

DEAL STRUCTURES THAT WORK!

By James R. Goldman

Deal structuring revolves around two basic issues: first, valuation and risk allocation; and second, income tax planning. While the two issues are different, they are quite clearly related. A deal structure that works not only considers property valuation and assignment of risk between buyer and seller, but also takes into account both parties' desire to control the timing of income tax payments.

Valuation and risk allocation

- **Traditional Structure**

Generally speaking, the sale of a manufactured housing community is consummated when the seller conveys its interest to the buyer for some combination of cash and assumed or new debt. All of the risks and rewards of ownership are conveyed at closing to the buyer and the future operating results of the community have no effect on the seller.

- **Contingent Consideration and Structured Earn-Outs**

There currently seems to be increased interest in manufactured housing transactions that add an element of contingent consideration to the traditional combination of cash and assumed or new debt. Basically, the contingent consideration represents the seller's right to receive additional payments from the buyer in the future based upon the operating performance of the community. A transaction which

includes contingent consideration often reflects the seller's desire to realize a higher sales price than the buyer believes is warranted (for instance, a seller may seek to recover its costs in developing a new community or expanding an existing community where the development or expansion has not yet generated sufficient revenue to justify the seller's asking price). Contingent consideration also reflects the buyer's willingness to pay a higher purchase price for a community, but only with reduced risk.

The provisions of a purchase and sale agreement that deal with contingent consideration are commonly and collectively referred to as an "earn-out." They provide that the seller will receive additional consideration for the sale of a property depending upon its performance over a defined period of time. Earn-outs are useful in bridging the valuation and risk allocation gaps between buyers and sellers. A guarded buyer and optimistic seller may differ over the anticipated post-closing financial performance of a property. By reducing the risk of underperformance of anticipated future growth to the buyer, an earn-out can enable the seller to ultimately attain a higher aggregate price for the property if he or she is willing to assume a portion of the risk associated with such anticipated future growth.

Earn-outs are generally structured in accordance with one of three basic methods or

approaches: the milestone approach, the net cash flow approach, and the joint venture approach.

- **The Milestone Approach**

At first glance, the milestone approach to earn-outs appears to be the most appealing because of its simplicity. The seller receives additional consideration from the buyer as a reward for accomplishing a discrete objective or series of objectives, such as the completion and delivery of new home sites, the construction of a new amenity, or the leasing of a specified number of new home sites over a defined period of time.

While this approach functions effectively in many instances, it generally fails to effectively allocate risk where the milestones are related directly to the generation of current cash flow, such as the leasing of new home sites. To apply the milestone approach to lease-up would require the buyer and seller to agree, either explicitly or implicitly, to an upfront value for each filled home site that reflects each side's expectation as to the costs and benefits of achieving fill. This pricing process must consider a wide variety of factors that could impact the property's financial performance including, without limitation, any spiffs, add-ons or free rent offered to new tenants to persuade them to lease a home site. Consider, for example, a seller that has invested \$20,000 per site to expand an existing community. While the seller might propose a milestone

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earn-out of \$20,000 for each additional site leased over a three-year period, such proposal would fail to consider the financial impact on the buyer of any leasing incentives and additional set-up costs. Additionally, if the expansion sites were filled by moving existing community residents from an older section of the community to the expansion, the achievement of such milestone would, at best, be neutral to the buyer and may likely result in a net decline in the community's near-term operating performance. In this way, the seller would have additional upside while the buyer would not have significantly reduced its risk.

(Note: The milestone approach to earn-outs fails to consider explicitly the time value of money, a fundamental element of a buyer's calculation of investment return.)

- **Net Cash Flow Approach**

The net cash flow approach to earn-outs is superior to the milestone approach because, as its name implies, it significantly refines the pricing process. Contingent future payments are tied to actual financial performance, resulting in less confusion for the buyer and seller as to the various factors that increased cash flow at the property over time. Essentially, all types of improvements in the community, net of their costs, are priced to a single measurable item: net cash flow.

