the IRS §1031 disclosure form does not inquire into whether the interest sold or exchanged is:

- a fractional interest in property;
- a fractional ownership interest in a partnership which owns the property; or
- a sole ownership interest in the property. [See IRS Form 8824]

Thus, a co-owner's annual reporting of their fractional interest on Schedule E (or F or C), and the sale and replacement of the interest on a §1031 disclosure form, does not trigger automatic disallowance or audit by the IRS.

As a result, the exemption from profit taxes declared by the taxpayer is cleared, without a question about the possible tax partner status of the owner whose fractional interest is sold or acquired.

Editor's note — A school of thought holds the view that these deficiencies in the IRS forms produce the result intended by a more friendly and lenient IRS. However, this might not be the case.[35]

34 26 USC §1031(a)(2)(D)

35 Rev. Proc. 2002-22

Chapter 12 Summary

The profit taken on the sale (or exchange) of an ownership interest in real estate may qualify for an exemption from income taxes under Internal Revenue Code (IRC) §1031. For a seller to use the exemption, the interest sold must be an ownership in property that together combine to qualify as like-kind property, commonly called §1031 property.

In contrast, an investor's fractional ownership interest in a group does not qualify as §1031 property if their interest is a co-ownership interest in an entity, such as a limited partnership (LP), limited liability company (LLC), corporation or tenants in common (TICs). It is the entity that owns the real estate.

An investor's sale of their percentage of co-ownership in the entity, independent of the sale of the real estate by the group, does not qualify for the §1031 exemption. The individual co-owner's reinvestment plan includes the sale of a fractional ownership interest in an entity classified as a tax partnership.

When classified as a tax partner for income tax reporting, the TIC investor is considered a co-owner of an interest in a tax partnership, not a co-owner holding an ownership interest directly in the real estate.

The coordinated conduct of co-owners in the exercise of ownership rights to operate the investment real estate they co-own is viewed differently under federal income tax law than under California partnership law.

When co-owners of property located in California share the income and operate under an unincorporated ownership arrangement such as a TIC, California partnership law classifies the profit-sharing group as a partnership.

Conversely, federal tax law places an emphasis on common law TIC rules to establish co-owner rights, but solely for the purposes of tax reporting.

Co-owners of California real estate vested as TICs, when engaged in the business of jointly operating the property on terms calling for them to share income and profits, are conducting themselves as partners.

As a partner, the vested co-owner does not hold a right to an interest in the property that they can independently possess or separately transfer by leasing the property to a tenant without concern for the other co-owners. The only transferable interest the TIC co-owner has is their fractional interest in the partnership.

TIC co-owners of rental property who act collectively to manage the property or authorize a property manager to operate the property on their behalf hold ownership to the real estate under what has been best entitled a tenancy in partnership.

When a co-owner of investment real estate is classified by the IRS as a partner, the real estate is considered to be owned by a tax partnership. Classified as a partner, the co-owner's ownership interest is that of a share in a partnership and does not qualify as §1031 property.

Co-owners may join together to own and operate income-producing property and will not be considered tax partners when they hire a broker (who may be a co-owner) as an independent property manager. The manager may be given all the authority they need to do all acts necessary to provide services for tenants which are customary under regular leasing arrangements.

An LLC or LP entity is typically used in real estate syndications to structure the co-ownership by investors of real estate. The use of an entity is both a more practical and prudent title holding arrangement than a TIC vesting.

California's property tax laws cause a reassessment of the property vested in an LLC or LP only when more than 50% of the ownership of the LLC or LP is assigned to another person by the original members of the LLC or LP.

Conversely, when title for the same co-owners is vested as TICs, each co-owner who conveys their TIC interests to others (including other co-owners), triggers reassessment of the fractional portion they conveyed.

The use of a wholly owned, one-man LP or LLC is an alternative available for the vesting of a co-owner's fractional interest. Title to their fractional ownership interest is held in the name of their LP or LLC as a TIC with all other co-owners.

Chapter 12 Key Terms

alienation .... **pg. 109**
disregarded entity .... **pg. 125**
Subdivided Lands Act (SLA) .... **pg. 122**

Chapter 13

Securities aspects of syndication

Learning Objectives

After reading this chapter, you will be able to:

- discuss the securities risks that exist in real estate development, lending and business operations co-owned as group investments;
- distinguish acquisitions of real estate that do create a securities risk from risks limited to the economics of the marketplace; and
- understand the protections provided by state and federal securities laws for investors who risk their capital in asset-creating investment schemes offered by others.

Key Terms

blind pool investment

investment circular (IC)

corporate securities risk

Economic risks of the real estate market excluded

A group of investors is brought together to collectively benefit from the co-ownership of real estate. This activity is called **syndication**. The investors' ownership is documented as participations in a **limited liability company (LLC)** or other form of co-ownership, such as:

- tenants in common (TIC);
- a corporation;
- a limited partnership (LP); or
- a general partnership.

However, the syndicator soliciting investors and forming the group needs to have an understanding of state and federal **securities laws** and their underlying social purpose. Without this knowledge, they are likely to offer investors **promotional value-adding activities** to enhance a real estate investment which puts the group investment within the control of *securities laws*.

The security relationship

The classic federal definition of a security relationship with investors is:

- an **investment** of money;
- a **common enterprise** based on the mutual success or failure of the group in its investment goals; and
- an **expectation of profits** produced by the **efforts of others**, not just by the property.[1]

In application, the purchase and ownership of real estate by any group of investors involves both the elements of an *investment* and a *common enterprise*. Thus, the syndicator's formation of a group for an investment in real estate has the potential for creating a **corporate securities risk**.

corporate securities risk
A risk of loss of investor funds that arises due to investment discretion when a syndicator acquires investor funds before identifying and disclosing an existing asset to be purchased.

However, to create a federally defined security when syndicating real estate ownership, the investment program needs to contain the third and critically distinctive element — the *expectation of profit* produced by other than the investor through an activity that creates value in the property. For a securities risk to arise, the investor releases control of their cash contribution, shifting control over the use of the funds to the syndicator or someone else, *before* the promised value-creating activity is completed.

The syndicator's task is to distinguish the additional risk created on an investor's release of funds to the syndicator based on a promise to perform an activity that creates value in a property from a group investment that does not present a securities risk and remains outside the securities law.

Expectation of a return

To be a security, the investment program sold to the group of investors needs to provide for a **return of the original investment** based on a promise, by the syndicator or someone else, of future property selection, physical development or other change of use for the real estate acquired, to be completed before the investment goal can be attained.

Conversely, a syndicator's formation of an investment group to purchase and operate an existing income-producing real estate project, or hold land for profit solely from resale, does not involve a **securities risk**. Here, the expectation of a return on the investment is based on and limited to the performance of the pre-selected property in the marketplace. Thus, the investment is subject to only the economic conditions and risks that affect the ownership of any parcel of real estate.

Here, the investors are not counting on the efforts of the syndicator or any other person to determine what property to acquire or for someone to produce improvements or develop a use for the property after the invested money has been released from the investor's further control.

1 **Securities and Exchange Commission** v. **W. J. Howey Co.** (1946) 328 US 293

Remember, LLC ownership is merely a **business structure** used as a form of group ownership for vesting of title to the asset acquired in a real estate investment program. Thus, soliciting and offering cash investors fractional membership interests in an LLC (or as TICs) formed to fund the acquisition of an existing income-producing property is not, without analyzing other activities in the investment program, the offering of a security.

Value-adding activities beyond the property

Conversely, an investment group formed to develop real estate or undertake an ongoing resale-marketing program, farming operation or business opportunity, regardless of the entity or form of vesting chosen for the group, contains securities risks. To create a corporate securities risk, the investors' capital is placed at a **risk of loss** through the need to complete significant value-adding activities after the acquisition of the property.

As you now understand, the selection by the syndicator of a property for acquisition after the investor relinquishes control of their cash, called a **blind pool investment**, is an activity controlled by securities law.

blind pool investment
The solicitation or receipt of investor contributions in a group investment program before the syndicator identifies and discloses the real estate interest the investors' funds will be used to acquire, an activity controlled by securities law.

A group investment program containing an activity that constitutes a securities risk imposes a duty on the syndicator soliciting investors' capital to comply with securities law. *Exemptions* exist that remove some investment programs containing securities risks from further compliance with securities laws.

Unless exempt, the syndicator first reports to the appropriate government agency:

- the California Department of Business Oversight (DBO) to comply with state securities rules (and qualify for a permit); or
- the Securities Exchange Commission (SEC) to comply with federal law.

Failure to qualify or register the sale of non-exempt corporate securities exposes the syndicator who creates the securities risk to civil and criminal liability.

The acquisition of a pre-selected existing property, without the intention to further improve it or pool it with others, by a group investment program avoids ownership activities that place the investors' capital at a risk of loss and under the control of securities laws. Activities that would bring the investment under securities law and create a corporate securities risk include:

- after-closing development of the property;
- *blind pool* asset selection; or
- collective post-acquisition coordination with others (rental pooling).

Existing asset vs. securities risk

Consider a group of investors who purchase a newly constructed apartment building that is unoccupied by tenants. The syndicator who solicited the investors serves as manager for the group and the property. The investors have the right to cancel the property management agreement with the syndicator by removing the syndicator as the manager on 30 days' notice (or less).

The local economy and marketing efforts by the syndicator do not produce enough tenants to occupy the property. Thus, the amount of rental income received is insufficient to pay operating expenses and installments on the mortgage. The investment fails and is liquidated by foreclosure.

The co-owner investors make a demand on the syndicator for a return of their investment funds, plus the legal rate of interest (10%). They claim the purchase of the existing occupiable complex, when coupled with the property management agreement, creates a *corporate security* that was neither exempt from securities law nor qualified by the DBO. The co-owners claim they relied on the syndicator's **management expertise** to locate tenants and rent out units in the newly constructed building and create a **return on the capital** they invested in the LLC.

Does the syndicator, who merely manages property in competition with other like-type properties, impose a liability on themselves for the return of the co-owner's capital under any securities law?

No! A corporate security is not created by the existence of property management activity or the promise or expectation of an annual return on their investment. Members of an LLC or TIC **retain control** over the management of the property.

Control over management retained

The investors have the right to terminate any property management agreement as well as the manager by a vote of the co-owners. More importantly, they may replace management with other management, a service readily available in the local brokerage community.

Here, the investors did not place their capital at risk in reliance on the skill and effort of another to **create value** in the property. Instead, they acquired a fully improved, existing asset in exchange for the funds invested, on the chance the rental marketplace will allow their investment to prosper.

Further, they retained ultimate control over management since they are allowed to change management at any time. The investors bought the property, not the syndicate manager or their management expertise (which was, instead, the subject of the property management agreement), as the investment.[2]

Expertise to create a return

Now consider a syndicator who sells small parcels of agricultural land planted with citrus trees to individual investors. Under a **service agreement** attached to each purchase agreement, the syndicator is to care for the trees and harvest and market the fruit produced by all the properties under their management. The term of the service agreement is ten years.

2 **Fargo Partners** v. **Dain Corp.** (8th Cir. 1976) 540 F2d 912

The syndicator manages the groves on all the separate parcels by coordinating the ownership and operations of all the parcels as a single, large-scale farming operation. The syndicator has the knowledge and equipment required to conduct a successful farming operation and **produce and sell** the crop.

Each investor is to receive a share of the net operating income from the syndicator's crop production based on their pro rata ownership of all parcels farmed under the service agreement, called a **pooling arrangement** or **horizontal commonality investment**.

In contrast to an apartment building co-owned by several investors with the syndicate manager locating tenants and renting existing units, an investment in a parcel of agricultural land operated as a farming business, coordinated and managed by the syndicator or others, contains a corporate securities risk. The investors rely solely on the expertise of the syndicator to **create a return** of their invested funds (capital) by **producing a crop**, then harvesting and selling it. As a further securities risk, they agreed to do so in cooperation with owners of other properties in a *pooling arrangement*.

No independent operation

Here, an investor who cancels the service agreement with the syndicator will not be able to independently operate their parcel of land and its grove with any economy to be successful. Operating separately from the owners of other parcels, they will not be able to readily hire another operator to coordinate farming operations with the owners of other parcels as a **collective** to produce and market crops.

The **financial success** of the operation requires all the parcels in an economy of scale to be operated as one, using special equipment and skills possessed by the syndicator.

Thus, even though the transaction was structured as a sale of a parcel of real estate to an individual purchaser combined with a service agreement, the series of related transactions display the critical elements of a corporate security — a group investment with an expectation of profits and success inextricably interwoven with the efforts of others to **produce a crop** and market it to generate an income and, ultimately, a return of the investment.[3]

Protecting the investor

The state and federal corporate securities laws exist to protect investors who risk their capital in **asset-creating investment schemes** offered by others. The social purpose is to give investors a reasonable opportunity to realize profits on their investment.

A securities risk is created under California securities law whenever an investor:

- places their funds at risk of loss; and

3 W. J. Howey Co., *supra*

- assumes a passive role, giving control of essential asset selection, development, pooling or resale decisions exclusively to the syndicator or others.

A security is created when the syndicator or others promise to perform an activity that **creates value** after the close of the purchase. Unless the creative activity is completed successfully, value will not be added to the property and the expected return of capital will not occur.

In essence, the investor did not invest in an existing asset, but in the *skill of someone else* to create future value in that asset. The expenditure of invested funds is no longer controlled by the investor, but by the syndicator or others.

Post-closing value-adding activities

Activities that occur after closing and create a **securities risk** include:

- obtaining government approval or permits for zoning or a higher and better use of the property;
- making further improvements or significant capital alterations to the property; or
- operating a business or farming operation that requires expenditures for inventory, production or sales.

Thus, for a security to exist, the syndicator must undertake an ongoing investment activity that continuously places the investor's capital at risk of loss until the promised value-adding activity is completed. The securities risk is contained in the management of money, whether obtained from the investors or borrowed funds, to improve the property, create the crop or obtain agency approvals for a new use to fulfill the purpose of the group investment.

Creating a securities risk

Examples of activities that include a securities risk for investors in syndicated real estate transactions include:

- subdividing, improving or reselling the real estate (dealer activities);
- operating a business on the premises acquired rather than merely managing the rental of the real estate or the ownership of vacant land; and
- investing in trust deed notes. [See Chapter 14]

California securities law is designed to give investors a fair chance of realizing investment objectives promised to be performed and completed by others. The syndicator is responsible for returning the investor's capital if promises of development are not fulfilled by completing after-closing activities that create the significant value necessary to provide for a return of the investors' contributions.[4]

4 **Silver Hills Country Club** v. **Sobieski** (1961) 55 C2d 811

The securities issue for the syndicate manager is to determine which investment activities include risk situations that trigger the application of securities law.

Controlled investments

The existence of a security is a matter of the substance of the transaction activities, not the ownership form used to conduct the activity. The economic function of the investment transaction, rather than the title the transaction bears or the type of business form used, determines whether a securities risk exists.

Editor's note — An exception to the substance-over-form rule is the issuance of stock. Any transaction that involves the issuance or transfer of investment certificates which are formally called stock is a controlled security, regardless of the economic substance of the investment in the stock.[5]

For example, the citrus grove investment program reviewed above was structured as a sale of a parcel of improved agricultural property. Each investor became the sole owner of an individual parcel of land — a real estate sales situation that, without further development after the acquisition, does not contain a securities risk.

However, each owner has no reasonable ability to **independently control or operate** the property and produce and market a crop in the farming business they bought into. Success was entirely in the hands of the syndicator to create value for a return of their invested funds through the husbandry, production, marketing and sale of the crop, and the coordination by pooling expenses and income with owners of other property.

Pooling and management

Consider an investor who purchases a condominium unit through a real estate broker. Normally, the purchase of a residential unit does not constitute a corporate security (other than as controlled by the subdivision law).

However, the broker also arranges for the buyer to enter into a **rental pooling agreement (RPA)** with a vacation rental management company for the ongoing operation of the unit. The broker has no connection to the management company employed in the *RPA* and receives no kickback or fee for the referral.

Under the RPA, the management company oversees a rental operation within the entire project in which the investor's unit is located. The property manager distributes spendable rental income to the investors of individual units based on their pro rata share of ownership participation in the RPA, not based on the actual performance of their separate units, an activity called **rental pooling**.

The RPA is a major inducement for the investor to purchase the condominium unit. The pooling arrangement enables them to locate tenants, rent the unit and collect rental income without being personally responsible for the day-to-day management of their unit. Critical to the investment is the sharing

5 **Landreth Timber Company** v. **Landreth** (1985) 471 US 681

of these investment risks; they will share the income and expenses with everyone else within the "pool." More strategically, the investor plans to cover their monthly mortgage payments and assessments on the condominium out of the rental income.

Future return generated by the efforts of others

Continuing our previous example, due to market forces, not management, the unit fails to produce the level of rental income the investor expected. The investor seeks to recover their investment from the broker, claiming the purchase of the condominium coupled with the RPA was a corporate security since the investor relied on the management efforts of others in the **joint operation** of several individually owned units to produce a return of their investment.

The broker claims they did not create a corporate security since the investor was not required to enter into the RPA as part of the agreement to purchase the condominium. Further, the broker was not in control of the management of the property.

Did the broker create a corporate security by arranging an RPA for the investor?

Yes! The purchase of the condominium unit coupled with the RPA was presented to the investor as *two separately controlled* components of a single investment scheme. The investor was induced by the broker to invest their funds in the common enterprise based on an **expectation of profits** produced by the efforts of others in a pool and split program — even though the broker was not personally responsible for coordinating the rental pooling effort.

Since the broker arranged for the investor to place their funds at risk on the close of escrow in anticipation of a future return generated by the efforts of others — the pooling and management of several separately owned properties under the RPA — a securities risk was created.[6]

Subdivided parcels sold to groups

Now consider a developer who acquires numerous acres of real estate for the development of a planned community. The developer sells unimproved parcels within the planned development to groups formed as LLCs (or TICs).

The parcels are advertised as being suitable for development as part of the planned community.

The developer does not promise to develop the parcels sold to the LLCs or to produce profits for the LLCs based on the development of the entire planned community, adjacent parcels or off-site infrastructure, or any profit pooling arrangements.

6 **Hocking** v. **Dubois** (9th Cir. 1989) 885 F2d 1449

One group of investors who acquired a parcel makes a demand on the developer and their broker for a return of their investment, claiming a security was created since they relied on the developer to complete the development of the planned community, which did not occur.

However, the group of investors had complete control over the parcel it acquired from the developer — nothing remained to be done after acquisition, except for the investors to wait for the market to deliver a profit or loss.

Thus, no securities risk was created, only an *economic risk*. The transaction was merely a sale of real estate to the LLC to hold for a profit on resale or later development as the group saw fit.[7]

Risk capital tests

State and federal courts apply slightly different tests to determine whether a securities risk exists in an investment program. In California, courts apply what is called the **risk capital test** to determine whether the investors in a syndicated real estate transaction are to benefit from securities law protection.

The *California risk capital test* requires the investors' capital to simply be placed at risk in a value-adding activity, *whether or not a profit* is expected or intended. Compared to federal securities law, California securities law is further-reaching and covers more investment conduct. Thus, it is the set of rules a real estate syndicator is primarily concerned about as it is more restrictive.

The federal risk capital test, on the other hand, revolves around the element of the *expectation of a profit* on the investment in a value-adding activity. For a security to exist under the *federal risk capital test*, the investors need to be induced to join the program by, among other activities, a promise that they will *profit* from their capital investment.

Personal use coupled with development

Under the California risk capital rule, a syndicator's mere promise of future profits does not in and of itself create a securities risk unless it is accompanied by the promise to perform an activity that creates value, such as property development.

For example, consider a developer who sells investors membership interests in a yet-to-be-built property to be developed as a country club. Later, when the developer fails to complete construction of the country club, the investors make a demand on the developer for their investment to be returned. They claim the developer violated California securities law since the club memberships sold were unqualified and non-exempt securities in a construction project.

The developer claims the country club memberships are not controlled by California securities law since the memberships merely provide for personal recreation and involve no expectation of a profit.

7 **De Luz Ranchos Investment, Ltd.** v. **Coldwell Banker & Company** (9th Cir. 1979) 608 F2d 1297

However, unlike federal securities law with its profit-driven test, an expectation of profit is not of concern to California securities law.

Here, the sale of memberships was coupled with a securities risk. The investors risked their capital on a "yet-to-be-built" project, relying on the developer to **complete the construction** of the country club after the members released their investment funds to acquire membership in the group's ownership of the property.[8]

Promised returns without development

To avoid creating a security under California's risk capital test, the syndicator's selection of a *specifically identified parcel* of real estate for acquisition needs to exist before the release of invested funds. Even then, the only business that may be conducted after acquiring the property is either:

- the locating of tenants and rental of the property; or
- the ultimate resale of the unaltered property at a profit.

If, on closing a purchase escrow, the investor receives *full value* for their investment in the form of a fixed asset, such as a share ownership in an existing parcel of real estate and a guarantee of a minimum profit, no security is created. The investor's capital is no more at risk than if they had purchased the asset outright, with or without a promise of profits.[9]

In another example, a syndicator completes their due diligence investigation on a property they locate and decide is suitable for syndication. A detailed **investment circular (IC)** is prepared. The IC states the real estate will not be further developed or improved, but simply owned and operated for what it is — a rental income property.

investment circular (IC)
A disclosure prepared by a syndicator and presented to potential investors explaining the nature of the investment program, significant features of the property selected for acquisition and the risks and financial consequences of the group investment, also known as a prospectus or memorandum. [See **ft** Form 371]

The investors solicited by the syndicator know they will receive ownership, directly or indirectly through an entity, of an identified existing fixed asset on the release of their money. Thus, their capital is not subjected to a securities risk — only the *economic risks* of locating tenants and incurring expenses in the rental marketplace, activities experienced by all property owners.

All money invested in real estate is, to some extent, at risk of loss due to fluctuating property values brought about by economic conditions, natural hazards, etc., called **marketplace risks**. However, *marketplace risks* merely affect the level of income, profit or loss. Income and profits (or losses) from ongoing rental operations in the local economy are not the concern of securities laws.

Exemptions when securities risk exists

A large number of investments that contain a securities risk are **exempt** by statute from control under securities law.

Investment programs offered by banks are exempt from securities law, as are *nonpublic offerings* by individuals.

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8 Silver Hills Country Club, *supra*

9 **Hamilton Jewelers** v. **Department of Corporations** (1974) 37 CA3d 330

For syndicators, a **nonpublic offering exemption** exists that is the most useful exemption available when soliciting and forming an investment program which includes an activity containing a securities risk.

The *nonpublic offering exemption*, called the **35-or-less interrelationship rule**, applies if:

- the investors do not number more than 35 (husband and wife counting as one);
- all investors have a meaningful, pre-existing business or personal relationship with the syndicator;
- the investors will not resell or distribute the interests they acquire;
- the solicitation of investors does not involve public advertising; and
- the syndicator files a notice of the transactions which fall under the exemption with the California of Corporations.[10]

Thus, when an investment program does contain a securities risk, such as exist in a construction or development project, the syndicator does not need to be further concerned with securities law if their program meets the requirements of the *35-or-less interrelationship rule* for the nonpublic offering of a security.

If a securities risk does not exist in the investment program, the solicitation of investors by public advertising is not an activity which places the investors' funds at risk.

Accredited investor exemption

Consider a syndicator who solicits LLC investors for a California property the syndicator intends to develop on behalf of the group. The LLC files paperwork with the SEC granting it the ability to sell an unlimited amount of memberships in the LLC, which are to be structured as **limited private placement offerings**. Under a federal securities law exemption, these types of offerings may only be made to **accredited investors**.[11]

The LLC solicits a small business owner with whom it has no prior relationship to invest in the LLC, without qualifying the business owner under the restrictions for a *limited private placement offering*.

The California DBO issues the LLC a desist and refrain order, claiming the LLC violated state securities law by publicly offering a membership in the LLC in a value-adding venture without the LLC being qualified or registered with the DBO.

The LLC claims the DBO's authority was preempted by the LLC's filing with the SEC as a non-securities offering.

Is the LLC exempt from the DBO's desist and refrain order due to its filing with the SEC as a non-securities offering?

10 Calif. Corporations Code §25102(f)

11 17 Code of Federal Regulations §230.501

No! Here, state securities law controls. The LLC did not adhere to the federal exemption requiring it to contact only *accredited investors*. Thus, it fell outside the scope of the SEC limited private placement filing and was subject to state securities law.[12]

Disclosure of securities and limitations on recovery

Consider a syndicator whose investment program contains a securities risk activity such as a condo conversion or development of improvements. To solicit investors, the syndicator posts their offering in the recreational rooms of condominium projects and mobilehome parks in which they have an interest. They do not obtain a permit nor do they register the sale of the investment program with the DBO or SEC.

Here, the syndicator publicly offered their investment opportunity containing a securities risk to anyone visiting the recreational rooms. Thus, their investment program was a **non-exempt** offering of a security. As a result, any investor in the program may recover the full amount of their investment from the syndicator, plus 10% interest from the date of investment, less any distributions the investor has received.[13]

Statute of limitations on recovery

However, the investor's recovery of their investment under California securities law is subject to a time constraint, called a **statute of limitations**. The *limitation* places a time deadline beyond which an investor is barred from filing a claim for the recovery of money.

An action to recover the investor's funds needs to be filed prior to the earlier of:

- two years after the date the investor funds the investment; or
- one year after the investor discovers the securities law violation.[14]

If the syndicator, as part of their investment memorandum, discloses securities permits have not been obtained — whether or not a security exists — the investor will be aware of the potential violation from the beginning. Thus, the investor's recovery under California securities law will be subject to the one-year statute of limitations for filing their complaint.

Until the **one-year limitation period** expires, the investor in an investment program that contains a securities risk and does not qualify for an exemption or was not qualified for investors by the DBO may unilaterally withdraw their investment funds at any time (plus interest less any distribution of earnings). However, when the one-year period following disclosure and the close of escrow has expired, the syndicator is no longer liable for any claims to money for securities violations.

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12 **Consolidated Management Group, LLC** v. **Department of Corporations** (2008) 162 CA4th 598

13 Corp C §25503

14 Corp C §25507(a)

Realistically, if an investor is willing to contribute their funds to a real estate syndication in the first place, they are unlikely to withdraw and file an action within one year. Real estate investments are unlikely to be observed as having gone awry within one year.

Thus, even if the syndicator is certain their investment program contains no activities that are securities risks that place the investors' funds at risk of loss after acquisition of the property, a disclosure that no permit exists limits the syndicator's exposure to civil monetary liability by commencing the one-year statute of limitations. [See **first tuesday** Form 372 §1.7]

Chapter 13 Summary

A group of investors is brought together, called syndication, to benefit from the co-ownership of real estate. The syndicator soliciting investors and forming the group needs to have an understanding of state and federal securities laws and their underlying social purpose. Without this knowledge, they are likely to offer investors promotional value-adding activities to enhance a real estate investment which puts the group investment within the control of securities laws.

The syndicator's formation of a group for an investment in real estate has the potential for creating a corporate securities risk. However, to create a federally defined security when syndicating real estate ownership, a return of the investment in the investment program needs to be produced by other than the investor through an activity that creates value in the property.

For a securities risk to arise, the investor releases control of their cash contribution shifting control over the use of the funds to the syndicator or someone else before the promised value-creating activity is completed.

The syndicator's task is to distinguish the additional risk created on an investor's release of funds to the syndicator based on a promise to perform an activity that creates value in a property from a group investment that does not present a securities risk and remains outside the securities law.

To be a security, the investment program sold to the group of investors needs to provide for a return of the original investment based on a promise, by the syndicator or someone else, of future property selection, physical development or other change of use for the real estate acquired, to be completed before the investment goal can be attained.

A group investment program containing an activity that constitutes a securities risk imposes a duty on the syndicator soliciting investors' capital to comply with securities law. Exemptions exist that remove some investment programs containing securities risks from further compliance with securities laws.

The state and federal corporate securities laws exist to protect investors who risk their capital in asset-creating investment schemes offered by others.

State and federal courts apply slightly different tests to determine whether a securities risk exists in an investment program. In California, courts apply what is called the risk capital test to determine whether the investors in a syndicated real estate transaction are to benefit from securities law protection. The federal risk capital test revolves around the element of the expectation of a profit on the investment in a value-adding activity.

Investment programs offered by banks are exempt from securities law, as are nonpublic offerings by individuals. If a securities risk does not exist in the investment program, the solicitation of investors by public advertising is not an activity which places the investors' funds at risk.

For a non-exempt offering of a security, any investor in the program may recover the full amount of their investment from the syndicator, plus 10% interest from the date of investment, less any distributions the investor has received. However, the investor's recovery of their investment under California securities law is subject to a time constraint, called a statute of limitations.

