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The Joint Venture as an Alternative Source of Capital

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THE ONGOING GLOBAL financial crisis, which emerged in the real estate sector, has been characterized by an almost unprecedented unwillingness of financial institutions to lend. Some of the largest institutional pillars of the U.S. and world economies having by now been toppled, most observers anticipate a very different world for investors in U.S. real estate in the coming months and years.

Debt financing is extremely hard to come by, even for projects with strong fundamentals that only a short time ago would have elicited stiff competition among a variety of willing capital sources; if it is available, lenders insist on much lower leverage levels than was customary a year ago. Investors that benefited from the ready availability of cheap financing from commercial mortgage-backed securities (CMBS) will face, when refinancing is required, the near disappearance of that market, leaving only the possibility of obtaining debt on less favorable terms from relatively few sources. While these properties are not necessarily distressed in the classic sense of having poor or declining performance, they will face loan maturity defaults because of the distress in the debt markets.

As a result, such owners may look to save their projects, and in some cases their entire empires, by soliciting equity investments from deep pocket investors, thereby reducing their debt burden to levels that are manageable in today's environment. Likewise, such investors may find equity pricing at distressed prices for fundamentally sound projects.

The U.S. real estate market has experienced largely uninterrupted growth since the mid-1990s, fueled by the CMBS market, which peaked in 2007 with more than $200 billion of new loans being originated.[1] CMBS limits exposure to default risk by pooling loans into mortgage securities and efficiently targets a broad range of investors with different appetites for risk, including many that had not typically invested in real estate debt. This market often provided debt at lower interest rates and higher leverage levels than traditional "balance sheet" lenders.

The current credit crisis, however, has paralyzed the CMBS market. Compared to the first quarter of 2007 when $61 billion of CMBS loans were originated, only $6 billion of CMBS loans were originated in the first quarter of 2008.[2] This decline looms large on the horizon, since so many CMBS loans that originated during the bubble are scheduled to mature in late 2009 through 2011. Given the state of the debt markets, sound assets as well as poor ones will face financial distress.

In order to avoid foreclosure, owners will need alternative sources of capital to de-leverage. One obvious choice is to obtain equity by means of a joint venture with a new investor and use the cash to pay down existing debt or access new debt at a lower leverage level. Many expect that deep-pocket investors will become more active in the joint venture market as refinancing pressures create buying opportunities.

Structural and Practical Advantages

From the distressed owner's perspective, the joint venture structure, while affording a means to avoid an impending debt default, also presents some hurdles.

If the plan is to preserve existing financing, acquiring a majority partnership interest will generally require lender consent, which could entail multiple lenders in the case of a syndicated mortgage loan and/or a mortgage-mezzanine structure. In the case of a securitized mortgage loan, rating agency confirmation will also likely be required. For a distressed property, one would expect existing lenders and rating agencies to welcome the injection of new capital, though one should also expect a thorough diligence review and close scrutiny of any proposed loan amendments.

The joint venture structure is even more attractive to the owner if the new investor does not seek management rights or control, as is often the case with foreign investors that have little U.S. presence or property management expertise. Such investors may be willing to grant the distressed owner significant control rights and/or management responsibilities. Of course, this assumes that the investor attributes the property's distress to market conditions rather than the owner's performance, and that the investor does not have a preferred third-party manager.

If the distressed owner is able to retain some property management role, it will be able to maintain market presence, preserve accrued intellectual capital and stay in business at some level until market conditions improve. In some cases, joint ventures will also afford an owner the opportunity to buy back the investor's interest at a later date, often through a right of first offer with respect to any proposed sale of the investor's interest or of the property.

Tax Planning Advantages

Also from the distressed owner's perspective, even if it does not retain control or management rights, the joint venture structure permits beneficial tax-structuring opportunities, which may be an essential element of the transaction.

Transfer of a beneficial ownership interest in property, whether for cash or assumption of debt, generally triggers the recognition of gain for U.S. federal income tax purposes. This is also the case when an owner contributes property to a joint venture with a third party, where the property owner receives a portion of the investor's equity contribution or the investor assumes or is treated as having assumed any part of the property's debt.

Given the long bull real estate market, even owners of currently distressed properties may well have accrued significant built-in taxable gain. To the extent that cash contributed to the joint venture is used to repay outstanding debt, the distressed

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owner may not have sufficient cash to cover its tax bill on the gain arising from the contribution transaction (because repayment of principal is not deductible for tax purposes), giving rise to so-called "phantom income."[3] However, a joint venture can, through several mechanisms, enable an owner to defer a significant portion of such tax obligations until a subsequent property disposition by the joint venture.

First, the owner may provide a personal or a so-called "bottom-dollar" guaranty[4] with respect to all or a portion of the property-level debt, so that the guaranteed amount is allocated to the owner for tax purposes. This increases the owner's taxable basis in its joint venture interest, which in turn enables the owner to contribute the property to the venture and receive an immediate cash distribution on a tax-free basis. It also prevents the owner from receiving a deemed taxable distribution, which would otherwise arise due to a decrease in its share of liabilities in respect of the contributed property.

