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RINA accountancy corporation

Real Estate Report

4th Quarter 2016 Volume 11, Number 4

Related Party Loans

By: Brad Gai, Stockholder

It is easy to "forget" about the formalities of a properly documented loan when a related party loan is made, especially if the lender is representing and acting on behalf of both the borrower and lender. This situation can set the stage for unintended consequences.

Mr. Jones is a successful real estate investor and over many years has had other investors approach him about investing with him. He has formed several LLC's for the various real estate projects he has invested in. Mr. Jones is the managing member of each LLC. Some of the same investors are members of one or more of the LLC's but not all of the LLC's and not all in the same percentages.

Of the several LLC's that Mr. Jones formed, White Acre LLC experienced a cash flow problem. White Acre LLC acquired a 20 unit apartment building with the expectation of performing some exterior updating and rehabilitation of the common areas. This would be followed by a unit by unit refresh of each apartment as they became vacant. The project had reserves to cover the projected improvements after putting 20% down on the purchase of the property and obtaining an 80% loan for the balance. The projected rents and debt service would generate positive cash flow after paying all expenses. A month after completing the exterior renovations and interior common area refresh work, the building experienced an infestation of bed bugs that quickly moved from unit to unit in the building. The common area work had eaten into a significant amount of the reserves that had been set aside from the initial LLC member investment. Tenants started leaving the building in a panic after one particular tenant was particularly vocal with his neighbors. The tenants also took to Yelp to give a dozen bad reviews of the building. Over the course of six weeks, the building had 10 vacancies and the property management company was having difficulty filling even one apartment. Cash flow went from positive to negative within two months in order to meet debt service and operating costs.

Mr. Jones knew that Green Acre LLC had accumulated some reserves over several years of successful operation. As managing member of Green Acre LLC, Mr. Jones provided a loan to White Acre LLC. Mr. Jones recorded the loan as an account receivable on the books of Green Acre LLC and as a loan payable on the books of White Acre LLC. Mr. Jones did not execute a formal note or any written agreement to indicate what interest rate would be paid, if any, or when the funds would be repaid to Green Acre LLC. It turned out this initial "loan" was the first of many similar loans from Green Acre LLC to White Acre LLC. It took a few weeks to eradicate the bed bug problem and several months to fill the vacant units due to the unfavorable internet comments and the investment put into refreshing each unit. During the months that Mr. Jones and White Acre LLC were putting the ship right, a buyer approached Green Acre LLC to acquire the Green Acre LLC property. The Green Acre LLC members approved of the sale. When they closed the sale and the Green Acre LLC was to be terminated, the loan from Green Acre LLC to White Acre LLC came to light. Green Acre LLC did not have the cash to distribute to the members because a significant amount of cash had been provided as loans to White Acre LLC and White Acre LLC did not have the cash to repay the loan. White Acre LLC did not have enough equity in the property to refinance the loan to repay Green Acre LLC. Mr. Jones was embarrassed and the Green Acre LLC members were a bit upset at what had been done.

Mr. Jones forgot he had a fiduciary duty to the members of both White Acre LLC and Green Acre LLC even if some of the members were in both LLC's. The loan was made without oversight and approval of the members of Green Acre LLC. An investor should be aware of the terms in the LLC management agreement. Does the agreement allow the managing member to borrow funds or to lend funds without the approval of a majority of the LLC members? What is the security for the loan? The loan Mr. Jones approved on behalf of Green Acre LLC was unsecured. The bank had the first position and mechanic's liens could have been filed for the work done to refresh the building and the units, although we assume most of that work was paid for with the advances from Green Acre LLC. It is possible the loans from Green Acre LLC went for debt service payments and some portion of the refresh work had not been fully paid.

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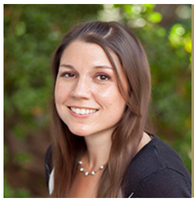

Best of Both Worlds — Using Section 1031 and 121?

By: Kelly Creed, Tax Manager

Combining the 1031 exchange with the 121 exclusion rules can be a powerful income tax planning tool available to you.

Section 121 of the Internal Revenue Code provides that property held and used by taxpayers as their primary residence for 2 years out of the last 5 years can exclude up to $250,000 ($500,000 Married Filing Joint) of gain from their taxable income when the property is sold.

With the recent increases in real estate values, many taxpayers are finding themselves with gains of over $250,000, and may have to report additional taxable gains, however there may be an alternative. Rev Procedure 2005-14 allows a taxpayer to move out of their primary residence and convert it to investment property. The question is how long must the property be held as investment property? Most experts recommend renting the property for 1 to 2 years to demonstrate that in fact the property is investment property. Once the property has been held as investment property for sufficient time, the taxpayer can sell the property and qualify for the section 121 tax free exclusion and for a 1031 exchange to defer the balance of the capital gain into more like-kind rental properties. However keep in mind that once you convert the property to investment property, you will need to sell within 3 years, to make sure you capture the 2 years out of 5 years, that you would need to use the property as your personal residence.

On the reverse, if you hold a property that you acquired in a 1031 exchange that has increased in value and are thinking about selling it, you may want to consider converting the property to your personal residence before selling. You will need to hold the exchanged property for a sufficient amount of time to demonstrate that you had the intent to hold the property as investment property, before you can then move in and convert the property to your personal residence. You must live in the property and use as your primary residence for at least 2 years. You will only qualify for a partial tax-free exclusion, however, since part of the property was characterized as "investment" before it was converted to a personal residence. The longer you use the house as your personal residence, the more gain you can exclude.

Both scenarios can be a helpful tax planning strategy if you have highly appreciated property.

If you have any questions, please contact your RINA representative.

Related Party Loans

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Best practice would include LLC member approval of all borrowing above a predetermined threshold amount. Adequate terms of repayment and a reasonable interest rate should be provided in writing. Security for the loan should be put in place similar to an arms-length loan. There should be consequences for failure to make the scheduled payments and provisions for collection and collection costs in the note agreement. Don't arrange the loan with yourself if you are in a position of authority as a managing member of an LLC, a general partner, or a trustee. If a related party loan is beneficial to all parties, then consider asking an independent party to "stand in" as one party in the establishment of loan terms and security to help avoid taking too loose an approach to terms and documentation.

SAVE THE DATE

Real Estate Advice Series Seminar

2017 Commercial Real Estate Forecast

Tuesday, January 17, 2017 — 8:30 am to 10:00 am

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Our Speaker:

Jeffrey Weil
Executive Vice President
Colliers International

For more information contact:

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The RINA Real Estate Report is published quarterly by RINA accountancy corporation for clients, employees and associates. The editor of the Real Estate Report is Timothy Tikalsky, our Real Estate Practice Group Leader.