Chapter 13 Key Terms

blind pool investment .... **pg. 133**
corporate securities risk .... **pg. 132**
investment circular (IC) .... **pg. 140**

Chapter
14

Trust deed investment for groups

Learning Objectives

After reading this chapter, you will be able to:

- discuss the documentation necessary for a syndicator to publicly solicit investors to make or purchase a trust deed loan; and
- understand the securities risk involved when fractionalizing trust deed investments.

Key Term

blind pool investment

Fractionalizing a trust deed note

Consider a buyer of real estate who retains a mortgage loan broker to solicit and arrange a large mortgage to be secured by real estate. The buyer and the broker enter into a mortgage agreement contingent on the broker locating trust deed investors with sufficient cash reserves to fund the mortgage.

To locate trust deed investors, the broker runs advertisements soliciting private investors with modest amounts of funds to form a trust deed investment group consisting of **ten or less investors**. The mortgage is too large for any one of the investors to handle alone or prudently carry the entire risk of loss.

As investors respond to the advertisements and subscribe, their funds are placed in an escrow trust account set up specifically for this mortgage until sufficient funds accumulate to fund the transaction. When fully funded, the borrower signs and delivers the note and trust deed to the mortgage escrow. Both documents reflect the fractional ownership of the note and trust deed by the numerous contributing investors named as beneficiaries, based on their proportional investments.

Collection and servicing agreement

The broker concurrently enters into a **collection and servicing agreement,** signed by each of the investors, to service the mortgage as their *collection agent*. The broker is authorized by the agreement to:

- advance payments to the investors from the broker's own funds to cover any delinquent installments; and
- bid on the property for the broker's own account in the event of a foreclosure under the investors' trust deed. [See **first tuesday** Form 237]

Has the broker created an *investment risk* that is regulated by California corporate securities law?

Yes! The broker's singular activity of **fractionalizing** the investment in a note and trust deed among multiple private investors creates a **corporate security**.[1]

blind pool investment
The solicitation or receipt of investor contributions in a group investment program before the syndicator identifies and discloses the real estate interest the investors' funds will be used to acquire, an activity controlled by securities law.

A mortgage loan broker syndicating trust deeds creates a *corporate security* if:

- they accept money from an investor or execute promissory notes *before locating* the real estate securing the trust deed, called a **blind pool investment** [See Chapter 13]; or
- the trust deed is *fractionalized* among multiple investors rather than acquired by one trust deed investor for their own account.

However, a broker may package **multiple-lender** trust deed investments and avoid securities violations, provided their conduct falls within one of two readily available exemptions from the securities law.

Securities exemptions for trust deed syndication

When fractionalizing a trust deed investment (and thus creating a securities risk), a syndicator has two options for complying with the securities law:

- the **nonpublic offering exemption**, called the **35-or-less interrelationship rule**; or
- the **public offering exemption**, called the **ten-or-less trust deed investment plan**.

To use the *nonpublic offering exemption,* the syndicator needs to have a meaningful, pre-existing business or personal relationship with the investors they privately solicit for the trust deed investment. [See Chapter 13]

However, under the *public offering exemption*, trust deed investment groups need not be limited to persons with a pre-existing relationship with the mortgage loan broker. A mortgage loan broker may publicly solicit trust deed investors by filing a **notice permit** with the California Bureau of Real Estate (CalBRE) under this second claim of exemption option.

1 **People** v. **Schock** (1984) 152 CA3d 379

The ten-or-less rules and reporting

The ten-or-less trust deed investment scheme (public offering exemption) allows a mortgage loan broker to publicly solicit investors to acquire a fractional interest in a trust deed note. To qualify for this ten-or-less exemption, the broker is required to comply with the following rules and guidelines:

1. A **multi-lender transaction notice** form, also called a *notice permit or claim of exemption,* is prepared and filed with the CalBRE within 30 days after:
   - 1.1 the mortgage loan broker **originates or sells** the first trust deed note made or acquired by ten-or-less investors they solicited from the public [See Form 545 accompanying this chapter]; or
   - 1.2 any change to the information in the original notice filed with the CalBRE, called an **amendment**.[2]

Advertising trust deed and note requirement

2. **Advertising for trust deed investors needs to:**
   - 2.1 include the **name** of the broker and their **license identification number**;
   - 2.2 comply with §260.302 and §2848 of California Regulations, Title 10, regarding advertising criteria, wording and disclosures; and
   - 2.3 include no reference to compliance with the CalBRE notice permit procedure since it infers merit or approval by the CalBRE.[3]
3. **The trust deed securing the note includes:**
   - 3.1 California real estate in which the broker, directly or indirectly, has no ownership interest or right to acquire an ownership interest [See Section 5 below];
   - 3.2 no agreement for the **future subordination** of the trust deed; and
   - 3.3 priority as a first trust deed if it is security for a **construction loan**, with funds disbursed as construction progresses; including 10% retention until expiration of the mechanic's lien period, and covered by title insurance providing priority against mechanic's liens.[4]
4. The note cannot be a *promotional note* secured by a junior trust deed, or a trust deed subject to a future subordination agreement, executed on:
   - 4.1 lots in a subdivision;
   - 4.2 unimproved property; or
   - 4.3 newly constructed, unsold property.[5]

2 Calif. Business & Professions Code §10238(a)
3 Bus & P C §10238(c)
4 Bus & P C §10238(d)
5 Bus & P C §10238(d)

Fractional interests sold by a broker

5. The fractional interests may be sold by a real estate broker, acting as either a **principal** or an **agent,** to finance:
   - 5.1 their acquisition of real estate at a foreclosure sale under a trust deed they are servicing or one that they originally sold to investors; or
   - 5.2 the broker's resale of real estate they acquired at a foreclosure sale under a trust deed they were servicing or originally sold to investors.[6]

Ten investors or less

6. The fractional interests are **sold to ten or less investors**.[7]
   - 6.1 An unlimited number of persons may be publicly solicited to purchase an interest.[8]
   - 6.2 A husband and wife, or any retirement funds or entity wholly owned by an individual and/or their spouse, that acquire a fractional interest are treated as one investor.[9]
   - 6.3 Any organization, such as a partnership, limited liability company (LLC) or corporation that was not specifically formed for the purpose of investing in the fractional interest is treated as one investor.[10]
   - 6.4 Each investor is to sign a statement indicating they meet minimum income or net worth standards. [See **first tuesday** Form 373]

     In the statement, the investor needs to state that their total investment in the trust deed note from all sources (directly or through their spouse, retirement fund or controlled entity) represents:

     a. 10% or less of their net worth (excluding cars, home and furnishings); or

     b. 10% or less of their current or prior year's adjusted gross income (AGI) for their Internal Revenue Service (IRS) 1040 tax return.[11]
7. Each investor is given *all the rights* of a mortgage holder and each interest sold to the investors is on the same terms.
   - 7.1 The investor's interest in the trust deed as a named beneficiary will be recorded before a release of the funds from escrow.[12]

Loan-to-value (LTV) thresholds

8. Based on the combined principal amounts of the fractionalized note and any prior encumbrances (bonds and trust deeds), as well as the current market value of the real estate as stated in a written **opinion of value** by an appraiser or the broker, the loan-to-value (LTV) ratio may not exceed the greater of:

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6 Bus & P C §10238(e)
7 Bus & P C §10238(f)
8 Bus & P C §10238(f)(2)
9 Bus & P C §10238(f)(3),(4)
10 Bus & P C §10238(f)(5),(6)
11 Bus & P C §10238(f)(1)
12 Bus & P C §10238(g)

8.1 80% for owner-occupied, single family residences (SFRs);

8.2 75% for nonowner-occupied SFRs;

8.3 65% for commercial and income-producing property;

8.4 65% for single family, residential-zoned lots or parcels;

8.5 50% for undeveloped property zoned for commercial or residential use;

8.6 35% for other real estate; or

8.7 the percent of value set by any private mortgage insurance (PMI) coverage issued for the fractionalized note.[13]

Editor's note — If unique circumstances exist, the broker may exceed the statutory LTV ratios if they are able to justify in writing their reasons for exceeding the limits. However, the LTV ratio may never exceed 80% of improved real property or 50% of unimproved property, except for single family, residentially-zoned lots or parcels, for which the LTV ratio may not exceed 65%.

*The broker needs to keep the statement containing the justification for exceeding the LTV limits in their files. Also, they need to provide the investors with a copy of the LTV statement with the lender disclosure statement.[14] [See **first tuesday** Form 235-1]*

Beneficiary statement and disclosures

9. The beneficiaries' operating agreement stipulates:

   9.1 a default on the note or trust deed is a default on all the investors' interests in the note; and

   9.2 a vote of investors holding more than 50% of the ownership interests in the note controls the action taken on a default in the trust deed and the selection of the broker, servicing agent or other persons who will act on behalf of the investors.[15]

10. The broker needs to disclose to the investors the **identity** of the specific trust deed note they are under contract to arrange or buy, thus eliminating the formation of *blind pool trust deed investments* under the ten-or-less notice of exemption.[16]

   10.1 On the sale of fractional interests, the investors' funds need to be deposited in a neutral escrow and disbursed on the recording of the investors' individual interests as named beneficiaries in the trust deed and note.[17]

   10.2 The broker needs to maintain records of the mortgage transaction, clearly identifying the manner of the receipt and disbursement of the investors' funds.[18]

13 Bus & P C §10238(h)(1)
14 Bus & P C §10238(h)(2)
15 Bus & P C §10238(i)
16 Bus & P C §10238(j)
17 Bus & P C §10145(b)
18 Bus & P C §10238(j)(3)

Form 545

Multi-Lender Transaction Notice (CalBRE 860)

MULTI-LENDER TRANSACTION NOTICE
(RE 860)

Prepared by: Agent ____________ Phone ____________
Broker ____________ Email ____________

GENERAL INFORMATION

- This notice is filed pursuant to Section 10238 of the Business and Professions Code.
- AN AMENDED NOTICE MUST BE FILED BY THE BROKER WITHIN 30 DAYS OF ANY MATERIAL CHANGE IN THE INFORMATION REQUIRED TO BE SET FORTH HEREIN.
- Mail completed notice to:
  Mortgage Loan Section
  2201 Broadway
  P.O. Box 187000
  Sacramento, CA 95818-7000

MULTI-LENDER TRANSACTION NOTICE

CHECK ONE

☐ ORIGINAL NOTICE ☐ AMENDED NOTICE

1. NAME OF BROKER CONDUCTING TRANSACTION UNDER SECTION 10237

2. BROKER LICENSE ID# | 3. MONTH FISCAL YEAR ENDS | 4. BROKER'S TELEPHONE NUMBER

5. FIRM NAME (IF DIFFERENT FROM 1)

6. STREET ADDRESS (MAIN LOCATION)

CITY | STATE | ZIP CODE

7. MAILING ADDRESS (IF DIFFERENT FROM 6)

CITY | STATE | ZIP CODE

8. SERVICING AGENT — IDENTIFY BY NAME, ADDRESS, AND TELEPHONE NUMBER THE PERSON OR ENTITY WHO WILL ACT AS THE SERVICING AGENT IN TRANSACTIONS PURSUANT TO SECTION 10229 (INCLUDING THE UNDERSIGNED BROKER IF THAT IS THE CASE)

9. TOTAL NUMBER OF MULTI-LENDER NOTES ARRANGED | 10. TOTAL NO. OF INTERESTS SOLD TO INVESTORS ON THE MULTILENDER'S NOTES

11. INSPECTION OF TRUST ACCOUNT — BEFORE ANSWERING THIS QUESTION, REVIEW THE PROVISIONS OF PARAGRAPH (3) OF SUBDIVISION (K) OF SECTION 10238. ***(See reverse.)***

CHECK ONLY ONE OF THE FOLLOWING:

☐ The undersigned broker is (or expects to be) required to file reports of inspection of its trust account(s) with the Real Estate Commissioner pursuant to paragraph (3) of subdivision (k) of Section 10238.
- Amount of multilender payments collected last fiscal quarter:
- Total number of investors due payments last fiscal quarter:

☐ The undersigned broker is NOT (or does NOT expect to be) required to file reports of inspection of its trust account(s) with the Real Estate Commissioner pursuant to paragraph (3) of subdivision (k) of Section 10238.

Certification

The contents of this notice are true and correct.

SIGNATURE » | DATE

TYPED NAME OF BROKER

SIGNATURE OF BROKER OR DESIGNATED OFFICER OF CORPORATE BROKER »

TYPED NAME OF PERSONS SIGNING THIS NOTICE

PAGE ONE OF TWO — FORM 545 (DRE 860)

Servicing agreement

11. A servicing agreement for managing the trust deed investment is entered into by the investors, in which the broker (or other licensed person) agrees to receive payments on the note, disburse the payments received to the investors and begin foreclosure proceedings on a default in the trust deed. [See first tuesday Form 237]

The mortgage collection agreement contains provisions for:

11.1 the deposit of payments into the broker's trust account on their receipt;

11.2 notice that payments deposited will not be commingled with any other funds, and will not be used for any purpose other than the servicing of the mortgage;

11.3 the disbursement to the investors of their pro rata share of the payments within 25 days of receipt;

11.4 notice to the investors if the source of payments is other than the borrower;

11.5 no guarantee or advance of funds for payments by the broker, unless the advance is due to the borrower's check being dishonored;

11.6 filing a request for notice of default (NOD) on prior encumbrances; and

11.7 sending investors a copy of any notice of trustee's sale (NOTS), filed on their behalf, or a request for reconveyance.[19] [See **first tuesday** Form 237]

Disclosure of material facts

12. **Material facts** will be disclosed to the investors on a CalBRE designed form.

12.1 The terms of the sale of undivided interests in the trust deed note include:

a. if it is an **origination** of a mortgage, the name and address of the escrow holder, date for closing and an itemized list of the costs incurred by the borrower and the investors on the origination[20] [See **first tuesday** Form 235-1];

b. if it is the acquisition of **an existing mortgage**, its sales price, any premium or discount on the principal balance and unpaid interest, the effective rate of return, the name and address of the escrow holder and the itemized costs incurred by the seller and the investors on the sale[21] [See **first tuesday** Form 235-2]; or

c. if the note is secured by a **blanket trust deed** as a lien on more than one parcel of real estate, additional disclosures of the identification and value of each parcel, the dollar amount of equity in each property after an apportionment of the amount of the trust deed note to each parcel and the resulting LTV ratio for each parcel.[22]

13. All other relevant *material facts* affecting the sale of the trust deed note.

14. On request from an investor, the broker needs to provide the investor the names and addresses of all other investors in the note.[23]

15. The broker is prohibited from acquiring, directly or indirectly, an **option to buy** the interests of the investors in the note or the real estate as part of the initial transaction to acquire, originate or service a fractionalized note.

However, the broker, after completing the syndication of the note or

19 Bus & P C §10238(k)
20 Bus & P C §10238(l)(1)(B)
21 Bus & P C §10238(l)(1)(A)
22 Bus & P C §10238(l)(1)(C)
23 Bus & P C §10238(m)

entering into a service agreement, may later enter into an agreement to purchase an interest in the note or the real estate if it is negotiated at the time of the acquisition.[24]

16. If the broker sells, originates or services fractionalized notes, and the amount of payments received from all sources in any **three-month period** exceeds $125,000, or the number of all investors participating during a three-month period exceeds 120, the broker is required to:
    16.1 have their **trust account** inspected by a certified public accountant (CPA) and forward the CPA's trust account inspection report to the CalBRE within 30 days after the period in review[25] [See **first tuesday** Form 546];
    16.2 file an **annual report** on the status of the **trust account** with the CalBRE[26] [See **first tuesday** Form 548]; and
    16.3 file an **annual report** of their **trust deed sales, originations** and **servicing** with the CalBRE.[27] [See **first tuesday** Form 547]

The 35-or-less interrelationship rule

The nonpublic offering exemption is the most useful exemption available to syndicators who put together an investment program which includes an activity containing a securities risk. The nonpublic offering exemption applies if:

- the investors do not number more than 35 (husband and wife counting as one);
- all investors have a meaningful, pre-existing business or personal relationship with the syndicator;
- the investors will not resell or distribute the interests they acquire;
- the solicitation of investors does not involve public advertising; and
- the syndicator files a notice of the transactions which fall under the exemption with the California Commission of Corporations.[28]

Thus, when an investment program contains securities risks, the syndicator does not need to be further concerned with the securities law if their program falls under the 35-or-less interrelationship rule for the nonpublic offering of a security. [See Chapter 13]

No blind pools with notice permit

Consider a trust deed broker who receives funds from investors to purchase trust deed notes the broker will originate or select. To evidence their receipt of the funds, the broker executes interest-bearing promissory notes in favor of the investors.

After purchasing trust deed notes with the investors' funds as agreed, the broker collaterally assigns the notes and trust deeds to the investors to secure the promissory notes the broker previously executed.

24 Bus & P C §10238(n)
25 Bus & P C §10238(k)(3)
26 Bus & P C §10238(o)
27 Bus & P C §10238(p)
28 Calif. Corporations Code §25102(f)

An investor loses money on the scheme and demands the return of their funds, plus 10% interest from the date they delivered the funds to the broker. The investor claims the broker's trust deed investment program violates *securities law* since the individual promissory notes issued to evidence the receipt of funds were not registered or qualified as corporate securities.

The broker claims no corporate securities risk exists since the notes became fully secured by the collateral assignment of the trust deeds.

Has the conduct of the broker created a **corporate securities risk** that placed the transactions under the control of the securities law, requiring the broker to obtain a permit or qualify for an exemption?

Yes! The broker placed the investor's capital at risk of loss by an activity controlled by the securities law. The funds were handed to the broker in reliance on the broker's skill in the **later selection** and delivery of trust deed notes. The success of the investment was inextricably bound to the broker's **managerial expertise** in selecting a suitable investment after the investors released their funds to the broker without treatment as trust funds. The investor had no choice in the selection of the trust deed note acquired before their funds were put at risk.[29]

Securities risk in a trust deed investment program

The mere acquisition or origination of one trust deed note by one investor, arranged by a trust deed broker and fully identified to the investor before they release their funds, is not conduct that creates a security, called the **California risk capital test.**

When the investor advances funds through an escrow to purchase or originate a specifically identified trust deed note, the investor receives the full value of their investment by an absolute assignment or execution of the note, secured by a trust deed on real estate of sufficient current value.

However, a trust deed investment program does contain a securities risk when:

- funds are handed to the broker for release *without first identifying* the specific trust deed note and security interest to be acquired in real estate; and
- the investor relies on the *skill and judgment* of the broker to later locate and deliver a suitable trust deed investment in exchange for the funds the investor previously placed with the broker.

The blind pool investment lacks specificity

In a blind pool investment, the investor puts up their money before a trust deed is located for purchase. In practice, the funds will then be readily available to the broker for funding the acquisition of a trust deed note when the broker later locates one they deem to be of suitable investment quality.

29 **Underhill** v. **Royal** (9th Cir. 1985) 769 F2d 1426

The investor does not initially invest their capital in a trust deed, but in the broker's expertise to conduct due diligence investigations and to analyze and select a future trust deed investment. The broker is given *carte blanche* to use the investor's funds as they see fit.

The securities risk is not in a trust deed, but in the performance of the broker's promise to later select and deliver to the investor a suitable trust deed note. Thus, lacking specificity of the investment, a corporate securities risk is created in the investment program entered into by this investor.

Chapter 14 Summary

A broker's singular activity of fractionalizing the investment in a note and trust deed among multiple private investors creates a corporate security. In addition, a mortgage loan broker syndicating trust deeds creates a corporate security if they accept money from an investor or execute promissory notes before locating the real estate securing the trust deed, called a blind pool investment.

When fractionalizing a trust deed investment and packaging multiple-lender trust deed investments, a broker has two options for complying with the securities law:

- the nonpublic offering exemption, called the 35-or-less interrelationship rule; and
- the public offering exemption, called the ten-or-less trust deed investment plan.

A trust deed investment program contains a securities risk and constitutes a blind pool investment when:

- funds are handed to the broker for release without first identifying the specific trust deed note and security interest to be acquired in real estate; and
- the investor relies on the skill and judgment of the broker to later locate and deliver a suitable trust deed investment for the funds previously placed with the broker.

The securities risk is not in a trust deed, but in the performance of the broker's promise to later select and deliver to the investor a suitable trust deed note, thus lacking specificity of the investment.

Chapter 14 Key Term

blind pool investment.. pg. 146

Chapter 15

Forming an LLC for a self-directed IRA

Learning Objectives

After reading this chapter, you will be able to:

- advise your clients on the use of a self-directed IRA LLC to provide risk management and asset preservation while allowing direct checkbook access to the IRA funds;
- distinguish between holding a real estate investment in a self-directed IRA (SDIRA) from investing in a real estate investment trust (REIT);
- properly hold title to an investment property in the name of the investor's SDIRA LLC, not in the name of the investor; and
- appoint a custodian to administer and a special advisor for oversight of an SDIRA LLC.

Key Terms

arms' length transaction

custodian

prohibited transactions

real estate investment trust (REIT)

self-directed IRA

special advisor

unrelated debt financed income

Savings shifted from stocks to real estate

An **individual retirement account (IRA)** is a savings program designed to defer income taxes on deposits and all income and profits until withdrawals are made. As an individual's investment account, an *IRA* is a conduit for the investment of savings, but not an investment itself. An IRA is management.[1]

Funds held in an IRA may be used to acquire and own multiple types of investments, such as:

- stocks;

1 26 United States Code §4975(e)(1)

- bonds;
- mutual funds;
- precious metals;
- real estate; and
- other investments.

Low real estate prices coupled with favorable rental conditions have drawn the attention of individuals with IRAs who are interested in shifting from securities to real estate. These individuals are looking to purchase income-producing real estate with their IRA funds. Historically, income-producing properties offer higher annual yields and better price returns than stocks and bonds in the long-term.

Tax advantages of the self-directed IRA

An advantageous method for investing IRA funds in real estate is to directly purchase and own real estate through a **self-directed IRA (SDIRA)**. Like a traditional IRA, the *SDIRA* is used to accumulate wealth through tax planning. The SDIRA provides the flexibility of asset diversification as real estate, property tax liens and trust deeds can also be purchased with SDIRA funds. [See Chapter 14]

self-directed IRA
An individual retirement account which enables the account owner to invest the IRA funds in a broad range of investments such as real estate, giving the owner direct and continuing control over the management of IRA funds.

As a shield against remote liabilities, savvy SDIRA owners place title to their real estate ownership in the name of a **limited liability company (LLC)**. To this end, establishing an SDIRA *LLC* provides this LLC title protection.

Owning real estate within an SDIRA LLC bypasses the individual income tax reporting typical for the ownership, operation and disposition of real estate. The owner of the IRA funds (the investor) does not own the property purchased through the SDIRA LLC. Rather, the IRA funds are contributed to the SDIRA LLC which becomes the *vested owner* of the property.

Taxwise, the investor personally does not and cannot report or claim:

- rent collected;
- property operating expenses;
- mortgage interest deductions (MID); or
- depreciation deductions.

The IRA owner's long-term benefit of an SDIRA investment in real estate is the *deferral of income taxes* on all annual income and profits earned from the properties purchased. Instead of paying income tax on otherwise reportable operating income and profits, income taxes are paid only on cash distributions when the owner withdraws monies from the IRA account for their personal use.

real estate investment trust (REIT)
A corporate security traded on the stock market as a conduit for making investments in income-generating real estate, trust deeds and government securities.

As in any IRA situation, all monies withdrawn from the IRA are taxed as **personal income** at individual income rates, not capital gains or dividend rates. To avoid penalties for early IRA withdrawals, the investor adheres to specific time frames for withdrawals and distributions.

Real estate investment trusts (REITs) distinguished

Holding a real estate investment in an SDIRA LLC is unlike using IRA funds to invest in a **real estate investment trust (REIT).** In a *REIT*, the IRA participation is similar to holding stock in a public corporation. However, under an SDIRA LLC, the IRA owner has direct and continuing control over the management of IRA funds, and the selection and operation of the real estate acquired with those funds.

An SDIRA permits the flexibility of asset diversification outside ownership of the traditional Wall Street selection of stocks and mutual funds as is typical of most IRA accounts. SDIRAs allow their owner to delve into real estate, property tax liens and trust deed notes selected by the IRA owner and purchased with SDIRA funds.

How is real estate ownership vested?

With an *SDIRA*, the investor makes and controls the investment decisions for placement of funds accumulated in the IRA account, instead of entrusting the account to an uncontrolled investment banker or employer.

Again, ownership of the property acquired using SDIRA funds is vested in the name of the investor's SDIRA LLC, not in the name of the investor.

For example, John Smith uses IRA funds to purchase real estate. Title is not held in the name of "John Smith" as an individual or trustee. Rather, title is held in the name of the SDIRA LLC.

Property management, but not by custodians

A real estate broker knowledgeable about the use of IRA funds to buy real estate through an SDIRA entity expands their practice to new clientele. These experienced brokers are able to advise IRA owners on diversifying their retirement funds into self-controlled real estate investments, no differently than an investment consultant does. In turn, client awareness opens up fee-generating opportunities for services of the broker and their agents, particularly acquisition and property management fees.

To begin the process, a **custodian** is appointed by the account owner for all retirement plans, including SDIRAs. In an SDIRA, a *custodian's* primary duty is to administer and manage the IRA account on the IRA owner's behalf. Management activities are controlled by the *Internal Revenue Service (IRS)* regulations and policy statements.

> **custodian**
> An individual whose primary duty is to administer and manage an individual retirement account (IRA) on the IRA owner's behalf.

The SDIRA custodian administrates for all transactions made with SDIRA funds, including:

- filing all IRS paperwork;
- keeping and reporting all SDIRA tax information; and
- counselling IRA owners about controlling IRS codes and regulations, such as those relating to prohibited transactions.

When purchasing an investment property with SDIRA funds, the custodian directs the investor on how to structure the transaction.

However, it is the investor (or their real estate broker) who is responsible for locating the income property to be purchased and negotiating the terms for acquisition by the SDIRA LLC. [See Chapter 5]

For starters, documents for the purchase of the property need to be in the name of the SDIRA LLC, including the initial purchase offer. [See **first tuesday** Form 159]

Once the investor and their broker identify the property to be acquired, the process of funding the closing through an SDIRA LLC is similar to that of a standard real estate purchase transaction.

Custodial fees and disbursements of operating expenses

Custodians impose **custodial fees** for their administration of an SDIRA. *Custodial fees* vary, depending on the service level required.

Editor's note — Investors need a long-term plan for the purchase of real estate by their IRA before setting up an SDIRA. Oftentimes, investors will allow IRA funds to just sit in an SDIRA, uninvested. Uninvested funds don't grow, while SDIRA accounts regularly incur administrative fees. These fees deplete cash reserves by eating away at the balance, ultimately leading to a loss. If an investor is only interested in buying stocks, bonds and mutual funds, an SDIRA is not a cost-effective option.

Investors need a long-term plan for the purchase of real estate by their IRA before setting up an SDIRA.

The demand for real estate investments by IRA owners is infrequent. Thus, most IRA custodians do not provide real estate investment services and do not set up SDIRAs since most custodians have no understanding or profit inclination to manage them. However, investors with IRAs looking to make real estate investments can find a selection of IRA custodians by searching the web under "real estate IRA" or "self-directed IRA."

Restrictions and disqualified persons

To begin purchasing real estate using funds held in an SDIRA, the property purchased needs to be an **investment**.

An IRA owner may not make personal use of a property held by their SDIRA LLC. If occupied, it may only be by a third-party tenant, not by the investor or their family. Also, real estate purchases made with SDIRA funds need to be **arms' length transactions**.[2]

arms' length transaction
A transaction in which both parties act only in their own self-interest and are not subject to any pressure from the other party due to a preexisting relationship.

Several restrictions are placed on who is allowed to be a party to the purchase transaction, as well as on the use of the property on acquisition.

Individuals and entities classified as **disqualified persons** are prohibited from having any interest in the property bought or sold by the SDIRA LLC.

2 26 USC §4975(c)(1)

Disqualified persons include:

- the IRA account owner and beneficiaries as well as most members of their family, including:
    - their spouse;
    - blood relatives (children, parents, grandparents, etc.);
    - spouses of blood relatives (son-in-law, daughter-in-law, etc.);
    - fiduciaries of the SDIRA such as the custodian or trustee, or any other SDIRA advisors; and
    - any entity (corporation, partnership, trust, etc.) in which any disqualified person or persons have a combined 50% or greater share.[3]

Prohibited transactions

Prohibited transactions include most transactions between the IRA and disqualified persons. The following SDIRA transactions and uses are prohibited:

- using the SDIRA-funded property as security for a personal loan;
- using SDIRA funds to purchase property for the investor's personal use (residence, vacation home, etc.);
- allowing a disqualified person to live in SDIRA-owned property; and
- personally receiving rental income from the SDIRA-owned property.[4]

> **prohibited transactions**
> Improper investment of individual retirement account (IRA) funds by the IRA owner resulting in self-dealing, defined as transactions between the IRA and disqualified persons.