The net cash flow approach benefits both buyer and seller, while also aligning their respective interests. The buyer is only obligated to pay for, and the seller is only allowed to participate in, increases in net cash flow beyond the agreed upon levels set forth in the pro formas. Neither party should be concerned with how such increased cash flow is generated for purposes of structuring the earn-out.

Another attractive aspect of the net cash flow approach is its inherent flexibility. Consider, for example, a community with moderate vacancies in its older sections and high vacancies in its newer expansion sections. There may be significant differences between the two sections in terms of rent, costs of completion and incentives to fill existing vacancies. The net cash flow method can account for these differences because the earn-out is based upon the net cash flow exceeding specified targets over a defined period. The parties may then calculate additional "real estate" value for the community by applying an agreed-upon cap rate to such "excess" net cash flow.

- **Joint Venture Approach**

The joint venture approach to structuring earn-outs works well in transactions where the seller wishes to remain involved with the property. Rather than convey an undercapitalized property at a loss, a seller may seek additional capital to complete amenities, expansions or other improvements. Often times, such a seller will want to retain management of the property to control the creation of future value.

Using the joint venture approach, the seller and buyer agree upon the value of a community based upon its "in-place" income stream as set forth in the pro formas. The seller may retain some portion of the property, typically ranging from ten to fifty percent. At the end of the earn-out period, cash flow either exceeding or falling short of the amounts assumed in the acquisition pro formas will be used to reset the parties' respective ownership interests, within agreed upon parameters. The parties continue thereafter to own the property as a joint venture, with the seller often times staying on as property manager.

The joint venture holds a community for a defined investment period, at the end of which it seeks to provide liquidity for any or all parties/partners through refinancing, sale, contribution to a REIT, or the like. Many joint venture agreements also contain buy-sell provisions which enable one of the parties/partners to purchase complete control of the community at a future time.

- **Income Tax Planning**

Under the Internal Revenue Code of 1986, as amended (the "Code"), taxpayers generally do not recognize taxable income unless and until they receive payment for the property conveyed. As a result, the timing of income tax payments may be controlled through careful planning as to when payments are received. In addition, the characterization of the payments received can affect the recognition of taxable income.

- **The Conventional Transaction**

Generally, the sale of a manufactured housing community can be accomplished through the transfer of title to a community, together with improvements and related personal property, in exchange for a combination of cash and assumed indebtedness. The attraction of this transactional structure is clear—certainty of result—the seller receives 100% of the proceeds from the sale at closing and is fully released from all the risks of ownership. Of course, the certainty of result has both benefits and detriments. The benefit is that the seller will receive the full amount of the consideration from the sale of its property at closing, with no future risk related to collecting any portion of such consideration or the future operating results of the property. The detriment is that the seller will recognize the full amount of any taxable income and

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pay the tax related thereto with the seller's tax return for the tax year in which the transaction occurred. Typically, the gain on the sale of a manufactured housing community will result in capital gain subject to the recapture of any depreciation (25 percent tax rate) pursuant to Sections 1245 and 1250. However, with today's long-term capital gain rate at 15 percent, the lowest that it has been and may be for many years, the current recognition of capital gains may be very attractive. A seller must also address estate tax planning issues where the seller doesn't want to pay both capital gains tax and also estate tax. Additionally, in cases where the property has been refinanced one or more times, a sale for cash and assumed indebtedness may result in a tax obligation greater than the net proceeds generated from the sale.

Assume, for example, that Seller has a 100 percent interest in Green Acres Manufactured Home Community, a five-star community that is worth \$10 million, subject to a first mortgage of \$6 million, and an adjusted tax basis of \$3 million. If Seller conveys Green Acres for a combination of \$4 million in cash and assumed debt of \$6 million, then Seller will generate a taxable gain of \$7 million, which generally will be subject to tax at the current capital gains tax rate of 15 percent, plus any recapture generally taxable at 25 percent. Assuming no recapture, Seller's current tax obligation under this example would be \$1.05 million and Seller would have received cash after-tax of \$2.95 million.