Note, however, that built-in gain in the property is not eliminated; rather, gain recognition is merely deferred until a later time (i.e., as the property is depreciated or upon its disposition). Consequently, the owner will typically negotiate for certain protections with respect to matters that could jeopardize its coveted tax deferral, e.g., a lockout period to postpone sale of the asset, and consent rights over decisions regarding the property-level debt in order to preserve the tax benefits afforded by the owner's guaranty. A distressed owner with a strong bargaining position may also seek an indemnity against breach of these tax protection devices.

It may also be possible to achieve tax deferral by the use of a so-called "UPREIT" structure, in which the property is owned by an "operating partnership" (OP) between the property owner and an investor organized as a real estate investment trust (REIT). Interests in the OP, known as UPREIT units, are issued to the owner as consideration for the contribution of the property to the OP. UPREIT structures are often used in acquisitions by publicly traded REITs, but can also be used in private transactions if the investor qualifies as a REIT.

The UPREIT units received by the contributing owner are usually convertible into REIT shares, thus offering deferred liquidity if the REIT is publicly traded, though a significant portion of the built-in gain will generally be triggered by exchange of UPREIT units for REIT shares. Moreover, this conversion feature establishes a fair market value for the UPREIT units, allowing the owner to borrow against them without immediate taxation.

If an individual owner holds UPREIT units until death, an heir would receive a step-up in basis (so that the built-in gain is avoided) and can exchange the units on a tax-free basis. Similar issues arise for the owner in the UPREIT as in the guaranty context (e.g., lock-out period).

It should be noted that investors can only use the UPREIT structure if they satisfy the requirements to qualify as a REIT. For example, a REIT cannot be closely held, such that five or fewer individuals control 50 percent or more of the REIT's value. Foreign investors will also prefer to invest through a REIT that is domestically controlled (i.e., 50 percent or more of the value of the REIT is owned by U.S. persons), because their gains from selling shares of a domestically controlled REIT are exempt from U.S. tax.

A property owner may also negotiate with its lenders to reduce property-level debt in exchange for equity interests in a joint venture with the owner. The IRS recently proposed regulations on the treatment of partnership cancellation of indebtedness income that may present additional planning opportunities in the joint venture context.[5]

When a partnership-debtor transfers equity (i.e., a partnership interest) to a creditor in satisfaction of partnership debt, it is treated as having satisfied the debt with an amount equal to the fair market value of that equity. The partnership will then recognize gain equal to the excess of the cancelled debt over the equity's fair market value, which may be substantial in the case of over-leveraged, distressed properties. However, the proposed regulations presume that such value equals the capital account for the exchanged partnership interest, which in some cases may minimize the gain otherwise recognized by the debtor's partners in such exchange. In addition, the exchange of debt for equity is generally tax-free for the creditor.

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During the life of a joint venture, a distressed owner may recognize phantom income. This often arises when an investor receives a preferred return on its equity (e.g., a coupon rate) and such equity must be repaid to the investor prior to amounts being distributed to the distressed owner.

The amount of phantom income will be impacted by certain partnership tax rules regarding the allocation of built-in gain and deprecation deductions with respect to contributed property. In particular, where property with built-in gain is contributed to a partnership, the rules ensure that built-in gain is allocated to the contributing partner and depreciation deductions are disproportionately allocated to the non-contributing partner.

Consequently, a distressed owner may want to negotiate for the right to receive "tax distributions" (i.e., cash distributions sufficient to cover its tax obligations) so as to mitigate the impact of phantom income. Tax distributions are generally treated as advances of future distributions to which the distressed owner is otherwise entitled and may also be subject to a repayment obligation.

Controversial issues that arise in this context include the amount of the tax distributions (e.g., whether the distressed owner should receive tax distributions without regard to loss carryovers from prior years or losses from other investments); priority of tax distributions (e.g., whether tax distributions should be available before or after payment of priority returns to the preferred equity provider); source and timing of any repayment of tax distributions by the owner; and collateral for the owner's repayment obligation.

Conclusion

The joint venture model offers flexibility to provide varying degrees of retained ownership and/or control and to accommodate the tax objectives of distressed owners. In the coming down-cycle, this structure will enable investors to acquire interests in properties from distressed owners who might otherwise be less willing to transact, thereby offering a means of recapitalizing properties while waiting for market conditions to improve.

1. CB Richard Ellis Inc. presentation at http://www.boyarmiller.com/documents/2008%20Capital%20Markets%20Breakfast/CBRE%20Melody%20Presentation%209-10-08.ppt ("CBRE Presentation").
2. CBRE presentation.
3. "Phantom income" is the term used when a taxpayer recognizes taxable income that does not generate corresponding cash flow.
4. A "bottom dollar" guarantee is a guarantee of the last dollars of debt, which is the least risky portion of the debt. A "bottom dollar" guarantee usually provides that the guarantor is not obligated to make any payments until all attempts to collect from the borrower have failed to produce gross proceeds to the lender of a specified minimum amount. Thus, the guarantor will have economic exposure under the guaranty only to the extent the value of the collateral declines below such specified amount.
5. See Internal Revenue Code Section 108(e)(8) and Proposed Treasury Regulation Section 1.108-8.