The purpose of these restrictions is to prevent *self-dealing*. Avoiding prohibited conduct minimizes conflicts of interest that jeopardize the IRA's tax-deferred status.

The entire value of the IRA is considered fully distributed when a prohibited transaction occurs. This includes funds and investments held by the SDIRA not involved in the prohibited transaction.

Once the IRA funds are distributed, the investor is subject to a substantial tax liability on the entire IRA if the transaction is not corrected within the taxable period. Further, a 15% penalty tax may be levied against the disqualified person on the full amount of the transaction.[5]

SDIRAs investments in investor-controlled LLCs

When purchasing income-producing real estate, many investors place real estate ownership and title in the name of an LLC.

An *SDIRA LLC* shields the investor's other IRA funds and personal assets held outside of the LLC from a loss resulting from the ownership of the property vested in the LLC.

Further, this structuring gives the investor "**checkbook control.**"

3 26 USC §4975(e)(2)
4 26 USC §4975(c)(1)
5 26 USC §4975(a-b)

Checkbook control gives the investor, as manager of the SDIRA LLC, direct access to the IRA funds. Thus, the owner avoids:

- custodial delays in the disbursement of funds for acquisitions and property expenses; and
- custodial fees based on transactions and account value.

When the investor using an LLC vesting finds a property suitable for purchase using their IRA funds, they simply write checks from the SDIRA LLC bank account for the purchase agreement deposit and to escrow for funding the price to close the transaction – all in the name of the LLC.

Checkbook control also allows the investor to avoid timing issues when funding earnest money deposits and closings using SDIRA funds. This control eliminates the risk of a custodial delay which jeopardizes the investor's purchase opportunity.

Arms' length transaction

Prohibited transaction rules apply to purchases made through an LLC. An investor is prohibited from first contracting to purchase or taking title to a property themselves, then assigning or transferring title to their SDIRA LLC. As before, the LLC transactions are required to also be *arms' length* in nature.[6]

When forming the SDIRA LLC, the LLC operating agreement contains provisions conforming to IRA tax rules and prohibited transactions, which standard LLC operating agreements do not contain. In addition, special management provisions are needed since the LLC will be managed by the investor, not the IRA custodian.[7] [See **first tuesday** Form 372-3 and 372-4]

Required content for LLC operating agreements may vary from one custodian to another. Properly prepared operating agreements fit both the needs of the LLC and meet the requirements of the IRS.

When retaining the services of a third party, such as an attorney, to assist in the creation of the SDIRA LLC, the LLC's formation expenses are paid by SDIRA funds. The investor may not use personal funds to pay any amounts incurred to form an SDIRA LLC. Payment of any debt or obligation of the SDIRA LLC by the account owner is a *prohibited transaction*.

Special advisor to the LLC

IRA custodians also require the IRA owner to appoint a "**special advisor**" to the LLC.

The LLC operating agreement contains a *special advisor provision* to implement this requirement along with tax consequences and information regarding prohibited transactions.[8] [See **first tuesday** Form 372-3 §7]

6 26 USC §4975(c)(1)
7 26 USC §408 and 4975
8 26 USC §§408, 4975

Sidebar

Setting up the LLC

Once the custodian of IRA funds is appointed and initially receives the IRA funds from the prior custodian, an LLC is formed to accept IRA funds from the IRA custodian.

The funds are then deposited into a bank account opened in the name of the LLC. SDIRA custodians have specific guidelines they establish for setting up SDIRA and LLC management arrangements.

To form an LLC, the IRA owner:

- *selects a name for the LLC ending with the words "Limited Liability Company," "LLC" or "L.L.C." , much like a traditional LLC. The words "Limited" and "Company" may be abbreviated to "Ltd." and "Co." [See Chapter 20; Calif. Corporations Code §17052(a)];*
- *signs and files* **articles of organization** *using an LLC-1 form issued by the Secretary of State [See the California Secretary of State's LLC-1 Form; Calif. Government Code §12190(b)];*
- *appoints a* **registered agent** *(usually the IRA owner) to accept service of process in the event the LLC is sued [Corp C §1505];*
- *prepares an* **operating agreement** *detailing the management, membership, special advisors and distribution of monies by the LLC [See* **first tuesday** *Form 372-3 and 372-4; IRC §408 and 4975]; and*
- *files a* **Statement of Information** *with the Secretary of State within 90 days after filing the articles of organization for the LLC. [See the California Secretary of State's LLC-12 Form; Corp C §17060; Gov C §12190(k)]*

A *special advisor* is a state-licensed *certified public accountant (CPA)* or attorney in good standing. This person is to be knowledgeable in IRA tax provisions and prohibited transactions. The special advisor appointment is also to be in writing, on a form provided by the custodian.

special advisor
A state-licensed certified public accountant or attorney in good standing appointed by a self-directed IRA LLC operating agreement who will be consulted on a transaction involving the LLC for the purpose of determining whether the transaction is allowed or prohibited.

An example of a special advisor provision incorporated within an LLC operating agreement is:

> ***"SPECIAL ADVISOR" TO THE LLC:***
>
> *The LLC will engage and maintain at all times an unrelated Special Advisor, a Certified Public Accountant (CPA) (or attorney), who will be consulted with respect to any proposed exchange, transfer, provision of goods and services, purchase, sale, income allocation, or other transaction involving the LLC or its assets.*
>
> a. *The purposes for engaging the Special Advisor is for determining whether, with respect to any investing IRA, the transaction may be a "prohibited transaction" or "listed transaction," may generate "unrelated business taxable income" or "unrelated debt-financed income," or violate any requirement of Section 408 of the Internal Revenue Code.*
>
> b. *The Special advisor will be: [name].*
>
> *The LLC Managing Member has the right to appoint, remove, or upon resignation, replace the Special Advisor.*

a. *Upon the termination of services of the Special Advisor, the LLC will notify [custodian], and submit a new special advisor engagement and representation letter, naming a replacement Special Advisor.*

b. *The LLC agrees not to engage in any transactions, etc. as outlined above until a replacement Special Advisor has been appointed. The appointment shall be in writing, and an executed copy of which shall be provided to [custodian]."*

*Editor's note — **first tuesday's** LLC Operating Agreement – For Self-Directed IRA is designed to meet custodians' requirements for SDIRA LLCs, giving IRA owners a boilerplate form to easily assist in the creation of the LLC. [See **first tuesday** Form 372-3 and 372-4]*

Self-management of IRA-owned real estate

Investors may choose to "self-manage" their IRA-owned property or hire a property manager. The contribution of the time, talent, expertise and effort is not an issue, unless it creates property value.

Self-managing can be cost-effective, but caution is required. The investor needs to follow all IRS regulations regarding the management of a property purchased through an SDIRA LLC.

When self-managing IRA-owned property, the IRA owner may:

- screen and select tenants;
- collect rent checks payable to the SDIRA LLC; and
- deposit rent checks with any credit card or cash receipts.

Rents payable to an SDIRA LLC are directly deposited into the LLC's bank account established by the investor as manager of the LLC.

The IRA owner may also perform maintenance and minor repairs. However, the efforts may not contribute a **sweat equity** increase to the property's value. Maintenance and repairs of a magnitude that increases the property's value are considered **capital improvements**. Value adding capital improvements may not be performed by a *disqualified person*. Thus, if the IRA owner is a licensed contractor, neither they nor their company may make any *capital improvements* to the property owned.

No personal contribution or conversion

The purpose behind this prohibition is to bar the conversion of the IRA owner's time and energy into tax-deferred IRA value.[9]

To avoid these personal contribution issues, an investor can hire a broker specializing in *property management* to handle the day-to-day property management of the IRA-owned real estate investment.[10]

Hiring a property manager also keeps the investors inactive in the operations of the investment. Thus, the investor avoids the risk of committing any

9 26 USC §4975(c)(1)

10 26 USC §4975(c)(1)(C)

prohibited transactions. However, the investor needs to also keep in mind that when hiring a broker to manage the property, rules regarding disqualified persons also apply. Thus, the management company cannot be owned by the spouse of the investor, or any other disqualified person.

Co-ownership of the investment

An investor is prohibited from using both SDIRA and non-SDIRA funds to acquire investment property which will be vested solely in the name of the SDIRA LLC. This is a prohibited comingling of personal and IRA funds. Co-ownership or mortgage financing arrangements need to be considered in this case.[11]

However, the property may be purchased using a combination of SDIRA and non-SDIRA funds if the person or entity providing the non-SDIRA funds becomes a vested **tenant-in-common co-owner** of the property for their share of the contributions to the price.

The co-owner investor can be:

- the IRA account owner;
- individuals including relatives of the investor; or
- an entity such as an LLC.

Each investor contributing funds to the purchase will appear on title as a percentage owner, based on their contribution towards the total costs of acquisition.

Tenant-in-common ownership situation

For example, consider an investor who wants to purchase a property for $100,000, including acquisition costs, but they can only contribute $60,000 from the SDIRA LLC to acquire the property. The investor, or any other person or entity, can contribute the remaining $40,000 from funds outside of the IRA and take title as a co-owner for their percentage of capital contribution.

The resulting ownership will be a tenant-in-common situation with the SDIRA LLC vested as a 60% owner of the property, and the co-investor owning 40%.

Here, the co-owned portion of the investment property purchased with non-IRA funds does not separately qualify for tax deferment under the IRA terms, even if the co-investor is also the IRA account owner. Co-owning the investment property requires all income and expenses to be divided between the SDIRA LLC and the co-owner based on their percentage share of ownership.

In this scenario, the co-investor is required to report the income and expenses generated from their 40% share of the investment. Also, co-ownership does not change or eliminate rules regarding prohibited transactions that affect or benefit the SDIRA-owned property.

11 26 USC §4975(b)

Cash flow and expenses

Ongoing expenses associated with owning and managing the investment property vested in the name of the SDIRA LLC need to be paid by the SDIRA LLC. Likewise, *operating income* generated by the investment property flows exclusively to the SDIRA LLC.

Thus, the investor may not take cash flow directly from the investment and bypass the IRA. The improper withdrawal of rental income destroys the SDIRA tax status, prematurely bringing on income taxes and penalties.

The investor's deposit of funds into an IRA is restricted to the maximum annual contributions allowed for traditional IRA tax accounting. Any payment of the SDIRA LLC's debts or expenses by the investor is deemed a disguised contribution of money to the IRA.

Editor's note — For 2015, the maximum annual IRA (traditional and Roth) contribution is:

- *$5,500; or*
- *$6,500 if the account owner is 50 years or older.*

Contribution limits do not apply to rollover contributions from an IRA to an SDIRA.[12]

Financing the purchase

Leveraging a purchase with financing may also be helpful in attaining additional or larger properties. However, financing real estate funded by an IRA produces additional tax reporting not required when financing a purchase to be vested in the name of the investor.

A mortgage of property owned by the SDIRA LLC needs to be **nonrecourse financing.** This means the IRA, the investor and the LLC do not have personal liability for the loan in the event of a default. The only recourse the mortgage may have as security is the investment property itself. If the IRA fails to make payments, the only remedy for the lender is to foreclose on the property.

unrelated debt financed income
Taxable income on the portion of income and profit realized from ownership of debt leveraged real estate by a self-directed IRA LLC.

The leveraged ownership of property by an SDIRA LLC generates income reportable by the SDIRA on a portion of annual operations and any sale of the property. Part of the income is attributed to the borrowed money on a pro rata basis, known as **unrelated debt financed income (UDFI)**. In the process, *UDFI* on "debt-financed" property leads to double taxation. The SDIRA pays a UDFI tax during the year the income is received, and the investor pays income taxes again when withdrawing funds from the IRA.[13]

For example, an investor purchases a rental property through their SDIRA LLC using a 40% down payment and 60% financing.

The rental income is exempt from taxation if the SDIRA LLC owned the property clear of debt. However, in this scenario, the property is 60%

12 IRS Publication 590
13 26 USC §514

encumbered. Thus, assuming the average debt level for the year was 60% of the purchase price, 60% of all net rental income and 60% of any profits on a sale of the property are subject to the UDFI tax.

The other 40% is tax-deferred as the investment made by the IRA. The capital borrowed to purchase the property did not become a contribution to the SDIRA LLC, but did contribute to the purchase and thus a percentage of the income (and expenses). An IRA owner's investment structured as co-ownership of the property, not as a mortgage on the property, avoids this UDFI tax.[14]

The percentage of net income and profits treated as reportable income for UDFI purposes decreases as the principal amount of the debt on the property decreases.

Filing the Exempt Organization Business Income Tax Return

If the property generates more than $1,000 in gross income subject to UDFI during the year, the SDIRA LLC files IRS Form 990-T, the *Exempt Organization Business Income Tax Return,* and pays a tax.

Although the instructions for Form 990-T make the "fiduciary" responsible for filing the tax return, many SDIRA custodians declare in their custodial agreements that the IRA account owner is responsible for filing tax returns.

When a mortgaged investment is owned by an SDIRA LLC, the investment paperwork is sent directly to the IRA account owner for tax reporting.

After the first 990-T is filed, an SDIRA subject to UDFI files on-going quarterly estimated tax payments.

14 26 USC §512(b)(4)

Chapter 15 Summary

An individual retirement account (IRA) owner may fund the acquisition of income property by establishing and transferring accumulated IRA funds to a separate self-directed IRA (SDIRA). Under an SDIRA LLC, the IRA owner has direct control over the management of IRA funds, and the selection and operation of the real estate acquired.

All income generated by the SDIRA investment remains with the SDIRA, since monies in the IRA may not be disbursed to the IRA owner until retirement. All earnings attributable to mortgage leveraging will be double taxed: once when earned and again when withdrawn from the SDIRA by the owner on retirement.

As a shield against remote liabilities, experienced IRA owners place title to their real estate ownership in the name of a limited liability company (LLC). Establishing an SDIRA LLC provides this LLC title protection, shielding the owner's other IRA funds and personal assets held outside of the LLC from a loss resulting from the ownership of the property vested in the LLC.

The primary IRA benefit of forming an SDIRA LLC is the IRA owner gains direct checkbook access to the IRA funds, in addition to investment selection and acquisition control.

To begin the process, a custodian is appointed for all retirement plans, including SDIRAs. A custodian's primary duty is to administer and manage the IRA account on the IRA owner's behalf. Management is controlled by the Internal Revenue Service (IRS).

The SDIRA custodian is responsible for all transactions made with SDIRA funds, including:

- filing all IRS paperwork;
- keeping and reporting all SDIRA tax information; and
- counselling IRA owners of controlling IRS codes and regulations.

When purchasing an investment property with SDIRA funds, the custodian directs the investor on how to structure the transaction. However, the investor or their real estate broker is responsible for locating the income property to be purchased and negotiating the terms for acquisition by the SDIRA LLC.

Chapter 15 Key Terms

arms' length transaction .... **pg. 158**
custodian .... **pg. 157**
prohibited transactions .... **pg. 159**
real estate investment trust .... **pg. 156**
self-directed IRA .... **pg. 156**
special advisor .... **pg. 161**
unrelated debt financed income .... **pg. 164**

Chapter 16

An overview of the LLC

Learning Objectives

After reading this chapter, you will be able to:

- differentiate between the protections offered by a limited liability company (LLC) versus a limited partnership (LP), real estate investment trust (REIT) or S corporation;
- identify the tax advantages and liabilities of an LLC;
- implement the process for establishing an LLC; and
- recognize the need to cancel an LLC on the sale of the property owned.

Key Terms

Articles of Organization (LLC-1)

real estate investment trust (REIT)

The LLC vs. an LP

A **limited liability company (LLC)** is a hybrid business entity. It combines limited liability advantages of a *corporation* under state law with the federal income tax treatment of a *partnership*.[1]

Like a **limited partnership (LP)**, the *LLC* itself does not pay federal income taxes. Instead, all reportable income, profits and losses of the LLC are **passed through** to the members for individual tax reporting. The members, as individuals, pay federal and state income tax on their share of any LLC income and profits.

The LLC is an entity comparable to an *LP*, but without a general (liability) partner. Limited liability in an LLC extends to all members, including the manager. Conversely, the managing general partner in an LP is personally liable for the partnership's debts.

1 Calif. Corporations Code §§17701.01 et seq.; Calif. Revenue and Taxation Code §§17941 et seq.

The syndicator in an LP sometimes seeks to limit their liability by forming a one-man corporation to act as general partner for the partnership, rather than naming themselves as the general partner. A **sole, corporate general partner** in an LP creates a liability limitation situation for the managing syndicator similar to the LLC, with its limited liability extended also to the manager.

Taxwise, however, an LP with a sole, corporate general partner is a co-ownership structure that is more regulated than an LLC. For instance, all partnerships with the same corporation as the sole general partner are taxed as corporations unless the corporate general partner owns assets with a net worth of at least 15% of the partners' contributions to all the partnerships, limited to $250,000 for total investor contributions up to $2,500,000. When contributions exceed $2,500,000, the net worth of the corporate general partner needs to be at least 10% of the total contributions by partners.[2]

Also, an LP structured with a corporate general partner is unable to take advantage of the exemption from tax reporting available to small partnerships and LLCs. Partnerships and LLCs with ten or less partners or members are exempt from filing the Internal Revenue Service (IRS) 1065 return, but only if all partners are individuals.[3]

The LLC vs. an S corporation

The LLC also resembles an **S corporation** in regards to taxes. Due to its state law corporate liability structure, an LLC is essentially an *S corporation* that is treated as a partnership for income tax purposes. However, an LLC has fewer operating restrictions imposed on the participants and their investments than in an S corporation.

For example, the shareholders in an S corporation must be individuals (or estates, organizations or trusts in limited circumstances). Also, an S corporation may have no more than 100 shareholders.[4]

The members of an LLC, on the other hand, may include any type of legal entity, such as corporations, partnerships and other LLCs, along with individuals. Also, no limit is imposed on the number of co-owner members that exist in the LLC.[5]

The LLC vs. a REIT

real estate investment trust (REIT)
A corporate security traded on the stock market as a conduit for making investments in income-generating real estate, trust deeds and government securities.

For real estate syndication purposes, the LLC also resembles a **real estate investment trust (REIT)**. *REITs* are unincorporated organizations formed for the purpose of group investment primarily in real estate. REITs provide limited liability for investors and pass-through of income for state and federal tax reporting by the investor.[6]

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2 Revenue Procedure 72-13
3 26 United State Code §6231(a)(1)(B)
4 26 USC §1361(b)(1)
5 Corp C §17701.02(v)
6 Corp C §23000; 26 USC §856

However, the REIT is not an appropriate syndication vehicle for group investments in local real estate. The LLC offers far more management flexibility and the same tax results for the participants.

For example, to qualify for federal tax reporting as a real estate investment trust, the REIT needs to have at least:

- 100 shareholders; and
- 75% of its business activities restricted to investments in real estate, trust deed notes, cash or government securities.[7]

No such restrictions apply to the LLC.

Further, an REIT is required to qualify its investment program with the California Department of Business Oversight (DBO). Conversely, an LLC only needs to qualify its investment program when a **securities risk** exists for its members and no exemption applies.[8] [See Chapter 13]

Formation by filing articles

To form an LLC, the syndicator signs and files the **Articles of Organization (LLC-1)** form issued by the Secretary of State (SOS) with the SOS. This is the equivalent of the LP-1 used for limited partnership filings. The SOS filing fee is $70.[9] [See SOS Form LLC-1 accompanying this chapter]

Articles of Organization (LLC-1)
An instrument provided by the Secretary of State (SOS) and used by a syndicator of real estate to form an LLC.

The $70 LLC-1 fee is for documents filed by mail. The SOS charges an additional $15 counter fee for any LLC documents delivered in person.

The person signing the LLC-1 does not need to be a shareholding member of the LLC. In a typical real estate investment program, the LLC-1 will be signed by the syndicator acting alone. The syndicator then typically designates themselves or an entity they control as the managing member named in the LLC operating agreement.

The LLC-1, when filed with the SOS along with the $70 fee, establishes the LLC as a **legal entity** in the state of California. The filing provides limited liability for its members and manager. No further recording of the LLC-1 with the county is necessary. However, a certified copy of an LLC-1 and any other addenda is typically recorded with the county recorder in the county where the LLC will hold title to real estate.[10]

The LLC-1 form can be obtained from:

- the SOS's Sacramento office;
- the branch offices of the SOS; or
- the website of the SOS at *www.sos.ca.gov/business-programs/business-entities/forms*

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7 26 USC §856(c)(4)
8 Corp C §23000(b)
9 Calif. Government Code §12190(b)
10 Corp C §17702.03(c)

Editor's note — Although LLC forms can be obtained from any branch office or downloaded from the SOS's website, only the Document Filing Support Unit in the SOS's Sacramento office will accept LLC forms for filing.

Contents and function of the LLC-1

The LLC-1 is a very limited and fairly simple document, intended mainly to:

- register the LLC with the state;
- establish the LLC as a legal entity in order to provide limited liability to all managers and members (and a minimum tax of $800 annually to the state);
- identify the agent who agrees to accept service of process in case the LLC is sued; and
- state the management structure of the LLC.

In an addendum to the LLC-1, the syndicator may include an **alienation-restriction provision.** An *alienation-restriction provision* assures members that the real estate vested in the name of the LLC cannot be sold, encumbered or subjected to a long-term lease without the consent of a majority in interest of the members. Thus, the provision serves to limit the manager's activities to the designated purpose of the LLC — to **own and operate** the real estate for the benefit of its co-owner members.

An LLC is commonly thought of as having two or more members. However, a single person may form and operate an LLC by filing an LLC-1 with the California SOS.[11] [See **first tuesday** Form 372-5]

A one-man LLC is disregarded for purposes of federal income tax reporting by the sole owner of the LLC.[12]

Limited liability

The liability limitation for members of an LLC is slightly less extensive in its protection from debts than it is for limited partners in an LP. The limited liability protection for the members of an LLC is the same as for the shareholders in a corporation and not that of limited partners in an LP.[13]

For example, the liability of a partner in an LP is absolutely limited to the amount of their capital contribution. However, corporate shareholders — as well as members in an LLC — may be held generally liable for the debts of the corporation or LLC if it can be proven that the corporation or LLC exists solely to shield the shareholders from liability for their debts or actions.

In an LP, the limited partners escape liability beyond the amount of their contributions. However, the general partner of the limited partnership is then personally liable for all partnership debts.

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11 Corp C §17702.01(a)

12 26 Code of Federal Regulations §301.7701-3

13 Corp C § 17703.04(b)

In a corporation or LLC, no member, officer or shareholder is generally liable for any of the entity's debts. Without personal liability for debts incurred by the LLC, an individual may use a corporate or LLC business entity to shield themselves from liability in the conduct of the investment.

Alter egos are not shielded from liability

Conversely, some individuals carry on their personal activities behind a corporation or LLC that is merely a facade, called an **alter ego**, causing the shareholder to lose their liability shield. [See Chapter 13]

A corporation, and thus an LLC, is considered an *alter ego* of a controlling shareholder if:

- the corporation or LLC is entirely dominated by a single individual or by a small group of shareholders or members;
- the economic interests of the corporation or LLC are indistinguishable from the interests of the shareholders or members; and
- an injustice may result from treating the shareholders' or members' acts as the acts of the corporation or LLC and not as their own.[14]

Also, a corporation or LLC that is **undercapitalized** to meet its reasonably anticipated demands for cash is often considered an alter ego of the shareholders. If a corporation or LLC is not funded with a sufficient amount of capital when created, it will not have adequate assets to pay off the debts it incurs in the **ordinary course** of business.

Sufficient capitalization is rarely an issue in real estate transactions since all funds required to own the property — in the form of equity cash and mortgage money — need to be raised before the property can be acquired.

If undercapitalized, a corporation or LLC is regarded as existing in name only, created to shield the shareholders or members from liability for personal debts incurred in the entity's name.[15]

Taxation by the FTB

To maintain the limited liability of its members as permitted by state law, the LLC needs to report and pay annual taxes and fees to the state.

Every LLC is required to pay an annual $800 minimum franchise tax. This same tax is also imposed on corporations and LPs.[16]

In addition to the minimum franchise tax, an LLC with over $250,000 in annual gross income (rents) is assessed an additional annual fee by the Franchise Tax Board (FTB) based on its gross income for that year. The fees, in addition to the $800 entity tax, are:

- $900 for a total gross income of $250,000 to $499,999;
- $2,500 for gross income of $500,000 to $999,999;
- $6,000 for gross income of $1,000,000 to $4,999,999; and

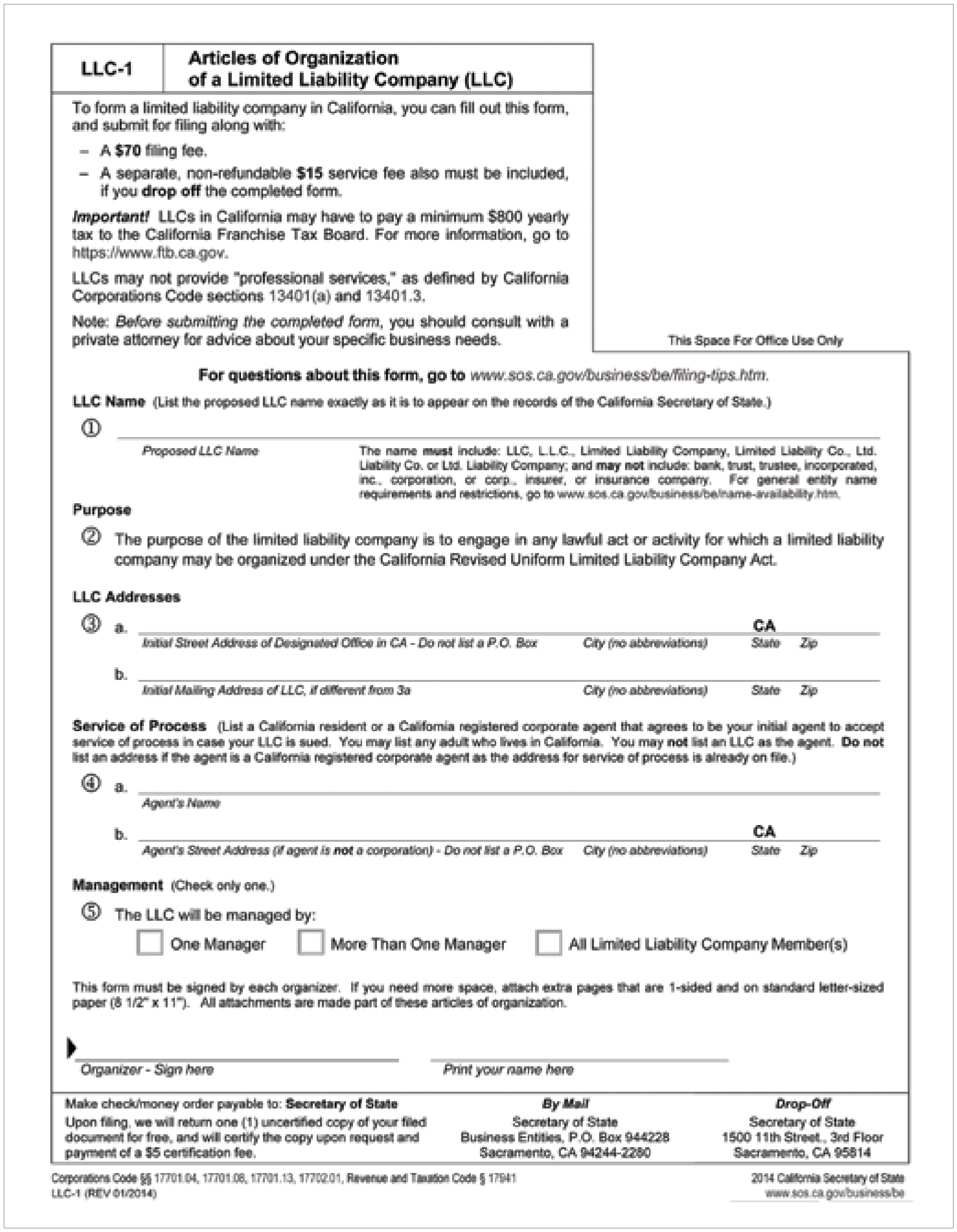
14 **Stark** v. **Coker** (1942) 20 C2d 839

15 **Automotriz del Golfo de California S. A. de C. V.** v. **Resnick** (1957) 47 C2d 792

16 Rev & T C §§17941, 23153(d)(1)

LLC-1

Articles of Organization



LLC-1

Articles of Organization of a Limited Liability Company (LLC)

To form a limited liability company in California, you can fill out this form, and submit for filing along with:

- A **$70** filing fee.
- A separate, non-refundable **$15** service fee also must be included, if you **drop off** the completed form.

