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or how to make money in real estate without repairing a roof

by John A. McGuire

Once prominent in the idiom of the underworld, the word "syndicate" has in the last few years moved up to become almost as important to the vocabulary of the business and professional man.

"Syndicate" has made the step up to respectability because investors, as well as entrepreneurs, have seen advantages in real estate syndication to their mutual benefit. They have made real estate syndication one of the most prominent methods of marketing medium-sized and large projects.

The benefits to the investor of a syndicate are easily perceived. Real estate syndication allows the investor to take advantage of opportunities in the real estate market and gives him a piece of the action in a bigger deal than he could afford alone. Further, with greater capital available to the syndicate, there is more likelihood of a favorable purchase. Syndication allows the professional man to enter the real estate market without assuming the daily burden of tenants; the management problems are handled by the general partner.

Syndication is particularly attractive to an investor in a high tax bracket since losses from the project—generated primarily by depreciation—are available as tax deductions. At the same time the investment will probably appreciate, possibly at a greater rate than if the funds had been invested in the stock market. While the tax losses will reduce ordinary income, the greater portion—or all, if the property is held 10 years—of any subsequent gain upon sale of the property will be treated as capital gain.

It might be well to point out here that being a member of a real estate syndicate will not be productive of significant investment tax credits since a building and its structural components are not eligible for the credit. If the subject of the syndication is an apartment building, no investment credit at all is available, as property used predominantly to furnish lodging is specifically excluded. If President Nixon's tax proposals become law, the investment credit will be repealed for property that was not contracted for prior to April 21, 1969.

Real estate brokers see in syndication the opportunity to earn a commission by putting a group together; dealing with the investors on an individual basis would result in fewer, if any, transactions. Also, the broker as syndicator may take a percentage of the equity for having put the transaction together. This interest will be taxed to the syndicator as ordinary income since it represents compensation for services.

He may defer recognition of the income if he will accept substantial restrictions to his right to withdraw or otherwise dispose of such interest. In that event, it is probable that the income will be recognized at the time the restrictions lapse, in an amount equal to the value of the interest as if there had been no restrictions when it was acquired.

Once a decision to syndicate is made, the syndicator's next hurdle is finding the right property.

After he has found the property, the syndicator will be required to make a deposit to hold it while he is finding the investors. He should make a minimum deposit while seeking as long an option period as he can, but the syndicator must be prepared to sustain the loss of his deposit should he be unable to close timely.

This might happen because he was unable to interest enough investors before the closing date; or there might have been delays by federal or state regulatory bodies supervising public sales of securities. The probability of either of these delays occurring will depend primarily upon how large a group of investors is required, the number of potential investors with whom the project is discussed, etc. The syndicator should not obligate himself to buy the property, since if the financing cannot be obtained, he could be subject to damages—possibly a harsher result than the loss of the deposit.

PACKAGING THE DEAL

Once the syndicator has the property secured, he must find the investors. Most of them will have to be convinced of the project's desirability, and a carefully written brochure should do the job. Assuming the subject of the syndication is an apartment building, the brochure should contain:

- General information about the project—how many units, the number of 1-bedroom, 2-bedroom units, the square footage of each type, the monthly rental; general features of the units such as air-conditioning, patio or balcony, garbage disposals, the types of ranges and refrigerators, a description of the parking facilities.
- Additional information—all available recreational facilities, location of the property in relation to medical services, shopping centers, schools and freeways, major employers in the area.
- Terms of the proposed acquisition—how the property is to be paid for, i.e. cash from investors plus the mortgages (indicating the interest rate and the term).
- Feasibility of the project—a general and then specific discussion of the factors that will assure success.
- Other factors—why this project will be more successful than competing projects in the area, discussion of the proposed management of the project.

The financial details, that is, the projections, are an integral part of the package the syndicator presents to the investors. At a minimum these projections should include a summary of projected operations in total and per unit of investment, which would disclose the taxable income or loss; the increase or decrease in federal income tax at assumed brackets; the cash flow; and the cash flow combined with the tax savings. The cash flow should include an assumed sale at the end of the projected holding period.

The assumed selling price could be computed as a capitalized amount based on the cash flow in the last year of the projections. A detailed statement of projected taxable income or loss, reconciled to the cash flow, should be provided. This schedule would be supported by detailed schedules of depreciation and mortgage amortization. Finally, a projected cash summary, on a total and on a per unit basis, should disclose the net estimated cash to the investor. This schedule would take into consideration the cash flow, the tax savings, the proceeds from the projected sale (net of income taxes) and the initial investment. The schedule could then reflect the net cash income to the investor which can be converted to an average annual (after-tax at an assumed bracket) rate of return.