- Tax Deferred Transactions

When an owner of real estate wants to sell a community but defer the current recognition of taxable gain and taxes, there are several ways to accomplish this objective. The most commonly used tax deferral techniques are: tax-free exchanges, installment

sales, contribution to partnership or limited liability company, lease with option to buy and ban with option to buy.

The following examines each of these techniques and demonstrate their application through the use of the Green Acres example.

- Tax Free Exchanges

Perhaps the most effective technique, and certainly one of the most popular, for deferring the recognition of taxable gain and the payment of taxes until a future date is through "tax free exchanges" as defined pursuant to Section 1031 of the Code. Section 1031 allows a real estate owner to exchange the owner's property for "like-kind" property without any current recognition of a taxable event. Under a "like-kind" exchange, all of the tax characteristics of the old property (tax basis, potential recapture, etc.) are transferred into the new property and, therefore, when the new property is sold, the gain on the old property and the new property is recognized and the tax is paid at that time. This method is widely used by property owners today who wish to reduce their involvement with, and risk from, existing real estate investments but stay invested in real estate. For instance, an "active" owner of a manufactured housing community may seek to exchange his or her interest in the community for a "passive" investment in a retail/industrial "triple-net leased" property (a free-standing retail building leased to Walgreen's).

In the Green Acres example, suppose Seller has decided to exchange Seller's interest in Green Acres for a Walgreen's triple-net leased property. At closing, Seller exchanges title to Green Acres for the title to the Walgreen's property, with no other cash payments being made. At this point, Seller's basis in the Walgreen's will be the same \$3 million basis that Seller had in

Green Acres as long as the Walgreen's property has at least \$6 million of debt on it at the time of the exchange. If Seller were to sell the Walgreen's the following day, Seller's taxable gain and tax would be identical to that Seller would have had through the sale of Green Acres.

- Installment Sales

The most commonly used technique to defer the recognition of taxable gain and the payment of taxes is through the installment sales method. An installment sale is accomplished by deferring the receipt of a portion of the proceeds from a taxable sale into the future (i.e., one or more tax years beyond the current tax year). This allows the recognition of the gain for tax purposes to be spread out over the period over which the future payments are received. (Note: There are several significant exceptions to this rule including the requirement that a seller recognizes any depreciation recapture at the time of sale and the limitations related to "qualified indebtedness". Please consult your personal tax advisor for application of these and other applicable exceptions.)

From the earlier Green Acres example, assume that instead of receiving \$4 million of cash in the current year, Seller elects to receive \$1 million per year with the first payment being received at closing. Seller will still realize a taxable gain of \$7 million on the sale of Green Acres (gross proceeds of \$10 million less adjusted basis of \$3 million) but Seller will only recognize and be taxed on a gain to the extent that Seller has received the proceeds of the sale. In this example, Seller will receive 25 percent of the gross cash proceeds (\$1 million) from the sale of Green Acres at closing, will recognize 25 percent of the taxable gain (\$1.75 million) and will pay capital gains tax (subject to any Section 1245/1250 recapture)

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of (\$262,500) for the tax year in which the sale occurred. In succeeding years, Seller will recognize that percentage of taxable gain that corresponds to the percentage of gross receipts received and pay capital gains taxes (subject to any Section 1245/1250 recapture) on such amounts.

Installment sales provide a seller with control over the timing of taxable gains. In this manner, a seller can time the recognition of taxable gains to coincide with taxable losses generated on other activities and, therefore, reduce Seller's overall tax burden.