Important! LLCs in California may have to pay a minimum $800 yearly tax to the California Franchise Tax Board. For more information, go to https://www.ftb.ca.gov.

LLCs may not provide "professional services," as defined by California Corporations Code sections 13401(a) and 13401.3.

Note: *Before submitting the completed form*, you should consult with a private attorney for advice about your specific business needs.

This Space For Office Use Only

For questions about this form, go to *www.sos.ca.gov/business/be/filing-tips.htm.*

LLC Name (List the proposed LLC name exactly as it is to appear on the records of the California Secretary of State.)

① ______________________

Proposed LLC Name

The name **must** include: LLC, L.L.C., Limited Liability Company, Limited Liability Co., Ltd. Liability Co. or Ltd. Liability Company; and **may not** include: bank, trust, trustee, incorporated, inc., corporation, or corp., insurer, or insurance company. For general entity name requirements and restrictions, go to www.sos.ca.gov/business/be/name-availability.htm.

Purpose

② The purpose of the limited liability company is to engage in any lawful act or activity for which a limited liability company may be organized under the California Revised Uniform Limited Liability Company Act.

LLC Addresses

③ a. ______________________ CA

Initial Street Address of Designated Office in CA - Do not list a P.O. Box *City (no abbreviations)* *State* *Zip*

b. ______________________

Initial Mailing Address of LLC, if different from 3a *City (no abbreviations)* *State* *Zip*

Service of Process (List a California resident or a California registered corporate agent that agrees to be your initial agent to accept service of process in case your LLC is sued. You may list any adult who lives in California. You may **not** list an LLC as the agent. **Do not** list an address if the agent is a California registered corporate agent as the address for service of process is already on file.)

④ a. ______________________

Agent's Name

b. ______________________ CA

Agent's Street Address (if agent is ***not*** *a corporation) - Do not list a P.O. Box* *City (no abbreviations)* *State* *Zip*

Management (Check only one.)

⑤ The LLC will be managed by:

☐ One Manager ☐ More Than One Manager ☐ All Limited Liability Company Member(s)

This form must be signed by each organizer. If you need more space, attach extra pages that are 1-sided and on standard letter-sized paper (8 1/2" x 11"). All attachments are made part of these articles of organization.

______________________ ______________________

Organizer - Sign here *Print your name here*

Make check/money order payable to: **Secretary of State**

Upon filing, we will return one (1) uncertified copy of your filed document for free, and will certify the copy upon request and payment of a $5 certification fee.

By Mail
Secretary of State
Business Entities, P.O. Box 944228
Sacramento, CA 94244-2280

Drop-Off
Secretary of State
1500 11th Street., 3rd Floor
Sacramento, CA 95814

Corporations Code §§ 17701.04, 17701.08, 17701.13, 17702.01, Revenue and Taxation Code § 17941
LLC-1 (REV 01/2014)

2014 California Secretary of State
www.sos.ca.gov/business/be

- $11,790 for gross income of $5,000,000 or more.[17]

If applicable, these additional taxes are to be paid on or before the 15th day of the sixth month of the taxable year. Underpayment of these additional taxes due will result in an extra fee equal to 10% of the underpaid amount.[18]

An LLC formed solely for real estate syndication purposes that acquires income-producing property with a scheduled gross income of less than $250,000 does not have to pay this additional tax.

17 Rev & T C §17942(a)
18 Rev & T C §17942(d)(1-2)

The LLC name

A syndicator selects a name for an LLC which needs to end with the words "Limited Liability Company," or the initials "LLC" or "L.L.C." The words "Limited" and "Company" may be abbreviated to "Ltd." and "Co."[19]

As a practical matter, the name selected for the LLC references the property purchased and operated by the LLC, such as the property's name or street address. To avoid making the ownership interests in the LLC easily traceable, the name of the LLC is not to include the name of the manager or any of the members.

Also, the name may not include the words "bank," "insurance company," "insurer," "trust," "trustee," "incorporated," "inc.," "corporation" or "corp."[20]

For example, a typical LLC name, created from the property's address, might be "Main Street Properties, a California Limited Liability Company."

An LLC name may be reserved by applying to the SOS with a Name Reservation Request Form. For a fee of $10, the name is **reserved** for 60 days. An additional $10 counter fee will be charged if the form is delivered in person to the SOS's public counter.[21] [See SOS Name Reservation Request Form]

Alternatively, a syndicator may use a private filing service to reserve the LLC name or file the LLC forms such as:

- Corporation Service Company, *www.cscglobal.com*;
- The Company Corporation, *www.incorporate.com*;
- BizFilings, *www.bizfilings.com*;
- CT, *ct.wolterskluwer.com*; and
- Nolo, *www.nolo.com*.

Preparing the LLC-1 articles

The LLC-1 includes a space for stating whether the LLC will be managed by all members or by one or more **appointed managers**. For real estate syndication purposes, the syndicator will, in most cases, check the box indicating the LLC has one manager — the syndicator themselves. Thus, they alone will be able to bind the LLC to buy, sell, encumber or lease real estate.

Also, the LLC syndicator designates an *agent for service of process* on the LLC-1 with an address in California, as is required of any statutory entity. The agent may be an individual or an entity and need not be a member of the LLC.[22]

For real estate syndication, the agent for service of process is usually the syndicator or their attorney.

19 Corp C §17701.08(a)
20 Corp C §17701.08(e)
21 Corp C §17701.09(a); Gov C §12190(a)
22 Corp C §17701.13(a)(2)

In addition to the appointed manager, the LLC's operating agreement may provide for the appointment of officers such as:

- president;
- secretary;
- treasurer;
- chief executive officer (CEO);
- chief financial officer (CFO); and
- chief operating officer (COO).[23]

The officers do not need to be members or managers of the LLC. For example, an accountant or bookkeeper who is not a member of the LLC may be hired as treasurer or the CFO.

LLC record requirements

The LLC is required to have an office in the state of California where it maintains its **records**. LLC *records* include:

- the names and addresses of all members and managers;
- copies of the LLC-1 and the operating agreement [See **first tuesday** Form 372];
- copies of state and federal tax returns;
- financial statements; and
- the books and records of the current and past four fiscal years.

A true copy of business records relevant to the amount, cost and value of all property owned, claimed, possessed or controlled within the county needs to be made available upon the request of the county assessor.[24]

LLC-12 information statements

Within 90 days after filing an LLC-1 with the SOS, the syndicator, as the LLC manager, files a **Statement of Information (LLC-12)** form. The *LLC-12* states:

- the name and address of the LLC, its CEO (if any), its manager or managers, its agent for service of process; and
- the type of business it conducts.

The LLC-12 is then filed every two years thereafter during the calendar month in which the articles of organization were first filed or in the five months preceding the original month of filing. A $20 filing fee is required each time the LLC-12 is filed.[25] [See SOS Form LLC-12 accompanying this chapter]

The LLC-12, along with a check for $20 payable to the SOS, is mailed to:

Secretary of State
Statement of Information Unit
P.O. Box 944230
Sacramento, CA 94244-2300

23 Corp C §17704.07(u)
24 Corp C §17701.13
25 Corp C §17702.09; Gov C §12190(k)

Failure to file the LLC-12 within the 90-day period following the filing date of the LLC-1 results in a $250.00 penalty. The LLC-12 may be viewed, filled out and printed from the website of the SOS at *www.sos.ca.gov*.[26]

The duty of filing the LLC-12 continues until the LLC files a C**ertificate of Cancellation (LLC-4/7)** which cancels the LLC entity. [See SOS Form LLC-4/7 accompanying this chapter]

If the information required in the filing LLC-12 has not changed since the previous filing, the LLC may simply file the form, stating no changes have been made.[27]

No professional services

LLCs are not permitted to be licensed as real estate brokers. The *Limited Liability Company Act* prohibits LLCs from offering professional services to others in the name of the LLC for a fee, which includes the services of accountants, attorneys, physicians and real estate brokers.

Some professions may conduct business and provide services under a parallel entity called a limited liability partnership (LLP), but not real estate brokers.

However, an LLC manager who is licensed as a real estate broker may act as the real estate agent representing the LLC as its broker, and collect a brokerage fee on transactions handled on behalf of the LLC.

Also, an LLC may act as a principal in any real estate related transaction, with the same powers as a corporation, partnership or individual. An LLC may also conduct business, buy, sell, finance and lease property, sue or be sued, enter into agreements, etc.[28]

FTB tax reporting

LLCs are considered partnerships for tax reporting purposes, except for the annual California franchise tax and tax on rental income.[29]

An LLC is required, like a partnership, to submit a state information return annually to the FTB. The form for filing an LLC information return is FTB Form 568.[30]

An LLC reporting as a partnership for federal income tax purposes is required to file a 1065 return annually with the IRS, unless the LLC qualifies for the ten-or-less small partnership exemption.

Nonresident members

Additionally, if an LLC has nonresident members, it is required to file an FTB Form 3832, the **Limited Liability Company Nonresident Members' Consent** form. All nonresidents (both domestic and foreign) need to sign Form 3832 to show consent for having their share of the distributed income from the LLC taxed in California. Each nonresident member is to then file a California income tax return.[31]

26 Corp C §§17713.07(b), 17713.09; Rev & T C §19141
27 Corp C §17702.09(b)
28 Corp C §17701.05
29 Rev & T C §28.5
30 Rev & T C §18633.5
31 Rev & T C §18633.5(e)(1)

LLC-12

Statement of Information

State of California
Secretary of State

L

STATEMENT OF INFORMATION
(Limited Liability Company)
Filing Fee $20.00. If this is an amendment, see instructions.
IMPORTANT — READ INSTRUCTIONS BEFORE COMPLETING THIS FORM

1. LIMITED LIABILITY COMPANY NAME

This Space For Filing Use Only

File Number and State or Place of Organization

2. SECRETARY OF STATE FILE NUMBER	3. STATE OR PLACE OF ORGANIZATION (If formed outside of California)

No Change Statement

4. **If there have been any changes to the information contained in the last Statement of Information filed with the California Secretary of State, or no Statement of Information has been previously filed, this form must be completed in its entirety.**

☐ If there has been no change in any of the information contained in the last Statement of Information filed with the California Secretary of State, check the box and proceed to **Item 15.**

Complete Addresses for the Following (Do not abbreviate the name of the city. Items 5 and 7 cannot be P.O. Boxes.)

	CITY	STATE	ZIP CODE
5. STREET ADDRESS OF PRINCIPAL OFFICE			
6. MAILING ADDRESS OF LLC, IF DIFFERENT THAN ITEM 5			
7. STREET ADDRESS OF CALIFORNIA OFFICE		CA	

Name and Complete Address of the Chief Executive Officer, If Any

8. NAME	ADDRESS	CITY	STATE	ZIP CODE

Name and Complete Address of Any Manager or Managers, or if None Have Been Appointed or Elected, Provide the Name and Address of Each Member (Attach additional pages, if necessary.)

9. NAME	ADDRESS	CITY	STATE	ZIP CODE
10. NAME	ADDRESS	CITY	STATE	ZIP CODE
11. NAME	ADDRESS	CITY	STATE	ZIP CODE

Agent for Service of Process If the agent is an individual, the agent must reside in California and Item 13 must be completed with a California address, a P.O. Box is not acceptable. If the agent is a corporation, the agent must have on file with the California Secretary of State a certificate pursuant to California Corporations Code section 1505 and Item 13 must be left blank.

12. NAME OF AGENT FOR SERVICE OF PROCESS

13. STREET ADDRESS OF AGENT FOR SERVICE OF PROCESS IN CALIFORNIA, **IF AN INDIVIDUAL**	CITY	STATE	ZIP CODE
		CA	

Type of Business

14. DESCRIBE THE TYPE OF BUSINESS OF THE LIMITED LIABILITY COMPANY

15. THE INFORMATION CONTAINED HEREIN, INCLUDING ANY ATTACHMENTS, IS TRUE AND CORRECT.

DATE	TYPE OR PRINT NAME OF PERSON COMPLETING THE FORM	TITLE	SIGNATURE

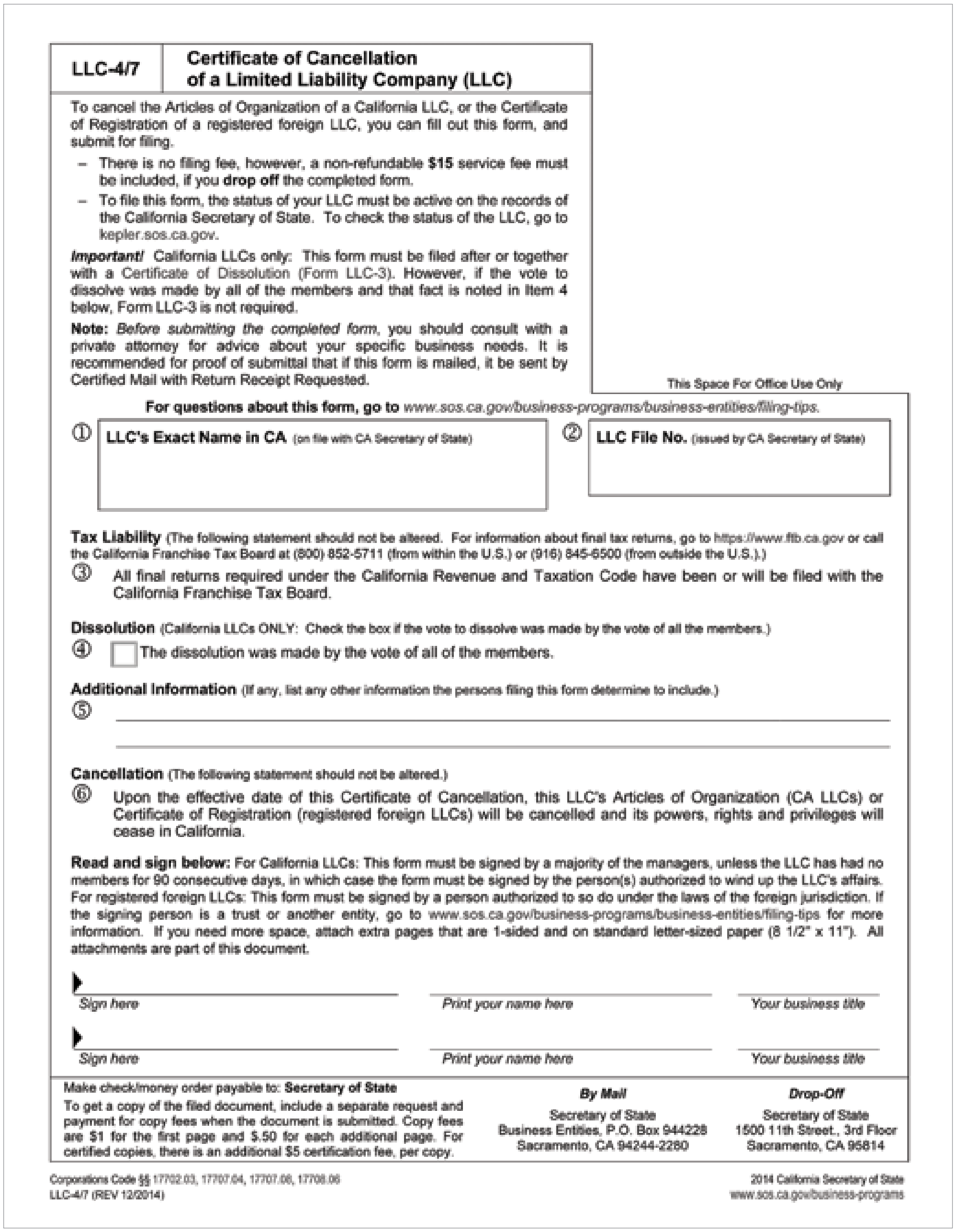
LLC-12 (REV 01/2014) APPROVED BY SECRETARY OF STATE

If an LLC fails to obtain a nonresident member's signature on Form 3832, the LLC will be responsible for paying California taxes for that nonresident member at the highest marginal tax rate. The LLC may recover any taxes paid on the nonresident member's behalf from that nonresident member.[32]

Form 3832 needs to be filed with the information return:

- for the first taxable period during which the LLC had nonresident members; or
- for any taxable period during which the LLC had non-signing nonresident members.[33]

32 Rev & T C §18633.5(e)(1)
33 Rev & T C §18633.5(f)



LLC-4/7 | **Certificate of Cancellation of a Limited Liability Company (LLC)**

To cancel the Articles of Organization of a California LLC, or the Certificate of Registration of a registered foreign LLC, you can fill out this form, and submit for filing.

- There is no filing fee, however, a non-refundable **$15** service fee must be included, if you **drop off** the completed form.
- To file this form, the status of your LLC must be active on the records of the California Secretary of State. To check the status of the LLC, go to kepler.sos.ca.gov.

Important! California LLCs only: This form must be filed after or together with a Certificate of Dissolution (Form LLC-3). However, if the vote to dissolve was made by all of the members and that fact is noted in Item 4 below, Form LLC-3 is not required.

Note: *Before submitting the completed form*, you should consult with a private attorney for advice about your specific business needs. It is recommended for proof of submittal that if this form is mailed, it be sent by Certified Mail with Return Receipt Requested.

This Space For Office Use Only

For questions about this form, go to *www.sos.ca.gov/business-programs/business-entities/filing-tips.*

① **LLC's Exact Name in CA** (on file with CA Secretary of State)

② **LLC File No.** (issued by CA Secretary of State)

Tax Liability (The following statement should not be altered. For information about final tax returns, go to https://www.ftb.ca.gov or call the California Franchise Tax Board at (800) 852-5711 (from within the U.S.) or (916) 845-6500 (from outside the U.S.).)

③ All final returns required under the California Revenue and Taxation Code have been or will be filed with the California Franchise Tax Board.

Dissolution (California LLCs ONLY: Check the box if the vote to dissolve was made by the vote of all the members.)

④ ☐ The dissolution was made by the vote of all of the members.

Additional Information (If any, list any other information the persons filing this form determine to include.)

⑤ ______________________________

Cancellation (The following statement should not be altered.)

⑥ Upon the effective date of this Certificate of Cancellation, this LLC's Articles of Organization (CA LLCs) or Certificate of Registration (registered foreign LLCs) will be cancelled and its powers, rights and privileges will cease in California.

Read and sign below: For California LLCs: This form must be signed by a majority of the managers, unless the LLC has had no members for 90 consecutive days, in which case the form must be signed by the person(s) authorized to wind up the LLC's affairs. For registered foreign LLCs: This form must be signed by a person authorized to so do under the laws of the foreign jurisdiction. If the signing person is a trust or another entity, go to www.sos.ca.gov/business-programs/business-entities/filing-tips for more information. If you need more space, attach extra pages that are 1-sided and on standard letter-sized paper (8 1/2" x 11"). All attachments are part of this document.

Sign here | *Print your name here* | *Your business title*

Sign here | *Print your name here* | *Your business title*

Make check/money order payable to: **Secretary of State**

To get a copy of the filed document, include a separate request and payment for copy fees when the document is submitted. Copy fees are $1 for the first page and $.50 for each additional page. For certified copies, there is an additional $5 certification fee, per copy.

By Mail
Secretary of State
Business Entities, P.O. Box 944228
Sacramento, CA 94244-2280

Drop-Off
Secretary of State
1500 11th Street., 3rd Floor
Sacramento, CA 95814

Corporations Code §§ 17702.03, 17707.04, 17707.08, 17708.06
LLC-4/7 (REV 12/2014)

2014 California Secretary of State
www.sos.ca.gov/business-programs

LLC-4/7

Certificate of Cancellation

An LLC is required to withhold taxes from income distributions made to nonresident members. Nonresident withholding is to be reported quarterly, as well as annually.[34] [See FTB Forms 592, 592-A and 592-F]

Federal small partnership exemption

Although it does not pay income taxes, a partnership — including LLCs since they automatically qualify as partnerships — is required, unless exempt, to file an information return with the IRS, reporting the income and losses passed through to the partners.[35]

34 Rev & T C §18633.5(e)(1)

35 26 USC §6031

In addition, if an LLC has foreign nonresident members, it needs to withhold federal taxes for any income distributions made to foreign members and remit taxes due from foreign nationals to the IRS on a quarterly basis.[36]

The tax form for filing the LLC information return is the IRS Form 1065. The IRS 1065 return informs the IRS of the LLC's income and losses and identifies each member along with their share of the income and losses.

An LLC automatically qualifies as a partnership for federal income tax purposes. Thus, an LLC may avoid filing an IRS 1065 return if it qualifies under the **small partnership exemption**.[37]

An LLC or partnership with ten or less participants, all of whom are natural persons or estates (husband and wife are treated as one), is not required to file an IRS 1065 Form.[38]

Additional limits on exemptions

The IRS has imposed further restrictions beyond the number of participants for the exemption. Even if the LLC has ten or less members, the IRS has ruled an LLC is not exempt from filing a 1065 return if:

- it has significant holdings;
- it is a "tier" entity, in which a parent entity holds interests in one or more sub-entities;
- each member's interest in the capital and profits is not owned in the same proportion; or
- all items of income, deductions and credit are not allocated in proportion to the owner's percentage of membership.[39]

Generally, most small investment groups do not have significant holdings and do report income and losses based on their percentage of ownership. Despite the additional restrictions imposed by the IRS, an LLC formed for real estate syndication with ten or less members can avoid filing the IRS 1065 return.

Each member reports their share of income, expenses, interest and depreciation in a schedule attached to their 1040 return, such as a Schedule E for rental ownership reporting as though they were a tenant-in-common (TIC) co-owner.

Cancellation of the LLC

Within 12 months after creating an LLC by filing the LLC-1 with the SOS, a syndicator may want to cancel the LLC. Cancellation eliminates the LLC entirely and terminates any further assessment of the annual $800 franchise tax on the entity.

Frequently, an LLC entity is formed solely to hold title to real estate for an individual who is the true owner of the property. For federal tax reporting

36 26 USC §1446
37 26 USC §7701, IRS Letter Ruling 9543017
38 26 USC §6231(a)(1)(B)
39 Revenue Procedure 84-35

purposes, the LLC solely owned by one taxpayer is considered a **disregarded entity**. As a result, an individual's personal tax handling of real estate vested in their "one-man" LLC is unaffected.[40]

The individual creates their one-man LLC by preparing, signing and filing the LLC-1. In a one-man LLC, the individual:

- takes on no co-owner members;
- acts as the sole owner of the LLC; and
- does not report to the IRS, but rather reports to the California FTB and pays the annual California LLC franchise tax.

Unable to close

Occasionally, a syndicator files an LLC-1 in anticipation of acquiring a property by forming an investment group, but is unable to close escrow and take title in the name of the LLC. Here, the syndicator may have encountered difficulty clearing contingencies and, as a result, cancels the purchase agreement and escrow. This may be due to their failure to solicit sufficient commitments from investors to fund the closing.

Either way, the LLC now exists as an entity, which triggers the required filing of the LLC-12 within 90 days after filing the LLC-1 to avoid the $250 penalty for failure to file.

The syndicator also needs to pay the ongoing annual $800 franchise tax as long as the LLC-1 remains uncancelled. Thus, within 12 months after filing the LLC-1, a syndicator who creates an LLC and no longer needs it, can prepare and file an LLC-4/8 (the cancellation short form) to rid themselves of further liability and the continued existence of the LLC as an entity.

No charge is incurred for filing an LLC-4/8. Any filing by mail is best sent Certified Mail Return Receipt Requested. [See SOS Form LLC-4/8]

Editor's note – An LLC-4/8 is the SOS's Short Form Certificate of Cancellation to be used only for cancellations occurring within 12 months after filing the LLC-1. For cancellations occurring after 12 months, the Certificate of Cancellation form LLC-4/7 is used to file an LLC cancellation with the SOS.

Before filing the LLC-4/8 cancellation, a final tax return needs to be filed with the FTB. However, a return does not need to be filed with the IRS if a return has not previously been filed.

40 26 CFR §301.7701-3

Chapter 16 Summary

A limited liability company (LLC) is a hybrid business entity. It combines limited liability advantages of a corporation under state law with the federal income tax treatment of a partnership. Like a limited partnership (LP), the LLC itself does not pay federal income taxes. Instead, all reportable income, profits and losses of the LLC are passed through to the members for individual tax reporting.

Limited liability in an LLC extends to all members, including the manager. Taxwise, an LLC is essentially an S corporation that is treated as a partnership for income tax purposes.

To form an LLC, the syndicator signs and files the Articles of Organization (LLC-1) form issued by the Secretary of State (SOS). The LLC-1 establishes the LLC as a legal entity in the state of California. A certified copy of an LLC-1 and any other addenda or documents is typically recorded with the county recorder in the county where the LLC will hold title to real estate.

The limited liability protection for the members of an LLC is the same as for the shareholders in a corporation and not that of limited partners in an LP.

Every LLC is required to pay an annual $800 minimum franchise tax. In addition, an LLC with over $250,000 in annual gross income (rents) is assessed an additional annual fee by the Franchise Tax Board (FTB) based on its gross income for that year.

Within 90 days after filing an LLC-1 with the SOS, the syndicator, as the LLC manager, files a Statement of Information (LLC-12) form. The LLC-12 is then filed every two years thereafter during the calendar month in which the articles of organization were first filed or in the five months preceding the original month of filing.

LLCs are not permitted to be licensed as real estate brokers. The Limited Liability Company Act prohibits LLCs from offering professional services to others in the name of the LLC for a fee.

However, an LLC manager who is licensed as a real estate broker may act as the real estate agent representing the LLC as its broker, and collect a brokerage fee on transactions handled on behalf of the LLC.

Also, an LLC may act as a principal in any real estate related transaction, with the same powers as a corporation, partnership or individual, to conduct any business, buy, sell, finance and lease property, sue or be sued, enter into agreements, etc.

Chapter 16 Key Terms

Articles of Organization (LLC-1).. pg. 169
real estate investment trust (REIT)....................................... pg. 168

Chapter
17

Liens against individuals

Learning Objectives

After reading this chapter, you will be able to:

- use a limited liability company (LLC) as a shield to allow real estate vested in the LLC to remain undisturbed by creditors of members;
- understand how the creditor of an individual LLC member may enforce a money judgment against the debtor member's ownership interest in the LLC.

Key Terms

buyout provision	**fraudulent conveyance**
charging order	**money judgment**

Vesting to shield assets from others

Consider a broker/owner of a high volume real estate office. The broker employs several sales agents and has continuous access to real estate entering the market for sale. The broker manages the office and sales agents, and periodically meets with clients handled by agents. The broker also occasionally acquires property for their own account as a principal.

Due to the business activities of the sales agents employed by the broker, the broker has liability exposure for the professional errors and misconduct of the broker's agents. Even though the broker has incorporated their real estate office and has **errors and omissions (E&O)** insurance coverage, their role as the *designated officer* exposes the broker to liability. Thus, the broker bears the responsibility for the constant supervision of the sales agents employed by the corporation.

The broker is cognizant of their need to personally maintain a low financial profile to avoid the appearance of a "deep pocket" which might itself trigger litigation. As a result, the broker vests all the real estate the broker personally acquires in **limited liability companies (LLCs)** the broker creates.

The broker's *conflicting ownership interest* between their brokerage office and any acquisitions handled in the office on behalf of the broker's LLC vestings is fully disclosed to any seller or buyer with whom the broker or their sales agents have any relationship. [See **first tuesday** Form 527]

Potentially dangerous personal lawsuit

Later, one of the broker's sales agents commits an error. The broker is faced with a potentially dangerous lawsuit arising out of the sales agent's misconduct while acting on behalf of the broker, unrelated to any of the broker's personal real estate acquisitions.

money judgment
An award for money issued by a court resulting from a lawsuit for payment of a claim.

The broker needs assurance the pending litigation, which seeks a **money judgment** against the broker personally, will not interfere with the ability to manage, sell or lease the real estate vested in the broker's LLC.

Will a *money judgment* or lien against an individual member who is an owner of an LLC interfere with the real estate vested in the LLC?

No! Ultimately, only the broker's ownership interest in the LLC can be affected.

Further, their broker's interest as owner of the LLC is **personal property**. Thus, any liens or judgments against the broker will not affect the real estate vested in the LLC — only the broker's interest as owner of the LLC and only if a **charging order** is issued by a court.[1]

A lien or money judgment against an individual who is a member or manager of an LLC is unrelated to the real estate vested in an LLC.