The exhibits are an abbreviated example of the type of financial information which was a part of a recent syndicator's presentation. Should the transaction be

subject to S.E.C. scrutiny, these projections would be deleted from the brochure.

FORM OF THE ORGANIZATION

It is most likely that the investment group will take the form of a limited partnership, with the syndicator as the general partner.

Holding the property as tenants in common presents a number of problems, not the least of which is management, added to the complexity of transferring title with 20—or 100—names on the deed.

With the use of a corporation other than a Subchapter S corporation, the losses cannot be passed on to the shareholders, and, should the operation have taxable income from the outset, profits cannot be distributed to the shareholders without this income being taxed twice, once at the corporate level and again at the shareholder's level.

A Subchapter S corporation has the advantage of allowing losses to be passed on to the investors, but this type of corporation is generally not a suitable syndication vehicle because under present law, it may have no more than 10 shareholders and forbids gross receipts from containing more than 20 percent of passive investment income. Under President Nixon's proposals, an increase to 15 shareholders would be allowed under certain limited circumstances and the restriction as to passive investment income would be removed.

A general partnership passes on losses, as well as any available investment credit, to the investors. And, since a partner's tax basis for his partnership interest includes his share of partnership liabilities, the partner may deduct losses generated by highly mortgaged depreciable property even if the losses greatly exceed his cash investment in the partnership. However, there are, from the syndicator's standpoint, problems here too. Each partner has a voice in the management as well as the ability to bind the partnership. With a number of partners this situation could become chaotic. Each general partner has unlimited personal liability. This is usually anathema to investors, and the investor generally is not interested in being a part of management; in fact, the opposite is usually the case, in that he does not want to be bothered with any management problems.

THE LIMITED PARTNERSHIP

The limited partnership, then, emerges as the best vehicle for syndication. It can provide the benefits—pass through of losses, the investment credit—of the general partnership while overcoming its deficiencies. Management can be centralized in the general partner, since the limited partnership agreement can give him operational control. Also, the investor's exposure to loss can be limited to his investment, or his required investment under the limited partnership agreement, in the venture. Assuming a mortgage on real estate is involved and there is no personal liability of any partner on the mortgage, a limited partner may include his share of the mortgage, determined in the same proportion as his share of the profits, in determining the basis for his partnership interest. As a result, he may deduct a loss in excess of his cash contribution.

This arrangement does not necessarily result in the best of all possible worlds if it is determined that the entity more closely resembles a corporation than a limited partnership. Should this be the case, the enterprise would be classified as an association taxable as a corporation, with the resulting loss of deductions at the shareholder level. However, a limited partnership will not be taxed as a corporation unless it possesses a majority of these characteristics:

- continuity of life,
- centralized management,
- limited liability and
- free transferability of interests.

If, for example, a limited partnership has centralized management and free transferability of interests but lacks continuity of life and limited liability, and if it possesses no other significant corporate characteristics—corporate seal, minute books or share certificates or the like—then it will *not* be taxed as a corporation.

The continuity of life characteristic may be avoided by providing in the limited partnership agreement that the partnership will terminate on the death—or dissolution, if the general partner is a partnership or a corporation—or withdrawal of the general partner, while also providing that the death or withdrawal of a limited partner will not terminate the partnership.

An organization has free transferability of interests if each of its members has the power, without the consent of other members, to substitute for himself someone who is not a member of the organization. The partnership agreement can provide that the interest of the general partner will not be assignable and that a limited partner may assign his interest only with the consent of the general partner.

An enterprise has the corporate characteristic of limited liability if, under local law, there is no member

XYZ APARTMENTS

PROJECTED TAXABLE INCOME (LOSS) AND CASH FLOW SCHEDULE (CONDENSED)[1]

	1969	1970	1971
Rental income	$ 248,195	$ 394,045	$ 405,803
Rental expenses	78,395	125,052	131,305
Operating income	$ 169,800	$ 268,993	$ 274,498
Depreciation	206,700	212,100	180,900
Interest	51,800	166,600	164,600
Taxable income (loss)	$(88,700)	$(109,707)	$(71,002)
Add: Depreciation	206,700	212,100	178,900
Less: Principal payments	(8,600)	(28,300)	(31,300)
Cash flow from operations	$ 109,400	$ 74,093	$ 76,598