- Contribution to Partnership or LLC

A seller's contribution of a property to a partnership or limited liability company (that has elected to be treated for tax purposes as a partnership) is another popular technique for deferring the recognition of gain and payment of income taxes. Often referred to as an UPREIT or DOWNREIT transaction, as a result of the popularity of this technique among public and private REITs, this approach involves the contribution of a property to a partnership or LLC for either regular or preferred interests in a partnership or LLC. As long as certain conditions are met, the contribution of the property to the partnership or LLC for the units is tax-free and the tax basis of the property becomes the seller's tax basis in the units. If the contribution is properly structured, no taxable gain will be recognized and no tax will be paid until the units are sold. This method is also useful when the seller wants to reinvest the proceeds from the sale of a property back into real estate. The principal difference between this method and the "tax free exchange" is that, if the partnership or LLC owns more than one property, the

reinvestment will be into a diverse pool of real estate properties. Also, even though these types of transactions are often referred to as UPREIT and DOWNREIT transactions, they can be accomplished with any partnership or LLC.

Returning again to the Green Acres example, suppose Seller wants to diversify the risk of owning a single property but wants to remain invested in real estate. Of course, Seller also wants to accomplish this without paying any income taxes. Seller may contribute Green Acres, subject to its existing indebtedness, to a partnership that already owns 19 manufactured housing communities in exchange for a negotiated interest in the partnership that reflects the net relative value of Green Acres and the partnership's other assets. Assuming that each of these communities was worth exactly the same amount as Green Acres, Seller's interest in the partnership (1/20th) would equal his equity in Green Acres. But now Seller may look to 20 properties to produce the returns that Seller formerly had earned from Green Acres and rely upon the partnership's management team to manage and create value at Green Acres and throughout the partnership's portfolio. This would all be done without the recognition of a taxable event; if structured properly, Seller would only recognize a taxable gain and pay taxes if Seller sold all or part of Seller's interest in the partnership.

Two additional benefits of this technique: First, in conjunction with Seller's contribution of Green Acres to the partnership, Seller may agree to reduce Seller's participation in the future growth of Green Acres and the partnership's other real estate assets in exchange for reduced risk through the receipt of a preferred interest in the partnership (which

would produce a yield on Seller's investment that would be paid prior to other investors); and, second, the ownership of partnership interests, in lieu of a direct interest in real estate, may facilitate estate tax planning strategies, particularly an annual gifting program.

- Lease with Option to Buy

Sometimes, the ultimate sale of a property may be accomplished more efficiently through two steps instead of one. For instance, if a seller wants to receive some cash immediately but defer the recognition of a taxable gain until a later date this may be accomplished through the combination of a lease with an option to buy. Through this technique, the seller leases the property to the buyer for a number of years and also sells the buyer an option to purchase the property for a period of time to begin some years later at a fixed price. During the term of the lease, the seller will recognize ordinary income from the lease payments but will still be entitled to deduct depreciation expense on the property. If structured properly, the lease deposit and the option payment the seller receives will not be taxed until the lease deposit is applied pursuant to the lease and the option is either exercised or expires. This technique gives the seller some cash immediately (without the recognition of taxable income and the payment of taxes) and also transfers some, but not all, of the risks and rewards of owning and operating the property to the buyer.

To illustrate this technique using the Green Acres example, assume that Seller wishes to avoid recognizing any significant taxable gains for at least ten years. Seller may agree to lease Green Acres to buyer for ten years, giving buyer many of the benefits and burdens of ownership, combined with an

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option to purchase Green Acres for \$12,000,000 in the last year of the lease. Seller's receipt of lease payments will produce current income that will be offset substantially by Seller's continuing depreciation of Green Acres. Additionally, the security deposit for the lease (equal to approximately one year's lease payment) would be received tax deferred and the amount paid for the option (equal to several percent of the gross price of the property) would be received tax deferred until the option is exercised, at which point the option payment would generally be applied to the purchase price, or would be recognized as taxable income if and when it expires unexercised. If Buyer fails to exercise the option, Seller would keep the option payment.