Further, only after a judicial *charging order* is processed can a money judgment against an individual attach to the individual's ownership interest as a member in an LLC.[2]

Interest in the LLC

An individual who is a member of an LLC has no interest in the real estate owned by the LLC. A member's ownership interest in the LLC is thus classified as *personal property*.[3]

While a member has no interest in any LLC property, the member is entitled to their share of the LLC's:

- operating income;
- sales proceeds; and
- assets in the event the LLC is dissolved.[4]

1 Calif. Corporations Code §17705.01
2 Corp C §17705.03
3 Corp C §17300
4 Corp C § 17707.05

Creditors, judgments and liens

A member in an LLC may have an *outstanding debt* they owe due to:

- a money judgment (i.e., lawsuit liability); or
- a local, state, or federal tax lien.

Once recorded, these money judgments or liens automatically attach to any real estate **interests vested** in the individual's name or the name of a trust they have established to hold title. Remember, a trust is not an entity and is not separate from the beneficiary who retains the rights of ownership.

However, a money judgment against an LLC member which does not name the member's LLC entity as a judgment debtor can only be satisfied by foreclosing on the member's *ownership interest* in the LLC, not the real estate owned by the LLC.

Thus, a LLC entity remains unaffected by a lawsuit against an individual member. The LLC, as a separate entity, carries on its normal business activities without interference from a member's creditor seeking to enforce its collection rights under a judgment.[5]

Charging orders to attach a share

Through a money judgment against a member in an LLC, the member's **ownership interest** in the LLC may be attached to satisfy the judgment. This procedure involves the use of a judicial attachment device called a **charging order**.[6]

Under a *charging order*, a creditor must first locate the LLC interests held by a judgment debtor. Once discovered, the creditor then applies to the court for an order to charge (place a lien on) the ownership interest in the LLC held by the individual member for payment of the judgment.[7]

charging order
An attachment device used by a creditor to place a lien on the ownership interest in a limited liability company (LLC) held by the individual member for the payment of a money judgment, and either appoint a receiver to hold the debtor member's share or foreclose on the member's interest in the LLC.

Notice of the hearing on the charging order is given to the debtor member and all other members of the LLC.[8]

A creditor of an individual member has two options to enforce a money judgment:

- **appoint a receiver** to receive the debtor member's share of the income and profits generated by operations of the property vested in the name of the LLC; or
- **foreclose** under the charging order lien on the member's interest in the LLC.[9]

Under a charging order lien, the appointment of a receiver is restricted to accepting the benefit of the individual member's interest in the LLC. The creditor acquires no greater rights than the debtor member had under the LLC *Articles of Organization* or the LLC *operating agreement*.[10] [See **first tuesday** Form 372]

5 Calif. Code of Civil Procedure §§708.310, 708.320
6 CCP §708.310
7 Corp C §17302
8 CCP §708.320
9 Corp C §17302
10 Corp C §17705.02

buyout provision
A provision in a limited liability company (LLC) operating agreement which, on termination of a member's interest, grants the remaining members the right to buy out the terminated member's interest in the LLC or dissolve the LLC. [See **ft** Form 372 §7]

A creditor with a judgment has the judicial means to go after a member's **economic interest** only. However, the reality of obtaining an individual member's interest may be more of a hassle than it is worth. The interest the creditor obtains from the debtor member is a nonvoting interest which prohibits interference with LLC activities requiring a vote. Thus, the creditor assumes no duty or liability owed to the LLC or its other members. [See Chapter 18]

Further, the LLC operating agreement typically provides for removal of the debtor member from the LLC if a charging order against the debtor member's interest is not immediately removed. [See **first tuesday** Form 372 §6.2(d)]

Buyout provisions triggered

One or all of the members in a LLC may terminate a debtor member's interest in the LLC on the notice of a charging order without causing the LLC to be dissolved. This right is granted in the LLC operating agreement on terms of the **buyout provisions**. [See **first tuesday** Form 372 §7]

On termination of a member's interest, the remaining members may buy the terminated member's entire interest in the LLC. Where more than one member exercises their option, those exercising will purchase their pro rata share based on their aggregate ownership interest. [See **first tuesday** Form 372 §7.1(b)]

Buyout provisions in an LLC agreement between members are the most common method used for the elimination of a debtor member and their judgment creditor. Additionally, the terms of buyout provisions are usually advantageous to the remaining members. [See **first tuesday** Form 372 §7]

Fraudulent conveyances by debtors

The transfer of property by an owner of real estate to *evade a creditor* is considered fraudulent when:

- the owner **intends to defraud** their creditors;[11] or
- a reasonably **equivalent value** is not received by the owner in exchange for the property transferred, and the owner is or will be insolvent (i.e., debts exceed assets) on the transfer.[12]

Any property transfer made for the purpose of avoiding creditors may be invalidated as a **fraudulent conveyance**.[13]

fraudulent conveyance
A property transfer made for the purpose of avoiding creditors or without receiving fair value on the transfer, which may be invalidated.

However, if the full value or a reasonably equivalent value is received by an owner for a transfer, the transaction cannot be invalidated. The creditor is then left to chase down and attach the proceeds received by the owner (debtor).

A *fraudulent conveyance* is indicated when an individual knows of pending litigation or claims against them, then transfers their real estate without receiving fair value.

11 Calif. Civil Code §3439.04(a)(1)
12 CC §3439.05
13 CC §§3439 et seq.

Fraudulent conveyance without fair value

Consider an LLC consisting of three members. Later, a judgment is obtained by a creditor against two of the members of the LLC in their individual capacities.

A creditor obtains a *charging order* against the members' individual interests in the LLC. All three members receive notice of the proceedings.

Prior to the enforcement of the charging order, the members dissolve the LLC. The two debtor members each transfer their ownership interest to the third member, who is unnamed in the judgment, for a minimal sum, if any.

Here, the transfer is fraudulent since the third member was on notice of the charging order and did not pay a fair value for the transfer by the debtor members. If a transfer is made by an owner without a fair exchange of value to a "buyer" who knew the transfer diminishes the creditor's claim, the "buyer" then becomes liable for the creditor's losses.[14]

Thus, the fraudulent conveyance of a debtor's "wealth" beyond the reach of a creditor will be subject to disciplinary action from the court.

The LLC asset shield

The use of an LLC to hold real estate assets was neither designed nor intended to be employed as a place to hide an individual's personal wealth. Rather, use of an LLC is a means to allow real estate vested in the LLC to remain *undisturbed* in the face of an individual member's adversity, and vice versa.

Consider an owner who places their ownership of real estate into a LLC. The owner receives a percentage or all of the ownership interests in the LLC for the conveyance — fair value for the transfer since they became the owner of the LLC which now owns the real estate.

In this instance, the conveyance is not fraudulent. The owner has merely exchanged their interest in the real estate for an interest in the LLC of the same value. Full value is received and no tax liability is incurred on the exchange.[15]

In essence, the owner has substituted their real estate vesting for a position in the LLC. The owner still owns a value equal to the equity in the real estate they transferred, only in a different form. Thus, the value of the owner's interest was not diminished since they received an equivalent value for the property. The nature of the owner's ownership interest merely changes from one of **real property** to one of **personal property**.

However, this simple change in vesting inherently makes it more difficult for creditor's to locate and attach the debtor's assets. The individual owner (debtor) on a recorded abstract of judgment is not the vested owner of any real estate.

14 **Taylor** v. **S & M Lamp Co.** (1961) 190 CA2d 700

15 26 United States Code §721

Further, the change in vesting makes the real estate, now the asset of an LLC, much more difficult for the creditor to reach due to:

- the charging order process;
- nonvoting status if they do foreclose; and
- the subject of buyout provisions in the LLC operating agreement.

As the creditor is attempting to locate and attach the debtor's assets, the LLC can continue its business of renting, selling or encumbering the property. On attaching the member's interest via a charging order and appointment of a receiver, the LLC distributes income proceeds to the judgment debtor who on foreclosure is a nonvoting member in the LLC.

Chapter 17 Summary

The use of a limited liability company (LLC) to hold real estate assets was not designed to be employed as a place to hide an individual's personal wealth. Rather, use of an LLC is a means to allow real estate vested in the LLC to remain undisturbed in the face of an individual member's adversity.

A member in an LLC may have an outstanding debt they owe due to a money judgment or a local, state, or federal tax lien. Through a money judgment against a member in an LLC, the member's ownership interest in the LLC may be attached to satisfy the judgment. This judicial procedure involves the use of an attachment device called a charging order. Once recorded, these money judgments or liens automatically attach to any real estate interests vested in the individual's name or the name of their trust.

A money judgment against an LLC member can only be satisfied by foreclosing on the member's ownership interest in the LLC, not the real estate owned by the LLC. Thus, an LLC entity remains unaffected by a lawsuit against an individual member.

A creditor of an individual LLC member has two options to enforce a money judgment:

- appoint a receiver to receive the debtor's share of the LLC income and profits; or
- foreclose under the charging order lien on the member's interest in the LLC.

A creditor with a judgment has the judicial means to go after a member's economic interest only. The interest the creditor obtains from the debtor member is a nonvoting interest which prohibits interference with the LLC activities requiring a vote.

One or all of the members in a LLC may terminate a debtor member's interest in the LLC on the notice of a charging order by prior agreement under the terms of the buyout provisions of the LLC agreement. Upon the termination of a member's interest, the remaining members may buy the terminated member's entire interest. Buyout provisions in a LLC agreement between members are the most common method used for the elimination of a debtor member and their judgment creditor.

Chapter 17 Key Terms

buyout provision .... **pg. 184**
charging order .... **pg. 183**
fraudulent conveyance .... **pg. 184**
money judgment .... **pg. 182**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Chapter 18

LLC membership buy outs

Learning Objectives

After reading this chapter, you will be able to:

- process an assignment and termination of a co-owner member's interest in an limited liability company (LLC);
- understand the use of buyout provisions in an LLC's operating agreement; and
- discuss the steps necessary to document and record a change in management of an LLC.

Key Terms

alienation

due-on clause

novation

operating agreement

right of first refusal

Assigning and terminating a member's interest

Consider an investor who acquires a fractional ownership interest in a limited partnership (LP) which owns real estate. Later, the partnership is *converted* to a limited liability company (LLC) to eliminate the general partner's exposure to future liabilities. [See Chapter 16]

An LLC **operating agreement**, nearly identical to the prior LP agreement, is entered into by all parties involved. Each investor's ownership interest in the LP is converted to a co-owner **member's interest** in the LLC, and the general partner is given the title of **manager**. [See Figure 1]

The investor now wants to sell their fractional *membership interest* in the LLC. However, the LLC *operating agreement* restricts the **assignability** of a member's interest, as did the LP agreement.

operating agreement
A form used by syndicators when setting up a limited liability company (LLC) to establish the procedures for operating the LLC and the rights and duties of its members. [See **ft** Form 372]

This restraint on assignability exists to prevent the admission of outsiders who might later interfere with the LLC's investment objectives and operations.

The LLC's operating agreement permits a member to **sell and assign** their membership interest in the LLC if:

right of first refusal
A pre-emptive right to buy a property if the owner decides to sell. [See **ft** Form 579]

- the manager or another member of the LLC exercises their **right of first refusal** to buy and acquire the investor's interest;
- the other members **waive their right to terminate** a member's interest if it is sold without their approval; or
- a voting majority of the members in interest **consent** to the sale and assignment of the member's interest.

The investor first offers to sell their membership interest to the manager under the *right of first refusal* given to the manager in the LLC operating agreement.

The manager declines the offer. The manager is forming new investment groups to amass their own future wealth and has no interest in repurchasing or marketing fractional interests held by investors in existing investment groups. The manager prefers to place investors into fresh deals which add fees and participation in ownership to the manager's portfolio.

Next, the investor offers to sell their fractional interest to other members of the LLC, who also decline.

The investor locates an outside buyer who is interested in buying their membership interest.

The other members pose no objection to the investor selling and assigning their interest and agree to *waive their right to terminate* the investor's membership interest on a sale to a buyer.

However, the other members are unwilling to:

- approve an assignment of the investor's membership interest; and
- accept the buyer as a **substitute member**.

Buyout provisions restrict assignments

By the terms of the operating agreement, a member's interest may be terminated by the remaining members if the existing member transfers their interest without the prior approval of the remaining members, unless they have *waived their right* to do so. On an assignment of a member's interest to a person other than a member without waiver or approval, the remaining members have the **right to buy out** the selling member's interest at what is usually an advantageous, predetermined price.

To continue with our previous example, while a waiver of termination rights allows the investor to freely dispose of their interest, the refusal by the other members to accept the investor's buyer as a member reduces the value of the investor's fractional interest.

The investor claims the LLC may not impair their right to sell and assign their fractional membership interest in the LLC to a buyer.

However, the **assignability**, and thus marketability, of a member's interest may be controlled by the LLC operating agreement.[1] [See Figure 1, **first tuesday** Form 372]

Approval of subtsitute member

While the investor may assign their interest to the buyer, the assignment is not freely made due to the restraint on a transfer agreed to in the LLC operating agreement. Even if a waiver is obtained from the other members, an assignment does not substitute the buyer of a fractional interest as a new member.

The remaining members need to *approve* of the buyer as a *substitute member* and *release* the selling member from liability to the LLC before the **right of membership** may be transferred to the buyer.[2]

Approval of the assignment of a membership interest is accomplished by a vote of a majority in interest of the members in the LLC, unless the operating agreement calls for a different voting percentage. [See **first tuesday** Form 372 §12.1(a)]

Unless approved as a substitute member, the buyer by an assignment of the investor's interest is a **nonvoting member** of the LLC.[3]

Assignable interests in an LLC

Title and ownership of the real estate is held by the LLC, an entity separate from its members. In turn, members of an LLC have no ownership interest in the LLC's real estate. Rather, an LLC member owns a **personal property** interest as a shareholder in the LLC which owns the real estate.[4]

Two **assignable interests** held by members exist in an LLC:

- the *ownership interests* held by contributing members, the investors and the syndicator; and
- the *administrative interest* held by the managing member, the syndicator alone.

The fractional ownership interests in the LLC are held only by its contributing members. The percentage shares of ownership in the LLC are based on the value of each member's contributions to capital, in the form of either:

- cash contributions by the investors; or
- purchase rights to acquire real estate contributed by assignment from the syndicator.

Unlike the passive position of a contributing member, the **managing member's position** carries with it the administrative responsibility to

1 Calif. Corporations Code §17705.02

2 Corp C §17704.07

3 Corp C §17705.02(a)(3)

4 Corp C §17705.01

Figure 1

Excerpt from Form 372

LLC Operating Agreement

5. **ASSIGNMENT OF INTEREST, SUBSTITUTED MEMBER:**
   - 5.1 Assignment of Interest: A member may assign his membership interest to any other member at any time after he has first given the manager 10 days' notice to buy his interest on the same terms agreed upon with another member.
   - 5.2 Invalid Assignment of Interest: All other assignments or transfers of members' interests are terminated according to the method under Section 6.
6. **TERMINATION OF MEMBERSHIP INTERESTS:**
   - 6.1 Termination of Manager: The termination of the Manager does not terminate any of the Manager's rights as a member.
   - 6.2 Events Causing Termination of a Member: A member may be terminated if any of the following events occur:
     - a. He dies, unless survived in interest by a joint tenant;
     - b. He is adjudged insane or incompetent, or is committed to a mental institution;
     - c. He transfers his interest to a non-member under Section 5.2 without obtaining prior consent from each remaining member;
     - d. He fails to immediately remove a charging order against his interest;
     - e. He files for bankruptcy;
     - f. He voluntarily retires, withdraws or resigns as a member;
     - g. He is expelled by court order or by all of the remaining members; or
     - h. He fails to contribute capital to the Limited Liability Company as agreed to in Section 2.1.
   - 6.3 Notice of Termination: Service upon the member to be terminated of a written notice stating the cause for termination and the effective date of termination terminates all of his powers and his right to share in Limited Liability Company profits as of the effective date. The effective date is 30 days after service of the notice. Each remaining member shall be served under Section 13.2 both a copy of the notice of termination and a notice of the option rights held by the remaining members under Section 7.
7. **OPTION TO PURCHASE:**
   - 7.1 Option to Purchase Upon Termination: Upon the termination of a member's interest under Section 6, the remaining members may:
     - a. Dissolve and liquidate the Limited Liability Company under Section 10.1; or
     - b. Buy the terminated member's entire interest. Where more than one member exercises his option, those exercising shall purchase their pro rata share based on their aggregate ownership interest.
   - 7.2 Notice of Exercise of Option:
     - a. When a member dies, notice of the option shall be given to the deceased's representative within 120 days after the representative's appointment.
     - b. When a member's interest is terminated under Section 6, notice of the exercise of the option shall be given to the terminated member before the effective date of termination, and in the way a notice of termination is given under Section 6.3.

actively manage the LLC and operate the real estate acquired using the capital contributed by the members. The manager is the **administrator** who oversees the day-to-day operations of the LLC and the real estate.

Structurally, the manager, like the president of a corporation, may be terminated and a new manager appointed at the discretion of the contributing members. The members hold voting rights they use to govern the LLC, like shareholders and directors of a corporation. Further, voting members control the **alienation** of ownership interest in the real estate vested in the name of the LLC.

alienation
The transfer of an interest in real estate from one person to another.

The percentage ownership share in the LLC received by the manager for assigning their purchase rights to the real estate is held in their name as a contributing member. Thus, the syndicator is both the managing member and a contributing member.

AMENDMENT TO OPERATING AGREEMENT

Of Limited Liability Company

Prepared by: Agent ______________ | Phone ______________
Broker ______________ | Email ______________

DATE: __________, 20____, at ______________________, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This amends the Operating Agreement of ______________________________, a California Limited Liability Company,
   1.1 dated __________, 20____, at ______________________, California,
   1.2 formed under a Certificate of Limited Liability Company (LLC-1) filed with the California Secretary of State on ______________, ______, as document number ______________, and
   1.3 recorded on __________, ______, as document number ______________, with the county recorder of ______________ County, California.

AGREEMENT:

The Operating Agreement of Limited Liability Company is amended as follows:

2. ______________________ is substituted as the new Manager in the place of ______________________, who is released of all rights and obligations under the Operating Agreement. The new Manager shall immediately file an LLC-2 Amendment to Certificate of Limited Liability Company with the Secretary of State and record the same with the office of the county recorder where the Limited Liability Company's real estate is located.
3. ______________________ is substituted as a new Member in the place of ______________________, who is released of all rights and obligations under the Operating Agreement. An assignment of the Member's interest is attached. [See ft Form 375]
4. The Limited Liability Company has acquired the ownership interest in the Limited Liability Company held by ______________________, who is released of all rights and obligations under the Operating Agreement. An assignment of the Member's interest is attached. [See ft Form 375]
5. ______________________ is added to the Limited Liability Company as an additional Member for the agreed capital contribution of $______________, payable in cash or ______________________, for a percentage ownership in the Limited Liability Company of ______%.
6. The Members agree to contribute additional capital to the Limited Liability Company in the amount of $______________, as set forth in Exhibit "A" of the Operating Agreement – LLC [ft Form 372] attached to this amendment.
7. Other ____

I agree to the terms of this amendment.

☐ See attached Signature Page Addendum. [ft Form 251]

Member's Name: ______________	Member's Name: ______________
Signature: ______________	Signature: ______________
Member's Name: ______________	Member's Name: ______________
Signature: ______________	Signature: ______________
Member's Name: ______________	Member's Name: ______________
Signature: ______________	Signature: ______________

FORM 374 03-11

Form 374

Amendment To Operating Agreement

The manager's individual membership share as a co-owner of the LLC typically arises out of their *assignment* to the LLC of their right to purchase the property which the LLC acquired, although they may have also contributed cash.

An assignee's right to participate as a member

The assignment of a member's ownership interest to another person, with or without the approval of the other members of the LLC, does not **dissolve** or alter the LLC entity. The LLC continues to function and is managed without concern for the assignment.[5]

5 Corp C §17705.02(a)(2)

Again, a contributing member's ownership interest in the LLC is assignable. However, the sale and assignment of a member's interest does not automatically entitle the buyer of the fractional ownership interest to governing rights held by a **voting member**.[6]

On an assignment of a member's interest, the remaining members need to either approve the assignment or waive their *right to terminate* the selling member's interest. If not, the selling member's assignment and the interest received by the assignee buyer may be terminated and bought out by the manager or other members under buyout provisions in the LLC operating agreement. [See Figure 1, **first tuesday** Form 372 §7.1]

When the remaining members do not consent to the assignment or buy out the interest assigned, the buyer of the fractional interest is only entitled to receive the same **accounting** of the distributions of income, profit or loss the selling member regularly received.[7]

No voting or participation rights

Additionally, without acceptance as a member by a majority vote of the remaining voting members, the buyer acquiring a member's fractional interest is not entitled to vote or participate in the governing of the LLC or exercise the rights of a member (other than receive regular accountings and distributions), unless the operating agreement states otherwise. [See **first tuesday** Form 372]

Likewise, a judgment creditor of a member –– not of the LLC –– may *involuntarily acquire* that member's ownership interest in the LLC. The creditor's process for acquiring the interest is a **charging order** issued by a court and a sheriff's sale of the member's fractional interest to satisfy the money judgment owed by the individual member.

However, on acquiring the fractional interest of a member at a judicially ordered sale of that interest, the foreclosing judgment creditor only receives the rights of an **assignee** as a nonvoting member of the LLC. Future distributions of income, profit or loss the original member was entitled to receive are all rights the creditor is entitled to.[8] [See Chapter 17]

A buyer or creditor who is assigned or forecloses on a member's interest and is not approved as a member receives only the member's **economic interest** in the LLC and assumes no duty or liability owed to the LLC or its other members.[9]

The obligations of a substitute member

The buyer of a selling member's fractional interest may be admitted as a **substitute member** by a majority vote of the remaining members. When substituted, the new member takes on all the **rights and responsibilities** of the selling member, including all capital contributions assessed against that member's fractional interest.[10]

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6 Corp C §17705.02(a)(3)

7 Corp C §17705.02(b)

8 Corp C §17705.03(b)(3)

9 Corp C §17301(b)

10 Corp C §17705.02(h)

Additionally, on approving an assignment to a *substitute member*, the remaining members vote to amend the LLC to substitute in the replacement member and release the selling member from future liability to the LLC, called a **novation**. Without a release of liability, or *novation*, the selling member remains obligated to the LLC under the operating agreement they originally entered into.[11] [See Form 374 accompanying this chapter]

novation
An agreement entered into by a mortgage holder, buyer and seller to shift responsibility for a mortgage obligation to the buyer by an assumption and a release of the seller from liability.

*Editor's note — After a member transfers their interest, they may not later interfere with the LLC's activities and purpose. The selling member's withdrawal does not release them from all obligations owed to the LLC and the remaining members. A **fiduciary duty** among original members remains to avoid interfering with investment opportunities and operations known to the released member and of value to the LLC.*[12]

The same fiduciary duty is owed to the LLC by the substitute member who becomes a voting member.

Documenting the transfer

An **assignment** of a withdrawing member's interest and **substitution** of the buyer as a new member are completed by:

- a written *assignment* from the withdrawing selling member to the buyer; and
- an *amendment* to the operating agreement by a vote of the remaining members.

With an assignment, the withdrawing member transfers all their rights, title and interest in LLC to the buyer who is acquiring their fractional interest. [See Form 374]

If the remaining members elect to accept the buyer as a substitute member, the operating agreement is *amended* to substitute the new member (buyer) for the withdrawing member. [See Form 375 accompanying this chapter]

For the amendment to be effective on the substitution of a member, it needs to be signed by the remaining members holding the percentage of ownership interest called for in the operating agreement, usually a super-majority (e.g., 75%).

If the operating agreement does not state the percentage of ownership interest required to consent to a substitute member, then a majority in interest of the members need to sign the amendment.

The LLC does not need to prepare or file a *California Secretary of State (SOS) Amendment to Articles of Organization of a Limited Liability Company (LLC-2)* on the assignment of a member's interest. [See SOS Form LLC-2]

However, when admitted to the LLC as a substitute member, the substitute member's name needs to be added to the list of current members which is required to be kept at the LLC office maintained by the manager.[13]

11 Corp C § 17705.02(h)
12 **Leff** v. **Gunter** (1983) 33 C3d 508
13 Corp C §17701.13(d)

Manager's assignments

The assignment of a **manager's interest** in an LLC to another person is more complex than the assignment of a member's interest. It is accomplished by:

- a written assignment by the manager or notice of termination by the members;
- a vote amending the operating agreement to identify the new (substituted) manager; and
- a filing with the SOS of an amended *Statement of Information (LLC-12)* naming the substitute manager.[14]

The withdrawing manager's interest is assigned to a substitute manager and the operating agreement is amended by preparing the same documents used to substitute members. [See Form 374 and 375]

An LLC-12, in addition to its initial and biennially filings with the SOS, is also used to report corrections and changes made to the LLC, including:

- a new principal office address;
- the name and address of the chief executive offer (CEO), if any; and
- the name and address of any manager which has been appointed or elected. [See SOS Form LLC-12 in Chapter 16]

When a new manager is appointed or elected and the revised LLC-12 is filed with the SOS, the prior manager's authority to act on behalf of the LLC is terminated.[15] [See Chapter 16]

Due-on provisions and property reassessment

Two further consequences need to be considered when assigning a selling member's fractional interest in an LLC.

First, the rights of mortgage holders to call on a transfer of ownership interests in the LLC vested with title need to be considered. The manager and remaining members need to review each provision in the trust deeds encumbering the real estate owned by the LLC for the existence of a **due-on clause.** The buyout of a co-owner's fractional interest may trigger the lender's **right to call or recast** the terms of the loan if the percentage of ownership in the LLC transferred is greater than the percentage permitted without lender consent under a trust deed due-on provision.

due-on clause
A trust deed provision used by mortgage holders to call the debt due and immediately payable, a right triggered by the borrower's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

The remaining members need to then decide whether to notify the mortgage holder of the "off-record" buy out and seek consent to the assignment before it is made.

Second, the remaining members need to ascertain whether the assignment of the selling member's interest is classified as a **change in ownership** which triggers **reassessment** by the county assessor and results in higher property taxes.

14 Corp C §§17702.06; 17704.07(c)(5)
15 Corp C §17702.03(c)

The transfer of more than 50% of the LLC's ownership interest to any one individual or entity triggers reassessment of the LLC-owned real estate.[16]

Accordingly, when more than 50% of the LLC's ownership interest are transferred, whether by one member or multiple members, reassessment is only triggered if any one individual or entity acquires more than a 50% ownership interest in the LLC.[17]

Thus, the transfer of 50% or less of the ownership interests held by members during the life of the LLC to any one individual or entity does not constitute a *change in ownership* and does not trigger *reassessment* of real estate vested in the name of the LLC.

Additionally, when a member with a minority interest in an LLC acquires enough ownership interests to hold a majority interest (more than 50%), a change of ownership occurs, triggering reassessment of the entire parcel of real estate owned by the LLC.[18]

Documenting a change of ownership with the SBOE

An LLC manager needs to sign under penalty of perjury a change of ownership statement and submit it to the State Board of Equalization (SBOE) within 90 days of the earlier of the:

- 50% change in ownership; or
- SBOE request for the statement.

Failure to timely file the change of ownership statement results in a penalty of 10% of the property taxes due on the new full cash value of the property.[19]

Membership vesting is estate planning

Vesting real estate co-owned by investors in an LLC instead of as tenants in common (TICs) eliminates any interference with title to the real estate on the death of an LLC member (and provides cover from liability for members and the manager).

The chaos created for the management of the real estate by death of a vested co-owner is totally eliminated by the use of an LLC entity for vesting the property. The steps involved are:

- the recording of an LLC-1 to create an LLC;
- entering into an operating agreement between the co-owner members; and
- vesting the real estate acquired in the name of the LLC.

This is in contrast to what occurs on the death of a co-owner when they are vested on title as a TIC.

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16 Calif. Revenue and Taxation Code §64(a)

17 **Ocean Avenue LLC** v. **County of Los Angeles** (2014) 227 Cal.App.4th 344

18 Rev & T C §64(c)(1)

19 Rev & T C §482(b)

Form 375

Assignment of Interest

ASSIGNMENT OF INTEREST
Of Limited Liability Company

Prepared by: Agent ____________________ **Phone** ____________________
Broker ____________________ **Email** ____________________

DATE: ____________, 20______, at ____________________________________, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This assignment is of a member's interest in ____________________________________,
a California Limited Liability Company (LLC), organized under an operating agreement dated ____________, 20______, at ____________________________, California,
and formed under a Certificate of Limited Liability Company (LLC-1)

1.1 filed with the California Secretary of State on ____________, as document number ____________,

1.2 recorded on ____________________20______, as document number ____________
with the county recorder of ____________________ County, California.