XYZ APARTMENTS

PROJECTED PARTNERSHIP OPERATIONS PER $20,000 INVESTMENT

	Taxable Income (Loss)	Increase (Decrease) in Tax 50% Bracket	Cash Flow	Total Cash Flow and Tax Savings
1969[2]	$ (2,534)	$ (1,267)	$ 3,126	$ 4,393
1970	(3,134)	(1,567)	2,117	3,684
1971	(2,029)	(1,015)	2,217	3,232

XYZ APARTMENTS

PROJECTED CASH SUMMARY[3]

		Total	Per $20,000 Investment
Cash provided by:			
Reduction in federal income tax		$ 199,600	$ 5,703
Cash flow from operation	$ 545,200		
Less prepayment of interest penalty	72,000	473,200	13,520
Proceeds from sale	$1,169,400		
Less federal income tax on sale	371,875	797,525	22,786
		$1,470,325	$42,009
Cash investment:			
Purchase price		700,000	20,000
NET CASH INCOME		$ 770,325	$22,009

Average annual rate of return after federal income tax (50% bracket) is 16.95%.

[1] The complete schedules are not reproduced because of space limitations. The actual projections were made through 1975 at the end of which there is an assumed sale. The complete schedules contain detail of the rental income and expense, including vacancy factors and allowances for increased expenses and income. Supporting schedules for depreciation and mortgage amortization were supplied.

[2] The actual schedules provide this information through 1975. There is also a schedule which provides this data for the project as a whole, which ties into the above projected taxable income (loss) and cash flow schedule.

[3] This schedule summarizes the net after-tax cash effect on the investor for the period covered by the projections. This summary is supported by schedules detailing the proceeds from the sale as well as the computation of the gain (allocated to Sec. 1250 and Sec. 1231 gain) and the federal income tax thereon.

who is personally liable for the debts of the enterprise. Under the Uniform Limited Partnership Act, personal liability normally exists for each general partner; but personal liability will not be recognized for tax purposes when the general partner has no substantial assets—other than his interest in the partnership—which could be reached by a creditor of the organization or when he is acting merely as a "dummy" for the limited partners.

The typical limited partnership will normally have the corporate characteristic of centralized management. This is so because most of the interests in the limited partnership will be owned by the limited partners who would have delegated operational control to the general partner.

The limited partnership, then, would generally only possess one of the above corporate characteristics, which would be that of centralized management. Therefore, the ordinary limited partnership will not be treated as an association taxable as a corporation and will not suffer the consequent loss of the tax advantages.

CONCLUSION AND CAVEAT

But there remain some problems.

The Treasury Department in its *Tax Reform Studies and Proposals* has clearly expressed its unhappiness with the "unreal" tax losses enjoyed by passive real estate investors, such as ". . . investment bankers, corporate executives, stockbrokers, and other high-bracket individuals who participate in syndicates . . ." [1] These "unreal" tax losses are those generated primarily by depreciation deductions.

Depreciation deductions are commonly enlarged by the "component" method of depreciation, which amounts to depreciating the building components by using different useful lives for the various elements. The effective useful life for the building as a whole is thereby reduced from the guides laid down by the Treasury. The Service has somewhat blunted this approach by taking the position that it is improper to use the guideline life for the shell while assigning lesser lives to other components of the building.

The Treasury has recently received support on this from the Tax Court. In *Colin M. Peters, 28 TCM 294, (3-17-69),* the taxpayer assigned a useful life to the building shell of 45 years; to the heating, ventilating and air conditioning of 12 years; to the plumbing and electrical system of 20 years, and to the asphalt tile of 10 years.

In this case the court held that the taxpayer did not show that economic obsolescence was a real threat to his property, rather than a lingering possibility; and that indefinite expectations and suppositions were not enough to support the claim for obsolescence. The court ruled that the taxpayer failed utterly to justify the shorter useful lives and sustained the Commissioner's use of 45 years for the entire building.

Although it is obvious that there are significant advantages to the investor and to the entrepreneur in syndicating a real estate transaction within the framework of a limited partnership, the Treasury's position on curbing what they feel are abuses indicates that changes, particularly in the area of depreciation, may be on the way.

The future, then, of the real estate limited partnership may not be entirely free from rough waters.

[1] Although this study was made by the prior Administration it was presented to the current Congress for its consideration.