- **Loan with Option to Buy**

Another two-step approach to selling a property is through a loan coupled with a purchase option. Under this technique, the buyer makes a loan (collateralized by the property) to the seller and also purchases an option to acquire the property in the future based on a fixed price or an agreed-upon formula to establish the price of the property in the future. The seller must make interest payments on the loan, at a rate at least equal to or exceeding the "applicable federal rate"—the minimum rate established by the U.S. Treasury Department. If this is structured properly, the seller will not pay taxes on the loan proceeds and will not recognize a gain on the sale of the option until the option is exercised or expires. This technique gives the seller the use of most of the sale proceeds without paying income taxes until a later date when, assuming the option is exercised, the sale is ultimately consummated. The principal disadvantage of this method is that it does not result in the transfer of most of the benefits

and burdens of ownership until the option is exercised. This is often unpopular with buyers who want to gain operating control of the property as soon as possible.

To illustrate this technique, assume that Seller agrees to borrow \$3 million from Buyer for five years at 5 percent interest, with no principal amortization. At that point, Seller would have received more cash (\$3 million) through the loan than Seller would have received on an after-tax basis (\$2.95 million; \$4 million of cash proceeds less \$1.05 million of income taxes) generated through a conventional sale of Green Acres. Lastly, Seller would still have the opportunity to participate in the future growth in Green Acres' cash flow subject to Buyer's purchase option.

Conclusion

Motivated sellers and buyers have a variety of structures available to them to affect the allocation of risk in a transaction and the timing of the recognition of taxable income and the payment of income taxes. Through the use of contingent consideration a seller is able to maximize the value of a manufactured housing community by retaining some of the risk of the community's future financial performance. In addition to maximizing the seller's return, the use of one of the aforementioned tax deferral techniques will enable the seller to defer taxes until the seller receives cash in the future.

As an example of how both the risk allocation and tax deferral techniques may be used together, again consider the Green Acres example. Unlike the earlier examples where Green Acres was assumed to be worth \$10 million assume instead that Seller and Buyer have different perspectives on the value of Green Acres because 20 percent of Green Acres is vacant (Buyer believes

Green Acres is worth \$10 million and Seller believes Green Acres is worth \$12 million). Seller believes it should be paid for the vacant home sites at the community even though they have not generated any cash flow. Buyer is skeptical about if and when the vacancy will be filled and cannot afford to pay for Seller's expansion until the new home sites begin to generate cash flow. Additionally, Seller does not want to pay tax on the full amount of Seller's gain and is comfortable with both Buyer's management capabilities and Green Acres' future prospects.

To resolve Seller's and Buyer's differences over the value of Green Acres, the parties agree to have Buyer pay for the "in-place" value of Green Acres today (\$10 million) and pay for the expected lease-up of Green Acres by paying Seller additional consideration to the extent Green Acres produces net cash flow over a five-year period exceeding the parties' agreed-upon pro forma. To address Seller's desire to defer taxes, the parties agree to have Seller receive approximately 50% of Seller's base consideration for Green Acres in cash (\$2 million) and 50 percent in preferred partnership interests (\$2 million) in a partnership to be jointly owned with Buyer. Future payments of contingent consideration would be paid in cash.

This approach allows Seller to receive a higher price for Green Acres if it leases up as Seller expects but protects Buyer in the event that the cash flows from Green Acres are less than expected. Under the installment sales method, Seller will not recognize taxable gain and pay taxes from the lease-up of Green Acres unless and until Seller receives payment of the contingent consideration from Buyer. Also, Seller will defer 50 percent of the tax (\$525,000) on the sale of

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Green Acres (assuming no payments are received with respect to the contingent consideration) by agreeing to accept preferred partnership units in a joint venture with Buyer in lieu of cash. As a holder of a preferred interest in Buyer, Seller will be entitled to receive distributions from Buyer at an agreed-upon level before any distributions are made to Buyer and, during the period of Seller's tax deferral, Seller will earn distributions on the money (\$525,000) that would have been paid in income taxes. Through this structure both parties benefit, and that's a deal structure that works!

James R. Goldman is managing director – chief investment officer of Green Courte Partners LLC. Contact him at 847-582-9412 or JimGoldman@GreenCourtePartners.com.