FOR VALUE RECEIVED:

2. I, ____, as the Assignor,
hereby sell, assign and transfer to ____________________________________, as the Assignee,
all my rights, title and interest as a member in ____________________________, a California LLC,

2.1 which interest is identified as Class "______" and represents ______% of the voting ownership of the LLC, and
☐ is represented by the attached Certificate of Interest in Limited Liability Company (if one exists).

3. Assignor hearby authorizes ____________________________________, as the Manager of the LLC, to reflect this assignment on the books of the LLC.

4. This assignment is subject to any restrictions on the transfer of an ownership interest provided in the Operating Agreement of LLC for the LLC.

4.1 Any necessary notices and approval of this assignment by the LLC or members and any right of first refusal or option to purchase the interest assigned held by the remaining members ☐ have, or ☐ have not, been consented to or waived by them.

5. Assignee hereby assumes and agrees to timely perform all Assignor's obligations under the operating agreement of the LLC.

Assignor:	Assignee:
☐ See attached Signature Page Addendum. [ft Form 251]	☐ See attached Signature Page Addendum. [ft Form 251]
Date: ____________, 20______	Date: ____________, 20______
Assignor's Name: ____________________	Assignee's Name: ____________________
Signature: ____________________	Signature: ____________________
Assignor's Name: ____________________	Assignee's Name: ____________________
Signature: ____________________	Signature: ____________________

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The membership interest held in the LLC by a deceased member is transferred on or after death according to how they vested their ownership interest, similar to a transfer of real estate interest on death.

Types of vestings

Six **types of vestings** are available for ownership interests held by individuals in real estate or personal property (shares in the LLC) located in California:

- joint tenancy;
- community property;
- community property with right of survivorship;

- TICs;
- sole and separate ownership (single, unmarried, spouse); and
- revocable living (inter vivos) trusts or other title holding arrangements.

Nature of owenership and distribution of interest on death

Vesting not only provides evidence of the ownership of an interest in property, vesting is a method of **estate planning**. A vesting states the nature of the ownership (community or separate) and intended distribution of the interest on the owner's death (by the right of survivorship, will or inter vivos trust).

Two or more individuals may vest the percentage of LLC membership interest they jointly own in "joint tenancy," such as "husband and wife as to a 20% interest, as joint tenants."

On the death of one of the joint tenant members, the surviving joint tenant who co-owned the interest with the deceased automatically succeeds as owner to the entire membership interest they had jointly held in the LLC.

The **sole advantage** of a joint tenancy vesting for a co-owned interest is the avoidance of probate. The same results occur when the husband and wife vest their co-ownership as community property with the right of survivorship.

Managing a deceased member's interest

When an LLC member dies, the member's legal representative, such as an executor, administrator or trustee, may exercise all of the member's rights in the LLC for the purpose of administering and securing the deceased member's estate.[20]

LLC operating agreements typically include buyout provisions granting the remaining members the right to **terminate a member's interest** upon their death, unless the deceased member's interest is held by a surviving joint tenant who co-owned the interest with the deceased.

Thus, the remaining members may purchase the deceased member's terminated interest under the buy/sell provisions in the LLC operating agreement.

If the option to buy out the deceased member's interest is not exercised, the remaining members are under no obligation to approve the deceased's legal representative as a new member of the LLC with voting rights and obligations to the LLC.

If they do not, the representative or any other successor of the deceased's interest may not vote or become involved in the governing of the LLC or the manager's administration of the LLC and its property.

20 Corp C §17705.04

Chapter 18 Summary

By the terms of a limited liability company (LLC) operating agreement, a member's interest may be terminated by the remaining members if an existing member transfers their interest without the prior approval of the remaining members, unless they have waived their right to do so. On an assignment of a member's interest to a person other than a member without waiver or interest, the remaining members have the right to buy out the selling member's interest.

An assignment does not substitute the buyer of a fractional interest as a new member, even if a waiver is obtained from the other members.

Unless approved as a substitute member, the buyer by an assignment of the investor's interest is a nonvoting member of the LLC.

Two assignable interests held by members exist in an LLC:

- the ownership interests held by contributing members, the investors and the syndicator; and
- the administrative interest held by the managing member, the syndicator alone.

The manager, like the president of a corporation, may be terminated and a new manager appointed at the discretion of the contributing members.

The buyer of a member's fractional interest may be admitted as a substitute member by a majority vote of the remaining members.

On approving an assignment to a substitute member, the remaining members vote to amend the LLC to substitute in the replacement member and release the selling member from future liability to the LLC. Without a release of liability, the selling member remains obligated to the LLC under the operating agreement they originally entered into.

Further consequences to consider when assigning a selling member's fractional interest in an LLC include:

- the rights of mortgage holders to call on a transfer of ownership interests in the LLC vested with title; and
- the possibility of reassessment by the county assessor resulting in higher property taxes.

Vesting real estate co-owned by investors in an LLC instead of as tenants in common (TICs) eliminates any interference with title to the real estate on the death of an LLC member.

Vesting not only provides evidence of the ownership of an interest in property, but is also a method of estate planning. A vesting states the nature of the ownership and intended distribution of the interest on the owner's death.

LLC operating agreements typically include buyout provisions granting the remaining members the right to terminate a member's interest upon their death, unless the deceased member's interest is held by a surviving joint tenant who co-owned the interest with the deceased.

Chapter 18 Key Terms

alienation .... pg. 192
due-on clause .... pg. 196
novation .... pg. 195
operating agreement .... pg. 6
right of first refusal .... pg. 190


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Chapter 19

Documenting the LLC investment program

Learning Objectives

After reading this chapter, you will be able to:

- form a limited liability company (LLC) for the purpose of owning and operating income producing real estate;
- understand the role of the syndicator as manager of the LLC and the property purchased; and
- process the solicitation of prospective investors to fund the acquisition of real estate in an LLC group investment plan.

Key Terms

Articles of Organization (LLC-1)

investment circular (IC)

operating agreement

power of attorney

return of capital

subscription agreement

The birth and expectations of an LLC

The formation and funding of a **limited liability company (LLC)** requires four documents:

- two to form the *LLC* itself; and
- two to solicit investors to fund the LLC.

The two documents needed to form an LLC include:

- the **Articles of Organization (LLC-1)** form, issued by the California Secretary of State (SOS) for use by the syndicator acting alone to establish and operate an LLC in California [See Chapter 16]; and
- the **operating agreement**, similar to most co-ownership agreements in its management, income- and profit-sharing, voting and buyout provisions. [See **first tuesday** Form 372]

Articles of Organization (LLC-1) An instrument provided by the Secretary of State (SOS) and used by a syndicator of real estate to form an LLC.

The two funding documents include:

- the **investment circular (IC)**, a narrative disclosing all the material aspects of the investment to prospective co-owner members, prepared as the product of the syndicator's due diligence investigation and analysis of property data [See **first tuesday** Form 371]; and
- the **subscription agreement**, the investor's agreement with the syndicator to contribute funds in exchange for an ownership share in the LLC. [See **first tuesday** Form 373]

The Articles of Organization

By stating the syndicator is the sole manager, the *Articles of Organization (LLC-1)* gives the syndicator the **power to bind** the LLC by entering into agreements following a vote by the members to buy, sell, finance and lease property.

It also provides the syndicator authority to independently contract for management, services, labor and materials to operate the real estate acquired by the LLC.[1] [See Chapter 20]

The operating agreement

operating agreement
A form used by syndicators when setting up a limited liability company (LLC) to establish the procedures for operating the LLC and the rights and duties of its members. [See **ft** Form 372]

The document that authorizes the operations of the LLC is the *operating agreement*. The operating agreement also states the rights and duties of the syndicator, as manager, and the co-owner members. [See **first tuesday** Form 372]

The operating agreement for an LLC needs to contain all the fundamental boilerplate provisions that lay out the working relationships between the syndicator and the co-owners. Provisions include profit-sharing and buyout arrangements, comparable to those used in any other co-ownership agreement, such as:

- limited partnership;
- tenants-in-common (TIC) vestings; and
- corporate stockholder co-ownership agreements.

The operating agreement is signed by all investors at the same time they sign the **subscription agreement** agreeing to invest and acknowledging their membership in the LLC. [See **first tuesday** Form 373]

Technically, a written operating agreement is not required to evidence the agreement between the co-owners and the syndicator who forms an LLC. However, it is prudent to form a group investment program based on a *written operating agreement*, not an oral one. Further, title insurance companies require their review of a written operating agreement for any LLC receiving an insured interest in property. [See **first tuesday** Form 372]

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1 Calif. Corporations Code §17703.01

Governing principles for operations

The governing principles for the ongoing operations and co-ownership in the LLC as stated in the operating agreement include:

- business purposes and objectives;
- capital contributions and percentage ownership;
- co-owners' participation in the distribution of income and profit from operations, financing, and sale;
- establishment of different classes of members (i.e., Class A membership shares granting priority distributions to cash investors and Class B membership shares granting a subordinated right to earnings held by the syndicator);
- officers, management, compensation and accounting; and
- assignment of interests, termination of a co-owner and buyout options; and
- dissolution and termination of the LLC.

Designation of the manager and officers

The operating agreement designates the syndicator as the manager of the LLC. As the manager, the syndicator may give themselves any title they want to use, such as:

- president;
- chief executive officer (CEO); or
- general manager.

As the lone manager, they are solely responsible for conducting the business affairs of the LLC and operations of the property it owns.

In addition to the manager, the operating agreement may provide for the appointment of other officers, such as a secretary, treasurer and so on, as in a corporate management structure. The officers do not need to be co-owners. For instance, an accountant who is not a co-owner may be named as treasurer if the syndicator deems the position is appropriate to provide oversight for the cash flow resulting from the investment program.[2]

The operating agreement for an LLC is fundamentally a **profit-sharing agreement**. It spells out when and how all the co-owner members will participate in the rents and profits generated by the property acquired with the funds they invested in the LLC.

The nature of earnings

To best understand the nature of the earnings generated for the co-owners by their investment in the LLC, a return "on" capital needs to be distinguished from a return "of" capital.

The **return on capital**, also known as *return on investment (ROI)* in the context of an equity investment by an investment group, is the ongoing, annual net operating income (NOI) from rents generated by the operation of an income-producing property which remains after payment of interest

2 Corp C §17704.07(u),(v)

return of capital
The annual return of funds originally contributed to the investors or, in the case of a real estate investment, that portion of the net operating income (NOI) annually sheltered from taxes by a depreciation deduction, as well as any net proceeds from a refinance or resale of the property, cumulative up to the amount of the original contributions, also known as return of investment. To be distinguished from a return on capital.

on mortgages. *Return on capital* takes the form of some or all principal amortization on mortgage debts and spendable income — NOI minus mortgage interest paid.

The return to investors from property operations is generally expressed in terms of *an annual percentage yield* based on the co-owners' original cash contributions. The classic example of a return on capital is the interest paid on a savings account. In real estate investments, it is that portion of the rents paid by tenants that remains after paying expenses and interest on borrowed capital.

Occasionally, the return is alternatively or additionally stated as "cash on cash." This is an expression of the ratio of spendable income (NOI remaining after mortgage payments of principal and interest) as a percentage of total contributions of all members, both Class A and Class B.

Conversely, the **return of capital**, also known as *return of investment*, is simply the return to the members of the amounts they originally contributed. In the case of a real estate investment, the *return of capital* is represented by the annual depreciation deduction as a percentage of the entire price paid to acquire and further improve the property.

However, in the context of a syndicated investment, the return of capital is typically presented as the portion of the loan reduction and spendable income sheltered from taxes by the annual depreciation deduction. This portion of NOI covered by depreciation is stated as an annual percentage of the co-owners' contributions.

Profits taken by a refinance (not taxed) or sale (taxed) are the result of capital growth through increased nominal value of the property due primarily to dollar inflation, property appreciation or improved property management (rents and expenses). While profits are a return on capital, they are not a return from operations (annual income) or a return of the original capital investment.

The investment circular for solicitation

The **investment circular (IC)**, also known as a **prospectus** or **memorandum**, is prepared by the syndicator. It is used to solicit prospective investors to buy a share of ownership in their LLC investment program. [See **first tuesday** Form 371 and 371-1]

The purpose of the IC is to present investors with the **material facts** about the investment opportunity, giving as much breadth in scope of activities and as much detail as is necessary for a prudent investor to be able to make a well-informed decision about whether or not to invest based on a review of its content. [See Chapter 20]

Information provided in the IC includes:

- the business and investment objectives of the LLC;

- a full description of the property to be purchased, including the condition of the improvements, natural and man-made (environmental) hazards, location, title and operation of the property;
- the proposed operating budget of the LLC;
- projected earnings for the co-owner members;
- a disclosure of the risks of loss involved;
- the background and qualifications of the syndicator;
- the compensation and duties of the syndicator as manager of the LLC; and
- copies of the LLC-1 articles, operating agreement and subscription agreement.

investment circular (IC)
A disclosure prepared by a syndicator and presented to potential investors explaining the nature of the investment program, significant features of the property selected for acquisition and the risks and financial consequences of the group investment, also known as a prospectus or memorandum. [See **ft** Form 371]

Generally, the syndicator will hand the IC to prospective investors to induce them to decide to contribute funds to the LLC. The investment amount is a non-negotiable, fixed sum for participating as a co-owner member.

The commitment to subscribe

An investor fills out the **subscription agreement** they receive as part of the IC package. They sign it and return it to the syndicator, committing themselves to contribute funds as a member of the LLC. [See **first tuesday** Form 373]

subscription agreement
A form agreement used by a syndicator when soliciting and subscribing investors for cash contributions to a limited liability company (LLC) for investment in real estate, to confirm their receipt and approval of the investment circular and LLC operating agreement, and acknowledge receipt of the funds they contribute and their membership in the LLC. [See **ft** Form 373]

The subscription agreement is broken down into three parts:

- the investor's offer to contribute funds to the LLC;
- the investor's acknowledgment of their receipt and review of the syndicator's transactional disclosures and declarations made in the IC; and
- the investor's income and net worth disclosures made to the syndicator for a determination as to whether the investor is a suitable candidate for co-ownership in the LLC.

Editor's note — "Certificates of interest" may be issued to the co-owners to evidence their ownership of a share in the LLC, but the shares in the LLC are not to be called ***stock****. Any transaction or investment program that involves the issuance of shares entitled stock is automatically considered a* ***corporate security****, regardless of whether the economic realities of the transaction include a risk of loss of the promotional reliance variety that constitutes a corporate security.*[3]

Also, by signing the *subscription agreement*, the investor indicates they understand the nature and risks inherent in the LLC investment program as disclosed by the syndicator in the IC.

Further, the investor provides general information on their:

- net worth;
- income;
- prior investment experience; and

3 **Landreth Timber Company** v. **Landreth** (1985) 471 US 681

- educational background.

Since the investors are entitled to receive detailed information on the syndicator, the syndicator presents their profile in the IC.

Before accepting any investor's offer to become a co-owner member, the syndicator reviews the information the investor provided in the subscription agreement to determine the LLC investment program's financial suitability for the investor.

On receiving the investor's subscription agreement to invest, the syndicator reviews their credentials to confirm their suitability as a member. If qualified to take on the risk of the investment, the syndicator accepts the investor's offer to buy a fractional membership interest by signing a copy of the LLC subscription agreement and returning it to the investor.

Power of attorney authority

Operating agreements for LLC investment programs consisting of a large group of investors often call for the members to give the manager a **power of attorney**. This authority allows the manager to act on behalf of the co-owners to exercise their voting rights under the LLC operating agreement.

power of attorney
A temporary authority granted to an individual by another person to perform activities for them typically during a period of incapacity or travel. [See **ft** Form 447]

A *power of attorney* is a written document separate from the operating agreement. It is entered into by an individual member, granting another person — the manager — the authority to enter into agreements and act on the individual's behalf.[4] [See **first tuesday** Form 447]

Granting the manager a power of attorney to act on behalf of an investor is not necessary when forming an LLC. Typically, the investor at the outset will sign all documents requiring their signature at one time, including the subscription agreement to invest, the operating agreement and their check to fund their contribution.

However, the power of attorney may be useful when routine activities of the LLC need to be approved by the co-owners under the voting provisions in the operating agreement, such as voting to admit a new or substitute co-owner, or to continue the LLC after an event occurs causing dissolution.

The power of attorney is not to be used to eliminate the need for co-owners to approve significant non-recurring ownership events, such as the *alienation of property rights*. Authority to alienate allows the syndicator to:

- reorganize the investment (through a refinance or exchange of properties);
- transfer possession by entering into a long-term lease; or
- dispose (sell) all or part of the investment property.

Thus, the scope of the authority granted to the manager under any power of attorney needs to be limited to the short-term, on-going operation of the LLC and the property. For example, the power of attorney might properly

4 Calif. Probate Code §4022

authorize the manager to vote on the co-owners' behalf to continue the LLC after a dissolution, but not to amend the operating agreement or refinance or sell the LLC's real estate.

Chapter 19 Summary

The formation and funding of a limited liability company (LLC) requires four documents:

- the LLC-1 Articles of Organization form;
- the operating agreement;
- the investment circular (IC); and
- the subscription agreement.

By stating the syndicator is the sole manager, the Articles of Organization (LLC-1) gives the syndicator the power to bind the LLC by entering into agreements following a vote by the members to buy, sell, finance and lease property, and to independently contract for management, services, labor and materials to operate the real estate acquired by the LLC.

The document authorizing the operations of the LLC is the operating agreement. The operating agreement for an LLC needs to contain all the fundamental boilerplate provisions that lay out the working relationships between the syndicator and the co-owners. The operating agreement designates the syndicator as the manager of the LLC.

The operating agreement for an LLC is fundamentally a profit-sharing agreement. It spells out when and how all the co-owners will participate in the rents and profits generated by the property acquired with the funds they invested in the LLC.

The IC, also known as a prospectus or memorandum, is prepared by the syndicator and used to solicit prospective investors to buy a share of ownership in their LLC investment program.

Finally, since the investors are entitled to receive detailed information on the syndicator, the investor provides general information on their net worth and income along with other relevant matters in the IC.

Operating agreements for LLC investment programs consisting of a large group of investors often call for the members to give the manager a power of attorney. This authority allows the manager to act on behalf of the co-owners to exercise their voting rights under the LLC operating agreement. The scope of the authority granted to the manager under any power of attorney is limited to the short-term, on-going operation of the LLC and the property.

Chapter 19 Key Terms

Articles of Organization (LLC-1).. **pg. 203**
investment circular (IC).. **pg. 207**
operating agreement .... **pg. 204**
power of attorney .... **pg. 208**
return of capital .... **pg. 206**
subscription agreement.. **pg. 207**

Chapter 20

The objectives of an investment circular

Learning Objectives

After reading this chapter, you will be able to:

- analyze the material facts to be included in documentation used to solicit investors who will fund the purchase of property;
- draft a well-organized, accessible and visually attractive investment circular (IC) for presentation of an investment opportunity to potential investors;
- determine when an investment opportunity includes an inherent risk of loss creating a corporate securities risk; and
- provide additional disclosures of special risks required for an LLC investing in trust deeds.

Key Terms

corporate securities risks **investment circular (IC)**

The syndicator's agency duty to disclose

An **investment circular (IC)** is a disclosure prepared by the syndicator and presented in pamphlet form, printed or digital, to potential cash investors. The purpose of the IC is to explain to the investor, as fully and plainly as possible:

- the nature of the investment program;
- the significant features and aspects of the property selected by the syndicator to be acquired; and
- the risks and financial consequences to investors in the group investment.

The greater the quantity of solid information provided by the IC, the more effectively the syndicator demonstrates the thoroughness of their:

- research of properties;
- due diligence investigations; and

investment circular (IC)
A disclosure prepared by a syndicator and presented to potential investors explaining the nature of the investment program, significant features of the property selected for acquisition and the risks and financial consequences of the group investment, also known as a prospectus or memorandum. [See **ft** Form 371]

- analysis of the property's worth as an income-producing asset with long-term earnings and profit potential.

A well-organized and comprehensive presentation of the selected property's attributes in an IC gives the prospective investor information on:

- the property's *physical condition*;
- its operating history of *income and expenses*;
- a forecast of its *future operations* under the syndicator's management;
- *title conditions* including mortgage financing of record;
- external conditions affecting the property due to its *location* and the surrounding neighborhood; and
- the rental and *resale market trends*.

Goals of an investment circular

The IC needs to be user-friendly and visually attractive to a prospective investor. The information contained in an IC has to allow a prospective investor to move effortlessly from page to page. The copy needs to have an open feeling, be clean in appearance and contain short sentences and short paragraphs.

A syndicator producing an IC takes efforts to avoid using encoded industry real estate jargon and legal terms. These are not easily comprehensible to a layperson, such as the typical investor. Instead, use **words of plain meaning** and in **common use** that are easily understood and absorbed by all. If the copy puts the reader off or is needlessly obscure, the investor will lose interest and not likely finish reviewing the investment opportunity, let alone contribute cash to the investment.

An IC is presented in a chronological manner, instructive throughout and reasonable in its conclusion. Avoid the use of hyperbole and excessive claims unsubstantiated by the syndicator's review of the property. Then, in response to any question a prospective investor my pose, the syndicator and investor perform a mutual review of relevant sections of the IC, discussing the answer to the satisfaction of the investor.

Corporate securities risk

corporate securities risks
A risk of loss of investor funds that arises due to investment discretion when a syndicator acquires investor funds before identifying and disclosing an existing asset to be purchased.

An investment program which seeks to acquire and operate an existing income-producing property for the same purpose the property is currently serving does not contain a **corporate securities risk**. This means the gathering of investors to acquire the property is not an activity regulated by the state or federal securities laws. Examples include the acquisition of an existing income-producing property acquired to be operated as the rental property it is with no change in use or addition of significant improvements.

Thus, the co-ownership operation of the property contains no *risk of loss* beyond the economic risks of ownership and operations imposed on all landlords, tenants, sellers and buyers in the marketplace.

Marketplace risks do not come within the purview of the securities laws. They are controlled by the broader behavior principles of economics.

Without the presence of a risk of loss for reason of undetermined property selection, change of use or construction, the investment program does not pose a *corporate securities risk* and does not fall within the securities law controlling the solicitation of investors to contribute capital. [See Chapter 13]

Examples of risk of loss creating a corporate security for a group investment program include commitments by the syndicator or others, such as:

- to rehabilitate the property for the rental market;
- to change its use (such as through subdivision for resale, development or construction);
- to change the zoning; or
- to obtain a use permit.

What creates a securities risk?

Also, any method or means used to locate and solicit investors to join in the co-ownership of real estate does not of itself – the solicitation – constitute an activity which presents a risk of loss within the securities law. The manner of locating investors does not turn a non-security into a security. Thus, advertising to solicit investors does not create a securities risk.

In contrast, the use of the IC to market a real estate investment opportunity that includes a securities risk requires some rewording and additional provisions in the LLC operating agreement and IC, such as the business purpose and future contributions provisions.

The transaction that includes a securities risk, such as a conversion to condominiums, construction of improvements, or other change-of-use activity that adds value to the property by the efforts of persons other than the investor, falls within the control of the securities law and outside the purview of this material.

Nonpublic solicitation of investors exemption

When a syndicated investment program is controlled by the securities law, exemptions are available that allow the nonpublic solicitation of investors. If not exempt, a securities permit needs to be obtained to publicly solicit investors. Whether or not the investment program is a security, to eliminate deceit a syndicator is always required to provide a full disclosure of the investment program — the sole purpose of an IC.

Further, if a securities risk exists, the solicitation of investors under the *nonpublic offering exemption* does not allow any information about the availability of the investment to be published as an **advertisement to the general public**. [See Chapter 13]

The syndicator's duty to prepare and present an IC to each prospective investor for a syndicated real estate investment program is imposed by **agency law**. Thus, due to their *agency relationship* with all prospective investors, a syndicator is required to make a full disclosure of all **material facts** regarding the property and the co-ownership.

The duty to disclose goes far beyond the general duty owed by an owner's agent to a prospective buyer when presenting a property they have listed for sale or lease.

In contrast, the syndicator has an agency duty to *care for and protect* the prospective investors, a fiduciary duty of a trustee. This includes presenting in a full and transparent manner the information they need to make a decision whether to invest. Thus, the IC and attached supplements and exhibits are the best method for making the disclosures and documenting that they have been made. [See Chapter 21 and 22]

Land investments

The operating agreement for an LLC formed to invest in **raw, undeveloped land** for later resale needs to contain a provision authorizing the syndicator to call for and collect periodic future contributions from the co-owners to fund payment of the carrying costs of owning the property. These costs include:

- mortgage installments;
- taxes; and
- insurance.

Also, no *spendable income* is expected from the ownership of unimproved real estate, only a profit on resale. [See Chapter 2]

Accordingly, the wording regarding the distribution of expected earnings and profits in the IC and operating agreement needs to be redrafted.

Trust deed investments

For an LLC investing in **trust deeds**, the purpose clause in the operating agreement is modified to state the LLC is being formed to purchase a particular note secured by specific real estate, rather than to purchase the real estate itself. [See **first tuesday** Form 372-1 §1.9]

Also modified is the *distribution of spendable income* provision. Distributable income in a trust deed investment is not generated by the operations of a rental property. Instead, interest is received on the note and distributed, unless the owner of the property securing the note defaults and the LLC is forced to foreclose and become the owner-operator of the real estate securing the note. [See **first tuesday** Form 372-1 §2.4]

If the note is secured by income-producing property, the IC presenting the trust deed investment will include much of the same real estate disclosures made for an investment in income-producing property. Thus, a trust deed IC requires additional disclosures beyond those needed solely for property. [See Chapter 19]

The IC discloses the condition of the note to be acquired, including:

- the loan-to-value ratio (LTV);
- the trust deed's priority on title;
- terms of payment;

- payment history;
- interest rate;
- due date; and
- the borrower's creditworthiness.

Also, the IC needs to disclose the *special risks* of trust deed investments, such as the possibility of foreclosure and ownership of the real estate due to a default.

Finally, ownership of a trust deed investment, whether structured as an LLC or a tenancy-in-common (TIC), is classified as a **security**. Thus, as an LLC investment in a trust deed, the conditions for a nonpublic offering exemption (or a permit) needs to be met. If structured as a TIC ownership by investors, a notice permit on a claim of exemption allowing public soliciting of investors is available to syndicators. [See Chapter 12]

Chapter 20 Summary

An investment circular (IC), prepared by a syndicator and presented to potential cash investors, explains to the investor:

- the nature of the investment program;
- the significant features of the property selected to be acquired; and
- the risks and financial consequences of the group investment.

A well-organized and comprehensive review of the selected property's attributes in an IC provides information concerning:

- the property's physical condition;
- its operating history of income and expenses;
- a forecast of its future operations under the syndicator's management;
- title conditions and encumbrances;
- external conditions affecting the property due to its location and the surrounding neighborhood; and
- the rental and resale market trends.

An investment program which seeks to acquire and operate an existing income-producing property for the same purpose the property is currently serving does not contain a corporate securities risk. In contrast, an investment opportunity that includes a securities risk requires some rewording and additional provisions in the LLC operating agreement and IC.

When the investment program is controlled by securities law, exemptions are available that allow the nonpublic solicitation of investors. If not exempt, a securities permit needs to be obtained to publicly solicit investors. If a securities risk exists, the solicitation of investors under the nonpublic offering exemption does not allow advertisement to the general public.

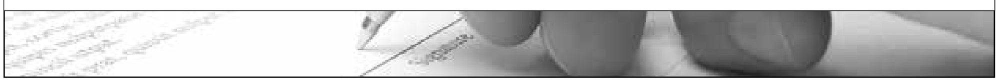
For an LLC investing in trust deeds, the IC needs to disclose the special risks of trust deed investments, such as the possibility of foreclosure and ownership of the real estate due to a default.

Chapter 20 Key Terms

corporate securities risks .... **pg. 212**
investment circular (IC) .... **pg. 212**

Chapter
21

The investment circular



A sample investment circular

The following are the facts used in an example acquisition and the basis for completing an **investment circular (IC)**.

Editor's note — None of the material in this Chapter will be covered in the quizzes or final examination for this course.

Consider a property identified for purchase by a syndicator. The property consists of:

- 30 residential units;
- 52,200 rentable square feet;
- a total lot size of 40,000 square feet;
- a replacement cost of $2,088,000;
- a total annual rental income of $327,350;
- other annual income of $3,650;
- total annual operating expense of $119,401; and
- a 5% vacancy rate.

The terms for the purchase are:

- $2,500,000 purchase price;
- $750,000 down payment (30%);
- new mortgage in the amount of $1,750,000, amortized over 30 years at 6% fixed interest due in five years; and
- $25,000 in mortgage fees and purchase costs.

The syndicator seeks **five investors** to fund the purchase with a contribution of $170,000 each, a total of $850,000 in cash. The $75,000 in surplus cash will provide funds for a $30,000 fee to be paid to the syndicator as compensation for organizing the investment group and $45,000 to be held by the limited liability company (LLC) as cash reserves and additional working capital.

The syndicator will receive a $150,000 Class B interest in the LLC as a co-owner with the cash investors (Class A members).

The investors will collectively hold an 85% co-ownership interest in the LLC as Class A members for their $850,000 cash investment. The syndicator will hold a 15% co-ownership interest as a Class B member for the syndicator's contribution of their right to buy the property of $150,000. The total capital contribution by all classes of members is $1,000,000.

The syndicator is designated as the **manager** of the LLC.

Editor's note — Below is a sample pre-filled investment circular based on this scenerio. Additional exhibits may be separately attached by the syndicator.

TRANSMITTAL LETTER

Dated: April 1, 20____

To: Name of Prospective Investor

From: Name of Syndicator, the Manager of
Any LLC Name, LLC,
a California Limited Liability Company.

Re: Investors with $ 170,000.00 cash available for placement in an income-producing real estate investment program.

You are kindly requested to consider this investment opportunity.

$ 850,000.00 cash will be raised for a down payment, closing costs, and reserve funds to purchase income-producing real estate.

The property to be acquired is a(n) 30-unit residential apartment building located at 123 Main Street, in Any town California.

The purchase price of this income property is $ 2,500,000.00.

The mortgage financing on the property is the total principal amount of $ 1,750,000.00.

Group ownership of this property will create the following advantages for the investors:

1. A high-yield priority return on invested funds from spendable income, equity build-up, and increase in property value;
2. No additional capital contribution;
3. Management of the property and accounting to be handled by the LLC manager; and
4. Individual co-owner tax benefits.

Please review the specially prepared investment circular accompanying this letter for the details of these and other advantages.

My deadline for funding the close of the purchase escrow is June 30, 20____.

Please call me at 555-555-1234 if you desire any further information.

Sincerely,

____

INVESTMENT OPPORTUNITY

______Any LLC Name______, LLC,

a California Limited Liability Company,

offers investors a

$______850,000.00______ cash

investment program

consisting of ______five (5)______

$______170,000.00______ Class A membership units

in the ownership of

income-producing real estate

valued at $______2,500,000.00______

This Investment Circular is dated: ______April 1______, 20______

INVESTMENT CIRCULAR

Presented by _____Any LLC Name_____, LLC,

a California Limited Liability Company
Offering Class "A" investment units at
$___170,000.00___ per unit.

The investment program is designed to raise cash in the sum of $___850,000.00___, for use by the Limited Liability Company (LLC) to acquire and operate, as a long-term investment, an existing income-producing ___30-unit residential apartment___ property. The investment is designed to deliver to the investor:

- spendable income;
- equity build-up by monthly amortized loan reduction;
- an inflationary hedge and appreciation in value;
- tax benefits of annual depreciation deductions;
- minimum management requirements;
- priority distribution of income and profits;
- liability limited to capital invested; and
- debt leveraged ownership serviced by rental income.

The investment program is limited to investors meeting minimum financial and suitability standards.

Other than filing articles of organization for the LLC, this investment program has not been qualified or registered with any governmental agency, as no qualification or registration is required by law. No permits of any kind have been sought or received prior to offering this investment program to prospective investors.

INVESTMENT CIRCULAR SUMMARY

___Any LLC Name___, LLC, a California Limited Liability Company, offers ___five (5)___ investment units of $___170,000.00___ each, as a long-term investment program involving a degree of risk.

The LLC is newly organized and has no operating history. It holds the contract rights to purchase income-producing real estate commonly referred to as ___123 Main Street___, in the City of ___Any Town___, ___Any County___County, California. The property current fair market value is $___2,500,000.00___.

The LLC will hold title to the property subject to a loan(s) totaling $___1,750,000.00___. The purpose of this offering is to raise capital funds for the down payment on the purchase of the income-producing real estate, pay an organizational fee to the manager and establish a reserve fund.

The material set forth in this circular is a presentation of this investment program and solicitation of investors. In the investment circular, the Manager has set out all available material facts and data for presentation to prospective investors.

This investment does contain risk factors, as it is more speculative than insured interest-bearing accounts or real estate owned clear of any mortgage financing.

The investors' interests in this LLC will not be acquired with the intent to resell. The interests offered will be difficult to market or resell, and liquidation of any individual member's interest will likely result only from resale of the property by the Manager. [See Section 6, Risk Factors]

The units offered may be subscribed to by investors who meet financial and suitability standards, and who are sufficiently well informed in real estate investments to discern for themselves the risks inherent in the offering.

If for any reason the subscription of sufficient investors fails to be completed by __June 30__, 20_____, the investor's funds will be returned in full without reduction in amount, together with any interest earned thereon.

The minimum financial suitability standards set by the Manager for this investment program require investors to have a minimum adjusted gross income of $__300,000.00__ and a net worth of $__1,000,000.00__, exclusive of personal residence, automobile, and personal property. The intention to purchase and hold a membership share in the LLC for long-term investment purposes rather than for resale is also a necessary requisite.

The Class A membership interests offered have not been registered with the Securities Exchange Commission (SEC) nor qualified with the California Department of Corporations (DOC), and no permits have been obtained from any governmental agency. This investment program is to capitalize the purchase and ownership of an existing asset, to be held for income from rents and profit on resale. No future improvement or development of any kind to create or complete this investment is anticipated, and the investment requires no reporting under any securities laws, state or federal.

INVESTMENT CIRCULAR

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5. Use of the Contribution Proceeds . . . . ___
6. Risk Factors . . . . ___
7. Description of the Real Estate . . . . ___
8. Projected First-Year Operating Budget . . . . ___
9. Projected Financial Benefits to Members. . . . . ___
10. Benefits Received by Members . . . . ___
11. Compensation and Duties of the Manager. . . . . ___
12. The Manager . . . . ___
13. Reserve Fund Account. . . . . ___
14. The Limited Liability Company Aspects . . . . ___
15. Reports to Investors. . . . . ___

EXHIBITS:

A. Purchase Agreements . . . . ___
B. Escrow Instructions and Assignment Supplement . . . . ___
C. Copy of Grant Deed into LLC . . . . ___
D. Buyer's Cost Sheet . . . . ___
E. Preliminary Title Report, Schedule "B" . . . . ___
F. Condition of Property (Building Inspection Report) . . . . ___
G. Natural Hazards and Environmental Disclosures. . . . . ___
H. Annual Property Operating Data Sheet (APOD) . . . . ___
I. Rental Income Rent Roll . . . . ___
J. Area Map of City/County . . . . ___
K. Property Management Agreement . . . . ___
L. Property Value Appraisal . . . . ___

ADDENDA:

A. LLC-1 with Transfer Addendum . . . . ___
B. LLC Operating Agreement with Exhibits . . . . ___
C. Subscription and Agreement to Invest . . . . ___

Any LLC Name, **LLC,**

a new California Limited Liability Company

formed for a group of investors

to acquire a(n) 30-unit residential apartment **building**

located in Any Town**, California.**

SECTION 1. INVESTMENT OBJECTIVES AND POLICIES

The Limited Liability Company (LLC) will purchase and operate, for long-term investment advantages, an existing 30-unit residential apartment, located at 123 main Street, in Any Town, California. The project is more commonly referred to as The Apartments.

The objectives of the LLC are to provide Class A members with:

- spendable income;
- equity build-up by monthly amortized loan reduction;
- an inflationary hedge and appreciation in value;
- tax benefits of annual depreciation deductions;
- minimum management requirements;
- priority distribution of income and profits;
- liability limited to capital invested; and
- debt leveraged ownership serviced by rental income.

Local and national conditions should allow the LLC to attain all these objectives. However, there can be no assurance these objectives will be fully attained.

The Manager will direct the acquisition of the real estate. Income, profits and return of invested capital from the LLC property will be the result of spendable income generated by property operations, proceeds of refinance or resale of the property, and annual tax benefits, in any.

The Manager will diligently conduct the affairs of the LLC to achieve these investment objectives.

Information presented in this investment circular is intended to provide a prospective investor with sufficient facts concerning the proposed investment to make an informed decision to invest. Estimates of income and expenses incurred by the LLC are based on existing facts and the best estimates of the manager and his advisors, and are not intended as guarantees or warranties to the investor.

Any real estate investment is speculative in nature and includes some degree of risk. It is suggested that a prospective investor contact his accountant, attorney or investment counselor for additional advice concerning this investment's suitability.

SECTION 2. SUMMARY OF PROPERTY PURCHASE

A contract to purchase the real estate has been entered into by ____John Buyer____, an individual, as the Buyer. These purchase rights will be assigned to the LLC for its acquisition of the property prior to closing, in exchange for Class B membership interests valued at $__150,000.00__.

The Seller, who has contracted to sell the property, is ____Joe Seller____. The purchase contract is dated ____October 1____, 20______. An escrow has been opened with ____Any name Escrow____, escrow number ____55-555____, dated ____October 15____, 20______.

The purchase contract and escrow instructions are attached to this investment circular as Exhibits "A" and "B". These documents are the only purchase contracts involved in this transaction.

The terms of the purchase price are:

Cash down payment	$__750,000.00__
Existing debt taken over	$__0.00__
New loan to record	$__1,750,000.00__
Note carried back by Seller	$__0.00__
TOTAL Purchase Price	$__2,500,000.00__

The amount of the cash down payment includes the return to the Manager of his deposit toward the down payment on the purchase price.

The purchase price is not the total cost to the LLC to acquire the property. Pro rations and adjustments for the Landlord/Tenant obligations are also included, as well as transactional closing costs. A completed Buyer's Cost Sheet for acquisition of the property by the LLC is set forth in Exhibit "D".

SECTION 3. REAL ESTATE FINANCING

The financing, its balance, interest rates, monthly payments, due dates and other facts are as follows:

The first trust deed encumbrance secures a note in the remaining balance of $__1,750,000.00__, payable $__10,492.13__ monthly, including interest at the rate of __6__%, until paid __due in five (5) years__.

The seller's carryback note, secured by a second trust deed on the property, is in the amount of $______________, payable $________________ monthly, including interest at the annual rate of ______%, all due and payable on ______________ 20______, with a final/balloon payment of $________________.

SECTION 4. CAPITALIZATION OF THE LIMITED LIABILITY COMPANY

The amount of capital to be raised by cash contributions from prospective investors is $__850,000.00__. To obtain this amount, __five (5)__ Class A units at $__170,000.00__ per unit are offered to investors.

Each subscribing investor may purchase a minimum of __1__ units and a maximum of __2__ units. Subscriptions are to be accompanied by full payment.

Should the total amount of capital to be raised not be received prior to the cancellation of the purchase escrow on the real estate, or ____June 30____, 20_____ if sooner, the subscription will terminate and all funds received from prospective investors will be returned promptly with any interest earned.

SECTION 5. USE OF THE CONTRIBUTION PROCEEDS

The capital cash contributions of $__850,000.00__ from investors with Class A interests will be deposited and disbursed as follows:

1. $__765,000.00__ will be deposited in escrow as the additional funds required to close the real estate purchase.
2. $__10,000.00__ will be disbursed to the manager to return his cash deposit in escrow toward the down payment on the purchase price.
3. $__30,000.00__ will be disbursed to the Manager as an organizational fee.
4. $__45,000.00__, approximately, will be deposited with any other funds remaining in the LLC bank account as a reserve fund to be used by the Manager at his discretion for expenditures which were or will be incurred for the organization of the LLC and the acquisition of the property, including costs related to a title search.

SECTION 6. RISK FACTORS

An investment in the Class A units offered involves some risk of loss of the capital invested. Potential investors are to carefully consider each of the following factors.

A. LLC Operations

This LLC is newly organized and has no operational history. The Manager will devote to the LLC's affairs such time as he, in his discretion, deems necessary and diligent.

This investment circular is intended to provide prospective investors with all the facts concerning the proposed investment which might affect his decision to invest. Estimates of income and operating costs, debt service and cash returns are based on existing facts and the best estimates of the Manager and his advisors. However, they are not intended as guarantees or warranties to the investor.

Many of the factors which may affect the LLC and its affairs are subject to change, or are not within the control of the LLC, its Manager, or its members. The extent to which such factors could restrict LLC activities or affect the value of the LLC properties is not currently ascertainable.

Factors which might affect the LLC include environmental controls, rent controls and government restrictions, adverse use of adjacent or neighboring real estate by its owners, changes in the demand for or supply of competing properties, changes in state or local tax rates and assessments, rapid depreciation in the value of the property, unexpected expenditures for repairs and maintenance, dramatic changes in general or local economic conditions, shortages or reductions in available resources or energy, acts of God or other calamities. The LLC will not be able to obtain insurance against most of these ownership risk factors.

B. Mortgage Risks

In the event the LLC's revenues prove insufficient to service its loan(s) and pay property taxes and operating costs, the LLC will be required to use reserve funds. Should reserve funds be insufficient, the LLC will seek additional funds in the form of loans. If loans are unavailable or imprudent, the members will be called upon to vote and approve additional capital contributions to raise the needed funds. If additional contributions are not approved, the investor's initial capital will be placed at risk of loss should the LLC default on its obligations.

The mortgage contains a FINAL/BALLOON PAYMENT, and thus the debt is not fully amortized. When the remaining balance of the Note is due and payable, there can now be no assurance that refinancing, modification or extension of the balloon payment will then be available to the LLC.

C. Tax Consequences

Limited liability companies qualify for treatment as partnerships for income tax purposes. On the sale of the property by the LLC, any sums distributed in excess of the investor's adjusted basis are presently taxed as capital gains, not ordinary income. However, no assurance can be made that capital gains tax rates will be available, or even apply.

D. Conflicts of Interest

The Manager has numerous other business responsibilities and ownership interests which will demand some or most of his time during the LLC's ownership of the property. The Manager's other interests include ownership of projects comparable to the property purchased in this transaction. To the extent his time is required on other business and ownership management decisions, he will not be involved in monitoring or marketing of the LLC's property.

SECTION 7. DESCRIPTION OF THE REAL ESTATE

A. Area Map

A map of the area immediately surrounding the property is set forth in Exhibit "J".

B. Property Profile

1. Improvements: 52000 square foot, 30-unit residential building
2. Zoning: A-1 zoning under ordinance from the City of Any Town, allowing Any Use.
3. Dimensions: ____________
4. Size: 40,000 square feet of net ground, exclusive of streets and rights of ways.
5. Soil: ____________
6. Utilities: ____________
7. Topography: ____________
8. Street: ____________
9. Improvements: ____________

C. Legal Description

The legal description of the parcel of property being purchased is set forth in the Grant Deed in Exhibit "C".

D. Title Condition

The property's title has been searched and a copy of Schedule "B" from the preliminary title report, prepared for issuance of title and affecting use of the property, is set forth in Exhibit "E".

E. Property Condition

A checklist itemizing the many features of the property and their condition is set forth in Exhibit "F".

F. Fair Market Value

The real estate to be acquired by the LLC has been appraised at a fair market value of \$ 2,500,000.00, as of March 15, 20______. A copy of the relevant portions of the detailed fee appraisal and valuation report prepared by Any Name Appraisal Co. is attached to this circular as Exhibit "L". The appraiser's fee for research and preparation of the report and opinion was \$ 1,000.00. The entire appraisal is available from the Manager on the request of any prospective investor.

SECTION 8. PROJECTED FIRST-YEAR OPERATING BUDGET

A 12-month annual budget has been prepared and is attached as Exhibit "H". The budget is referred to as an Annual Property Operating Data Sheet (APOD).

The budget estimates the probable gross rental income likely to be received and operating expenses expected to be incurred in the operations and management of the property. By an analysis of the APOD as a budget, it demonstrates the cash flow for the next 12-months of ownership by the LLC, not for a calender or tax year, which will vary.

The gross operating income on the budget represents the rents and other income anticipated to be collected and deposited to cover disbursements of operating expenses and loan payments. The gross operating income is estimated by first establishing the scheduled rental income for all units and space available to be rented, whether or not they are now rented.

A vacancy factor will always exist due to turnover of tenants, if for no other reason, such as lack of demand, oversupply of units or other fluctuations in the local or national economy. The vacancy factor is set forth on the budget and deducted from the gross scheduled income to set the gross operating income.

Actual rents will differ slightly from the budget analysis since the demand for rental and security of vacant units varies from month to month.

Presently, tenants under written rental and lease agreements occupy approximately __95__% of the scheduled rental space. An itemized rent roll of tenants, the unit of space they occupy, and the rent they pay is set out on the dated rental income statement in Exhibit "I".

Spendable income calculated on the budget is for a 12-month period. The spendable income consists of rental income remaining for reserves and distribution to co-owners after payment of all operating expenses and loan payments.

The spendable income provides a cushion against unexpected increases in operating costs and any decrease in rental income. As projected on the budget, the vacancy factor would have to rise to __25__% before the cushion of spendable income would be eliminated.

Taxwise, the budget projects the reportable income or loss from ownership operations anticipated to be experienced during the first year of operation. All operating expenses are deducted from the gross rental income, resulting in the net operating income (NOI). The government's depreciation schedule allows a non-cash deduction from the NOI as well as a deduction from NOI for interest accrued and paid on purchase/improvement loans.

Each co-owner will report their pro rata ownership share of the actual end-of-year reportable income or loss on their Federal Income Tax Form 1040, Schedule "E". The LLC, under the small partnership exemption, will not report on a Federal Income Tax Form 1065 and will not prepare a Schedule K-1.

SECTION 9. PROJECTED FINANCIAL BENEFITS TO MEMBERS

This income property investment program, under the budget presented and explained in Section 8, will deliver the members the following economic benefits:

1. Spendable income;
2. Equity build-up by monthly amortized loan reduction;
3. An inflationary hedge and appreciation in value; and
4. Tax benefits of annual depreciation deductions.

Typically, based on the budget, a 17 % member would receive the following dollar amounts of benefit and percentage yield under the previous four categories:

Item:	Annual Amount	17 % Member's Amount	17 % Member's Percentage Yield
1. Spendable Income	$ 69,326.00	$ 11,758.42	8.16 %
2. Loan Reduction	$ 20,906.00	$ 3,554.02	2.46 %
3. Value Increase (2 % annual rise)	$ 50,000.00	$ 8,500.00	5.88 %
4. Tax Savings	$	$	%
TOTAL Annual Benefits	$ 140,232.00	$ 23,839.44	16.5 %

These projections are, at best, estimates of the dollar and percentage amounts expected from the property's first 12 months of operations and will differ from the end-of-year report since it will be for only a portion of the calender year. Also, the dollar amount of each of the benefits received will vary.

Spendable income will be disbursed quarterly beginning 6 months after closing. Earnings represented by the annual loan reduction and increased property value will be cashed out and distributed when a refinance or resale of the property occurs. Tax benefits from reportable losses result in a reduced income tax payment for the member who qualifies when filing his return.

SECTION 10. BENEFITS RECEIVED BY MEMBERS

The LLC will be comprised of ownership interests held by Class A Members and Class B Members. Cash investors will hold Class A interests; John Buyer will hold Class B interests.

Class A Members will have priority over Class B Members' interests on all cash disbursements made to members by the LLC.

Members will receive the following benefits:

1. 85 % annual cash disbursements from the net spendable income projected to be earned. Net spendable income consists of those funds remaining from gross rental income after payment of all operating expenses, management fees, and debt service.

Disbursements of unreserved spendable income will commence beginning with spending income generated for the ____3rd____ quarter of operations. Any net spendable income received during the interim period will be placed in the reserve account and used for its purposes.

Spendable Income is to be distributed first to the Class A members in a sum equal to __85__% a year, cumulative, of their original contributions; then to Class B members in a sum equal to __15__% a year, cumulative, of their original contributions. Any remaining Spendable Income will be distributed pro rata to all members based on their ownership interest.

2. Equity build-up results from loan reduction due to the amortization of the mortgage financing encumbering the property. This equity build-up is converted to cash and distributed on refinance or resale of the property.
3. Sale and refinance proceeds remaining after payment of all costs and mortgages on the sale/refinance and repayment of loans made by members will be first distributed to Class A Members until they have received their contributions, plus ___0___% annually thereon from the date of contribution, less any disbursements received.

   Next, proceeds then remaining will be distributed to the Class B Members until they have received their contributions plus ___0___% annually thereon from the date of contribution, less any disbursements received.

   Then, any proceeds remaining will be distributed to all members to be shared in accordance with their percentage of ownership.
4. Depreciation deductions will be taken by each individual member on his capital contribution and pro rata share of purchase-assist or improvement loans. The depreciation schedule will be chosen by the member and his accountant under the appropriate government-issued depreciation schedule.

SECTION 11. COMPENSATION AND DUTIES OF THE MANAGER

The Manager will receive no compensation from any aspect of this transaction, other than those set forth in this section.

A. Contribution to the LLC

A contract to purchase the real estate has been entered into by ____John Buyer____, an individual, as the Buyer. The purchase rights created by entering into this contract will be assigned to the LLC for its acquisition of the property prior to closing. In exchange for the assignment, the above named individual is receiving Class B membership interests valued at $__150,000.00__.

The Manager will receive a fee of $__30,000.00__ cash for services in the creation and formation of the LLC entity, solicitation of members and accompanying time and effort.

B. Management of the Property

The LLC and the members will employ ____John Buyer____ to manage the LLC property. The property Manager will receive a fee of __6% of gross rental income__

[See Property Management Agreement, Exhibit "K"]

All members will sign the property management agreement to provide for themselves a form for qualifying for the federal income tax rental loss deduction.

Should a later resale of the property occur, the Manager is to receive 6 % of the price of any resale, and in the event of a refinance, 2 % of the refinancing, if he is the procuring cause of the resale or refinance.

SECTION 12. THE MANAGER

The Manager of this LLC will be John Buyer.

The Manager will be responsible for supervising the LLC's operations, including compliance with legal and regulatory requirements, and the preparation and forwarding of periodic reports to the members. [See Section 15, Reports to Investors]

The Manager has the ultimate authority in all matters affecting the ongoing business affairs of the LLC and establishes guidelines with respect to the LLC's investment.

SECTION 13. RESERVE FUND ACCOUNT

A reserve fund will be established from contributions remaining after expenditures made in the acquisition of the real estate payment and payment of organizational fees. These expenditures are estimated to total $ 45,000.00 . [See Section 5, Use of the Contribution Proceeds]

Also, during the first 2 quarters of operations, all net spendable income will be deposited into this account. The account will be maintained at a bank in an interest bearing account in the name of the LLC.

The purpose of this reserve fund is to cover any unforeseen and unforseeable emergency costs. Business reversals due to local and national economic conditions occasionally occur and cannot be determined in advance. The reserve fund will cover any deficit cash flow which might occur, with the expectation of avoiding the need for additional capital contriubtions from the investors. The fund is to be handled at the sole discretion of the manager, for the general benefit of the LLC.

SECTION 14. THE LIMITED LIABILITY COMPANY ASPECTS

The operating agreement, which each subscribing Class A investor agrees to by signing duplicate copies of its signature page, is attached to this investment circular as Addendum "B". Set forth in the operating agreement are all the terms for sharing the income and losses from the operation of the property, the obligations of the manager, the rights of the members and the buy-out provisions should an event occur which terminates a member's interest. Some of the more important aspects are reviewed in this section.

For tax purposes, the ownership is intended to be treated as a partnership. There should be no taxation of the LLC, except for the California annual franchise tax. The LLC will not report on a Federal Income Tax Form 1065, since 10 or fewer members will participate in the program. Each member will include in his individual tax return on Schedule "E" his pro rata share of income and expenses from operations, including interest. Members will choose their own depreciation schedules.

The operations of the real estate will be supervised by the Manager. Should he die or be terminated as the Manager by a majority vote in ownership, then another Manager will be appointed by the members.

Buy-out provisions cover the termination of members' interests due to events ranging from death, bankruptcy or withdrawal, to expulsion by court order or by all the remaining members. Should one member be terminated, the other members have the option to purchase his interest.

The operating agreement calls for the LLC to terminate on any of these events. However, the remaining members may vote to continue after an event occurs which causes the LLC to terminate.

Two processes are provided for determining the price to be paid to a terminated member should the member be bought out by the remaining members. The real estate's full current value is received only by those persons whose interest is held by their estate. Those members terminated for "voluntary" events such as judgment debtor attachments, bankruptcy, withdrawal, etc., will receive only a return of their invested capital. No interest or additional value will be received.

The interests held by the members are not readily marketable. No market exists for the resale of membership interests in LLCs, and one will not likely develop. Liquidity is further restricted as the Manager has the right of first refusal to purchase any member's interest which is offered for sale. If he chooses not to do so, the remaining members have the right to purchase the interest sold. Should all members not exercise their right to purchase, any sale to a non-member which the remaining members do not approve is also cause for termination of the interest sold. The value of the buy out option on such a sale to a third party is the return only of the capital invested.

The liability of all members, including the Manager, will be limited to the amount of their capital contributions. The Manager will file articles of organization for the LLC with the Secretary of State to establish this limitation on liability.

SECTION 15. REPORTS TO INVESTORS

Periodic reports to investors will include:

1. On closing of the property acquisition:
   - a copy of the recorded LLC-1 (articles of organization) of the limited liability company;
   - a copy of the operating agreement signed by all members and setting forth each member's percentage of ownership;
   - a copy of the recorded grant deed to the LLC;
   - a copy of the policy of title insurance on the LLC's ownership of the property; and
   - a copy of the beginning LLC balance sheet on acquisition of the property.
2. After the end of each calendar quarter:
   - an itemized income statement on year-to-date rental income, operating expenses and interest and principal payments on the loan(s).
3. After the end of each calendar year:
   - a balance sheet showing the LLC's end-of-year net worth and financial position; and
   - an itemized income and loss statement on end-of-year rental income, operating expenses and interest and principal payments on loan(s).

NOTICE: The LLC will not report on a Federal Income Tax Form 1065, and a K-1 Schedule for the members will not be prepared or filed:

Reports available for inspection or copying at the office of the LLC include:

- rental or lease agreements with tenants;
- monthly operating statements;
- bank account records; and
- the LLC file.

NOTICE: Your accountant will need some of the annual reports and the initial costs of acquisition to prepare your annual 1040 federal income tax return and a Schedule "E", for rental income, expenses, interest and depreciation.

Chapter 22

Supplementing the investment circular

Learning Objectives

After reading this chapter, you will be able to:

- gather and organize detailed property information and financial data for an income property to supplement the investment circular (IC) given to potential investors.

Exhibits to the investment circular

The category of property most prudent for real estate investment groups to own and operate is an **existing income-producing property.**

As an existing property, facts about the operations of the property under its previous ownership exist and are readily available to the syndicator.

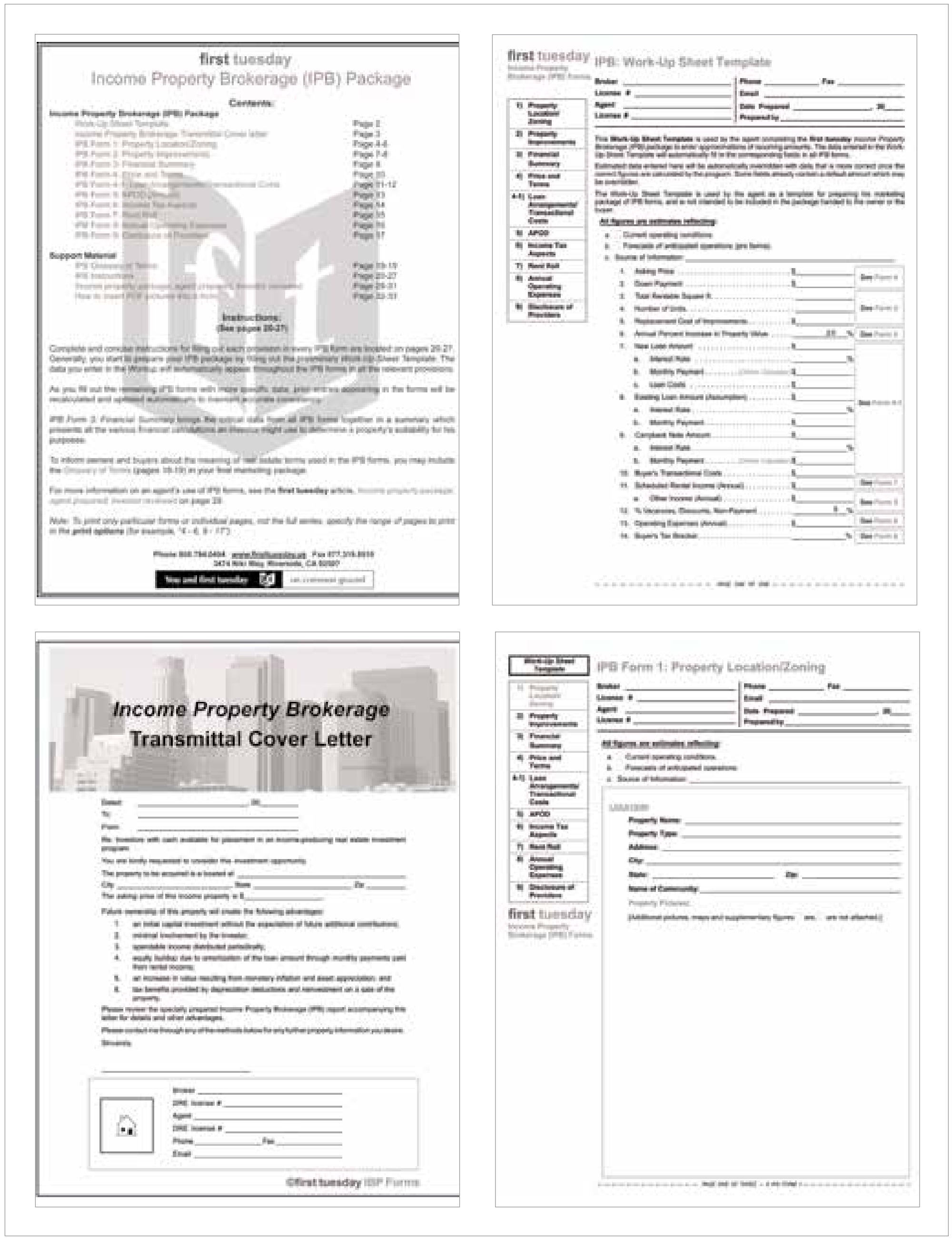
Consider a syndicator who locates an existing income-producing property the investor believes is suitable for group investment.

The syndicator submits an offer to purchase (or **Letter of Intent** to initiate negotiations) to the seller which is accepted. A **due diligence investigation** of the property is commenced. At some point, the investigation results in the decision to move forward with the acquisition. Escrow instructions are prepared and signed to complete the front-end documentation assuring the syndicator that the owner is bound to deliver clear title and possession of the property. [See **first tuesday** Form 185]

Next, an **investment circular (IC)** is prepared by the syndicator and used to solicit prospective investors to commit to contribute and acquire a share of ownership in the syndicator's limited liability company (LLC) investment program. [See Chapter 21]

The purpose of the IC is to present potential cash investors with the **material facts** about the investment opportunity and the significant attributes of the property selected to be acquired with group funds.

Income Property Brokerage (IPB) Suite of Forms

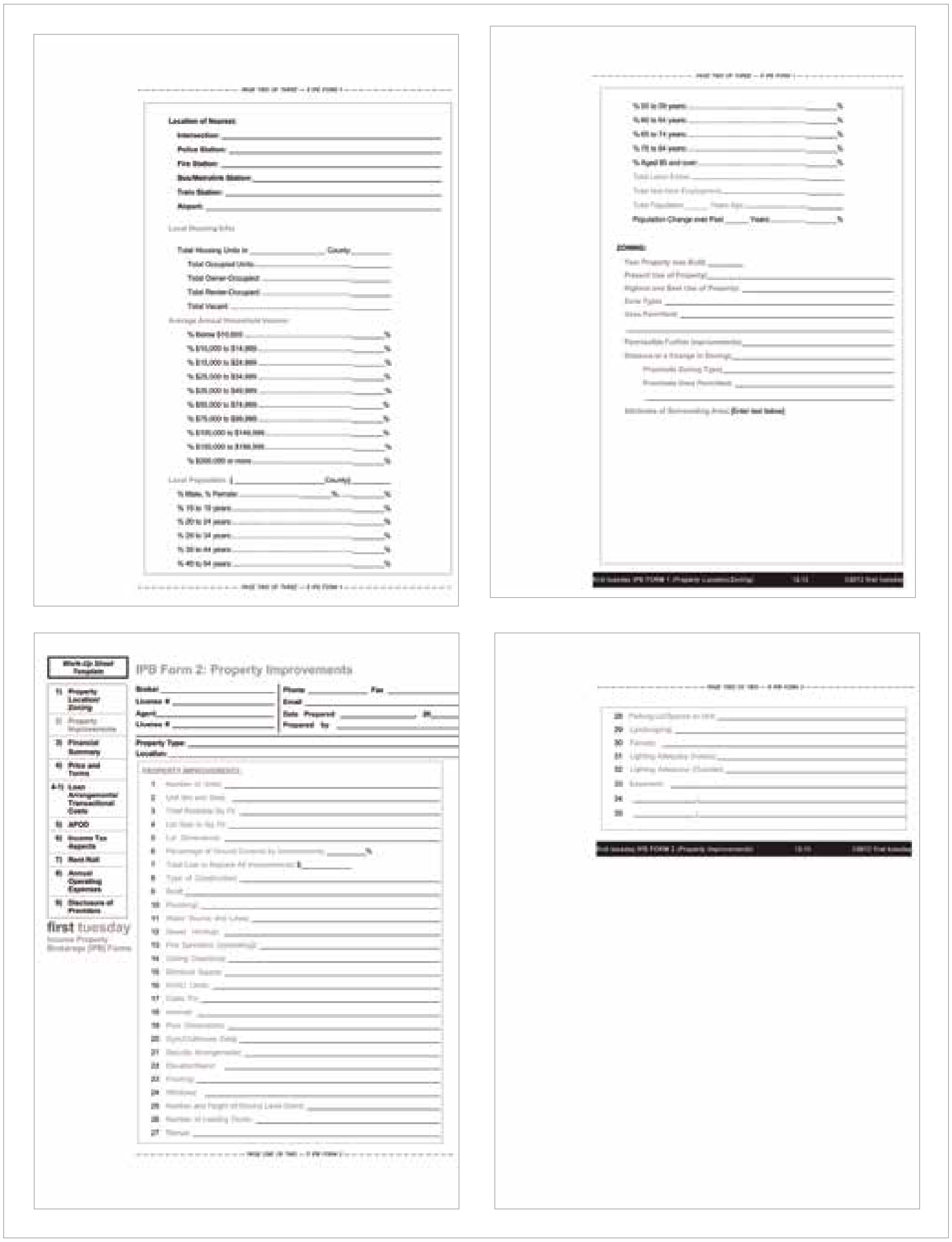

first tuesday
Income Property Brokerage (IPB) Package
Contents:
IPB: Work-Up Sheet Template
Income Property Brokerage
Transmittal Cover Letter
IPB Form 1: Property Location/Zoning

Material facts are gathered by the syndicator during the *due diligence investigation* of the property, including data about the property's:

- location and demographics;
- improvements;
- current income and expense data;
- mortgage information;
- physical conditions of the land and improvements;
- title conditions; and
- attributes of the property's location.

IPB Suite of Forms

cont'd



Much of this is contained in the IC itself. However, more detailed data may be added to supplement different sections or be attached as a referenced exhibit to the IC. [See Chapter 21]

This supplementary data is best presented by the syndicator using a property analysis program, such as **first tuesday's** Income Property Brokerage (IPB) program.

IPB Suite of Forms

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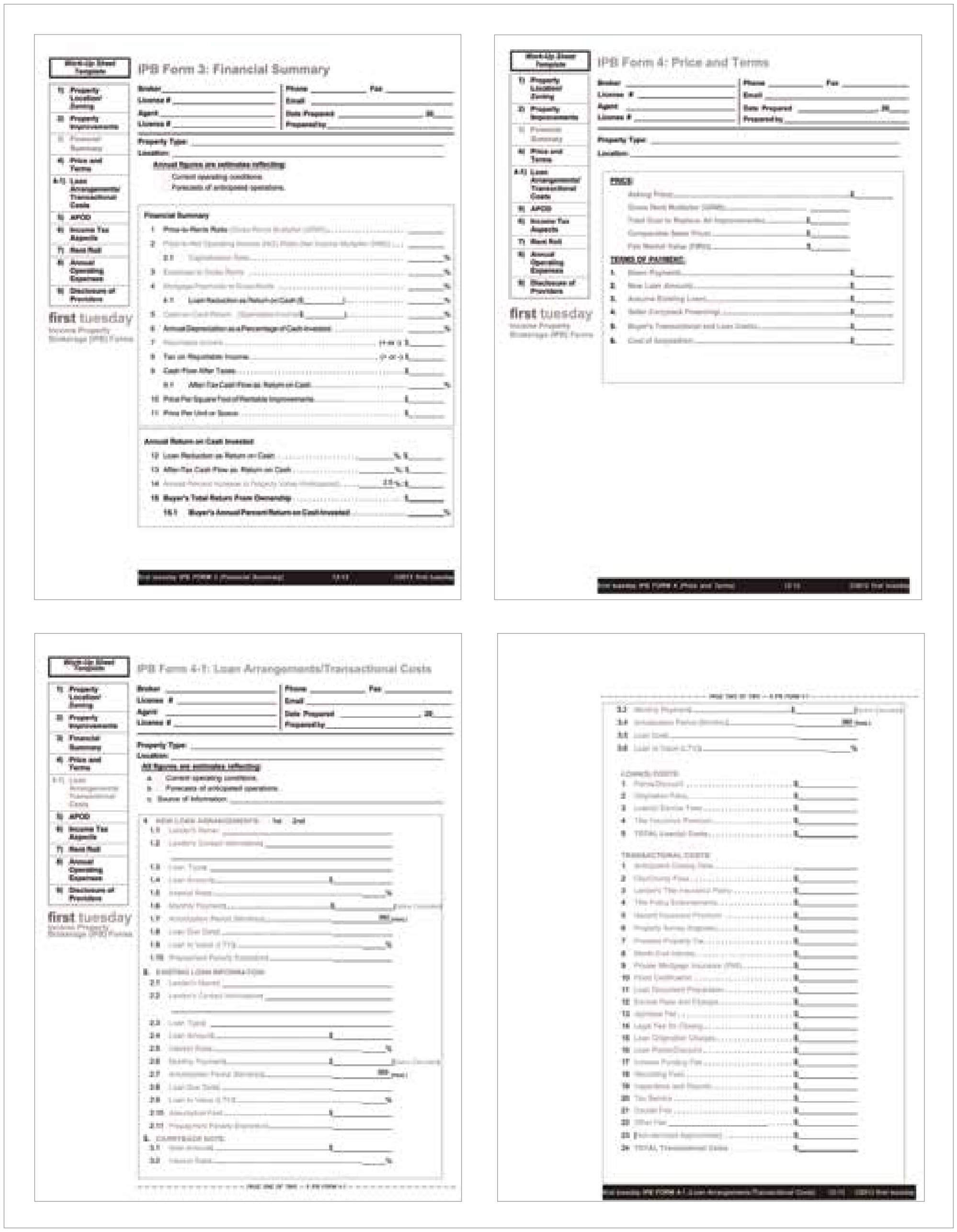
IPB Form 3: Financial Summary

IPB Form 4: Price and Terms

IPB Form 4-1: Loan Arrangements/Transactional Costs

Like the IC, all supplements and exhibits need to present the property's operating and financial information in a self-explanatory format. With IC information and data, an investor forms conclusions about whether the performance expected of the property will meet their investment objectives.

Together, the purpose of the IC and supporting documents is to give as much breadth and scope as necessary for a prudent investor to be able to make a well-informed decision about whether to subscribe to acquire a member ownership of the LLC.


IPB Form 5: APOD (Annual)


IPB Form 6: Income Tax Aspects


IPB Form 7: Rent Roll

IPB Suite of Forms

cont'd

No data, no action

If the LLC is to be fully subscribed within 45 days after the IC and supplementary data is presented to investors, the information provided by the syndicator needs to be complete and accurate.

Investors in income property want data to act upon. As the catalyst, data sets the investment machinery in motion. To attract the attention of income property investors serious about contributing to an LLC acquisition and operation of a property, the syndicator needs to marshal as much data as possible concerning the property.

As always, each property is unique in its ability to generate rental income, and its expenses will vary from other comparable properties in the area. However, group investment in an existing income-producing property

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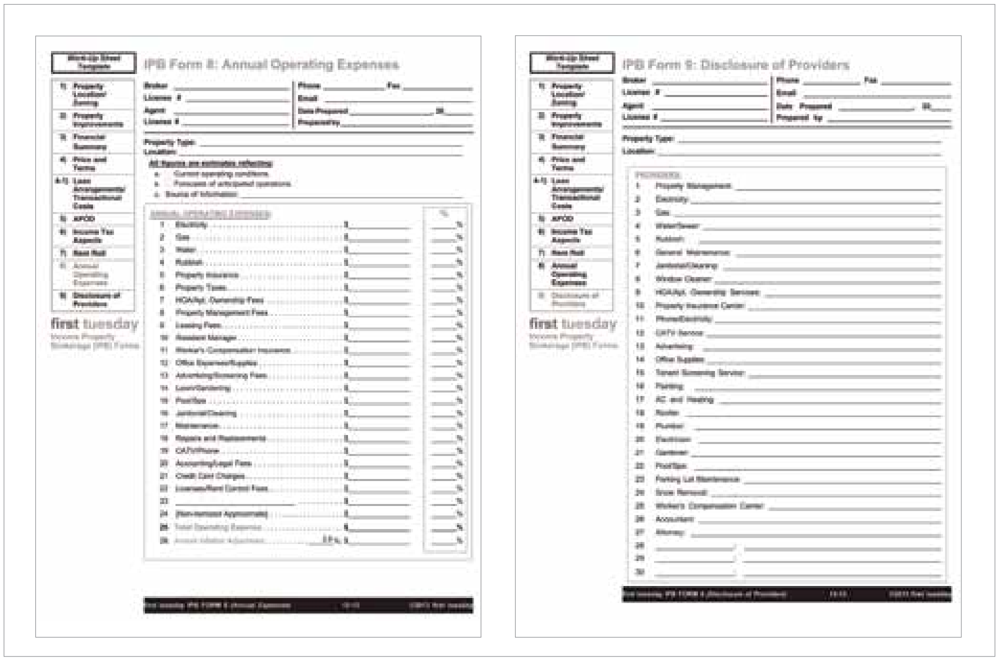

IPB Form 8: Annual Operating Expenses

IPB Form 9: Disclosure of Providers

provides the advantage of having already been operated. Thus, facts about its operations as known to the owner are available to the syndicator (or the deal is not done).

Substitute and supplement the IC

Section 7: Description of the Real Estate of the IC allows for the syndicator to provide information to the investor about the property selected by the syndicator for acquisition.

Additional detail about the property is contained in IPB Form 1, *Property Location/Zoning*, and Form 2, *Property Improvements*, including:

- the location of the nearest amenities;
- local housing information, such as total occupied units and vacancy rates;
- average annual household income of the surrounding area;
- local population demographics;
- zoning and construction details;
- uses of the property permitted;
- distance to a changed in zoning; and
- an itemization of the property improvements, including:
    - the number of units;
    - total cost to replace all improvements;
    - types of construction;
    - landscaping; and
    - easements encumbering the property.

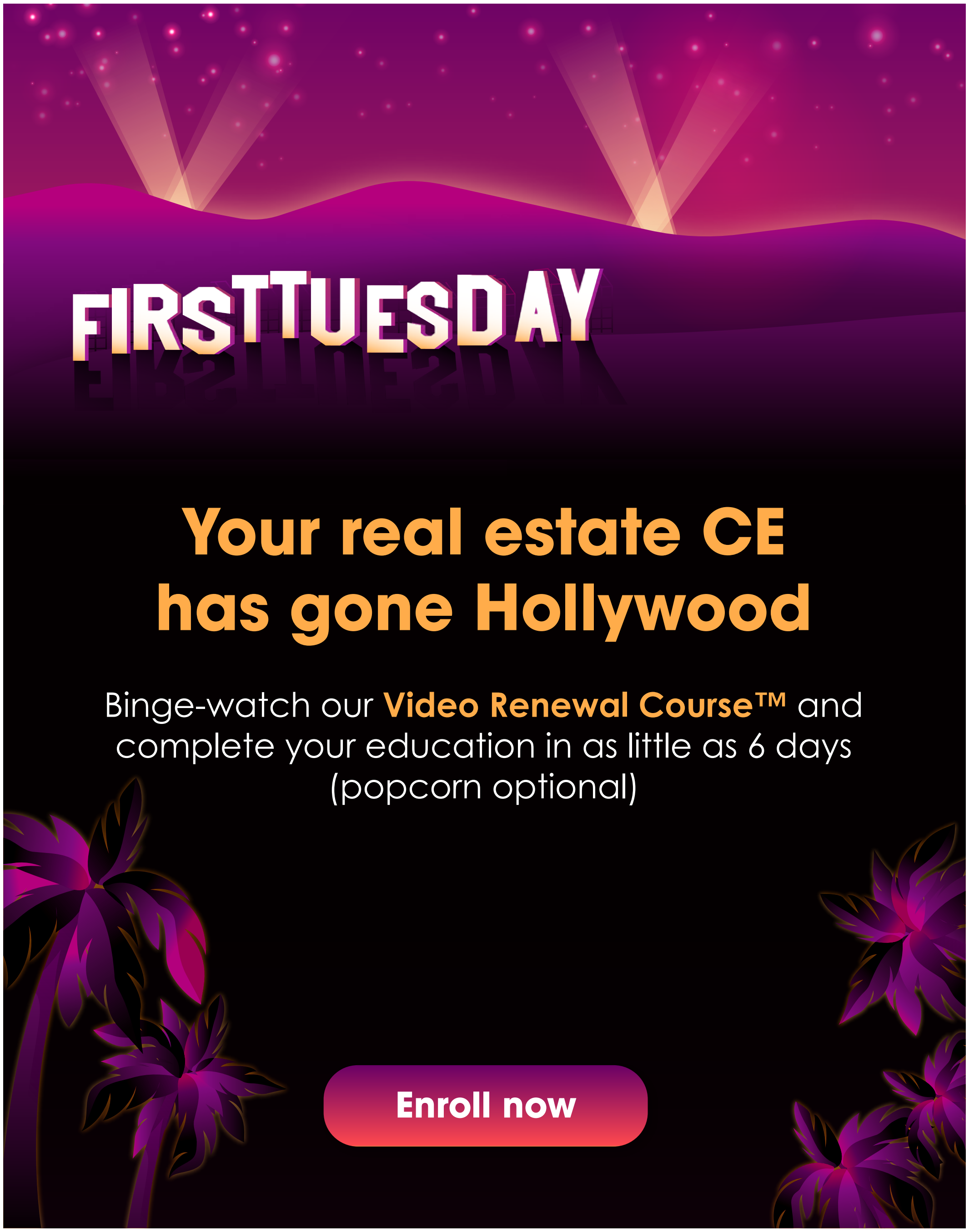
This data may be included in Section 7 of the IC as supplemental material, or referenced and attached as an exhibit to the IC.

Further, the IPB *Work-Up Sheet Template* and *Financial Summary* provide greater financial analysis then the IC, including:

- the gross rents multiplier (GRM);
- net income multiplier (NIM);
- capitalization rate (cap rate);
- expenses to gross rents;
- spendable income;
- loan reduction as a return on cash; and
- annual percent increase in property value.

This data may be included in *Section 9: Projected Financial Benefits to Members* or attached as an exhibit to the IC and referenced in Section 9.

*An interactive version of this suite of forms, and all 400+ published by **first tuesday**, is available online at www.firsttuesdayjournal.com and on the Forms-on-CD.*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Glossary

A

adjusted gross income (AGI) 102
The total of the taxpayer's reportable income and losses from all three income categories.

alienation 109, 192
The transfer of an interest in real estate from one person to another.

amortization 21
The systematic reduction in the principal balance of a long-term real estate mortgage by constant periodic mortgage payments.

appreciation 24
An increase in property value at an annual rate greater than the rate of inflation as the result of favorable economic conditions, such as increased demand for a location or increased wealth of the local population.

arms' length transaction 158
A transaction in which both parties act only in their own self-interest and are not subject to any pressure from the other party due to a preexisting relationship.

Articles of Organization (LLC-1) 169, 203
An instrument provided by the Secretary of State (SOS) and used by a syndicator of real estate to form an LLC.

B

blind pool investment program.............................133, 146
The solicitation or receipt of investor contributions in a group investment program before the syndicator identifies and discloses the real estate interest the investors' funds will be used to acquire, an activity controlled by securities law.

buyout provision... 184
A provision in a limited liability company (LLC) operating agreement which, on termination of a member's interest, grants the remaining members the right to buy out the terminated member's interest in the LLC or dissolve the LLC. [See **ft** Form 372 §7]

C

cash-on-cash return 69
Spendable income stated as a percentage of total member contributions to equity capital, represented by operating income remaining after all expenses and mortgage payments have been paid and before depreciation deductions or income taxes.

charging order.. 183
An attachment device used by a creditor to place a lien on the ownership interest in a limited liability company (LLC) held by the individual member for the payment of a money judgment, and either appoint a receiver to hold the debtor member's share or foreclose on the member's interest in the LLC.

conflict of interest 76
When a broker or agent has a positive or negative bias toward a party in a transaction which is incompatible with the duties owed to their client. [See **ft** Form 527]

corporate securities risks 6, 132, 212
A risk of loss of investor funds that arises due to investment discretion when a syndicator acquires investor funds before identifying and disclosing an existing asset to be purchased.

cost basis 92
The cost incurred to acquire and improve an asset subject to adjustments for destruction and depreciation, used primarily for tax reporting.

custodian 157
An individual whose primary duty is to administer and manage an individual retirement account (IRA) on the IRA owner's behalf.

D

disregarded entity 125
A sole proprietorship separate from its owner for liability purposes, such as a single member limited liability company (LLC) or limited partnership (LP), where the owner reports business income on their personal tax returns, also called a pass-through entity.

due-on clause 196
A trust deed provision used by mortgage holders to call the debt due and immediately payable, a right triggered by the borrower's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

E

equity buildup 21
The process of mortgage reduction through amortized mortgage payments and any additional payoff of principal.

equity financing 31, 80
Down payment funds solicited from cash investors by a syndicator for the purchase of an income-producing investment property to be co-owned by a group of investors. Contrast with mortgage financing.

errors and omissions (E&O) insurance 48
An insurance policy covering claims made on a broker or agent due to their negligence and the defense of those claims.

existing rental property 6
The category of property most prudent for real estate investment groups to own consisting of existing residential and nonresidential income-producing properties.

F

financial capacity 64
An investor's general financial strength based on their assets and liabilities and their ability to absorb losses of their own funds or borrowed funds without major personal disruption. [See **ft** Form 350]

fraudulent conveyance 184
A property transfer made for the purpose of avoiding creditors or without receiving fair value on the transfer, which may be invalidated.

G

good faith deposit 16
A deposit made by a syndicator to evidence their good faith intent to buy when making their offer. Also known as earnest money. [See **ft** Form 401 §1.1]

gross operating income 20
The actual income from all sources that property operations can be expected to generate over a 12 month period, from which expenses are paid, mortgage payments are made and a profit is earned.

I

inflation 24
The price changes over time in consumer goods and services, quantified in consumer price index figures.

initial conference 55
The first meeting between a syndicator and prospective attorney conducted prior to entering into a retainer agreement where the syndicator discusses their real estate dispute and interviews the attorney to determine their professional background, qualifications and compatibility.

investment circular (IC) 47, 140, 207, 212
A disclosure prepared by a syndicator and presented to potential investors explaining the nature of the investment program, significant features of the property selected for acquisition and the risks and financial consequences of the group investment, also known as a prospectus or memorandum. [See **ft** Form 371]

L

letter of intent 9
A non-binding proposal signed and submitted to a property owner to start negotiations. [See **ft** Form 185]

liability limitation provision 14
A purchase agreement provision limiting the dollar amount of seller losses the syndicator is liable for in the event the syndicator breaches the agreement. [See **ft** Form 159 §10.8]

liquidated damages clause 14
A forfeiture provision in a purchase agreement purporting to fix the amount of money a seller is to recover from the buyer on the buyer's breach of the agreement.

M

money judgment 182
An award for money issued by a court resulting from a lawsuit for payment of a claim.

moral hazard 75
An investment situation in which the risk of loss is borne primarily by a group of investors, not the syndicator, structured to discourage the syndicator from working for results that exceed minimum performance standards and motivate the syndicator to take unacceptable risks.

N

net operating income (NOI) 35, 73
The net revenue generated by an income producing property, calculated as the sum of a property's gross operating income less the property's operating expenses and used to determine a property's value and pay mortgage debt. [See **ft** Form 352 §4]

note rate 36
The interest rate agreed to between the buyer and the lender on a promissory note. Contrast with real interest rate.

novation 195
An agreement entered into by a mortgage holder, buyer and seller to shift responsibility for a mortgage obligation to the buyer by an assumption and a release of the seller from liability.

O

operating agreement 47, 189, 204
A form used by syndicators when setting up a limited liability company (LLC) to establish the procedures for operating the LLC and the rights and duties of its members. [See **ft** Form 372]

P

parity distribution 39, 69
An equal sharing between all members in a limited liability company (LLC) of earnings in the form of spendable income and proceeds of a sale or refinance.

passive category income 101
Profits and losses from rental real estate, operations and sales, and from non-owner-operated businesses.

power of attorney 208
A temporary authority granted to an individual by another person to perform activities for them typically during a period of incapacity or travel. [See **ft** Form 447]

prohibited transactions 159
Improper investment of individual retirement account (IRA) funds by the IRA owner resulting in self-dealing, defined as transactions between the IRA and disqualified persons.

R

real estate investment trust (REIT) 156, 168
A corporate security traded on the stock market as a conduit for making investments in income-generating real estate, trust deeds and government securities.

reserve account **68**
An account established by a limited liability company (LLC) to cover miscellaneous transactional costs incurred to create the LLC and purchase the property, and for unexpected operating expenses. [See **ft** Form 371 §13]

retainer agreement.. **56**
A contract entered into between an attorney and syndicator specifying the respective responsibilities of the parties and the hourly rate, deposit and other applicable fees charged for the attorney's legal services.

return of capital **100, 206**
The annual return of funds originally contributed to the investors or, in the case of a real estate investment, that portion of the net operating income (NOI) annually sheltered from taxes by a depreciation deduction, as well as any net proceeds from a refinance or resale of the property, cumulative up to the amount of the original contributions, also known as return of investment. To be distinguished from a return on capital.

return on capital **88**
An annual yield on invested capital, stated for group investment purposes as a percentage of equity capital contributed by group members to fund the costs of acquisition and improvements of a property, represented by the property's net operating income (NOI) less interest paid on mortgage debt, also called return on investment (ROI).

right of first refusal.. **190**
A pre-emptive right to buy a property if the owner decides to sell. [See **ft** Form 579]

S

self-directed IRA **156**
An individual retirement account which enables the account owner to invest the IRA funds in a broad range of investments such as real estate, giving the owner direct and continuing control over the management of IRA funds.

special advisor **161**
A state-licensed certified public accountant or attorney in good standing appointed by a self-directed IRA LLC operating agreement who will be consulted on a transaction involving the LLC for the purpose of determining whether the transaction is allowed or prohibited.

Subdivided Lands Act (SLA)...................................... **122**
A law administered by the California Bureau of Real Estate (CalBRE) which protects purchasers of subdivided land consisting of five-or-more parcels or condominium and apartment projects containing five-or-more units (with exceptions) from fraud.

subscription agreement... **207**
A form agreement used by a syndicator when soliciting and subscribing investors for cash contributions to a limited liability company (LLC) for investment in real estate, to confirm their receipt and approval of the investment circular and LLC operating agreement, and acknowledge receipt of the funds they contribute and their membership in the LLC. [See **ft** Form 373]

suspended losses **102**
A capital loss incurred as a result of passive activities on a property that is not realized in a given tax year and carried forward for use in future years to offset income or profits from the property incurring the loss.

syndication 1
The activity of a syndicator to bring together a group of investors in co-ownership formed as a limited liability company to fund the purchase of a propety, and perform property management during ownership and eventually resell the property.

syndicator 2
An individual who solicits cash contributions from investors to fund a limited liability company which will acquire real estate for investment purposes.

U

unrelated debt financed income 164
Taxable income on the portion of income and profit realized from ownership of debt leveraged real estate by a self-directed IRA LLC.

W

watered stock 29
A condition that occurs when the dollar value of the investors' percentage of ownership on closing will be less than the down payment they have funded to acquire an investment property.