New equity structure improves cash flow

BY KENNETH HART and BERNARD BAKER III

In light of President Bush's desire to reduce the capital gains tax, a Florida law firm has come up with a new structure for equity club developers that is designed to improve cash flow, give more control of profits and possibly reduce taxes by 30 percent.

Some background might first prove helpful.

In the early days, developers formed the equity club by entering an "agreement to turnover" the assets to members. More aggressive developers granted the club an "option" to buy the property for a price equal to its membership sales.

The option deal permitted the developer to defer paying tax on his gain until the "option" was exercised. Options and turnover agreements were often treated as installment sales, so the developer didn't have to pay tax until he actually received cash.

But the Revenue Act of 1987 repealed the beneficial installment treatment for most equity club transactions. Many developers then turned to the "§ 351 transaction" which allowed developers to sell memberships directly to members. That ensured that a developer wouldn't be subject to tax before he received cash. But it also presented some problems.

First, some cases concluded that the developer doesn't receive a basis in the memberships for the debt used to construct the clubhouse, golf course and other amenities. That had the effect of distorting his income from membership sales.

A developer's cash flow was also severely restricted because he could only use after-tax membership sales proceeds for debt service or construction costs.

Finally, there was no possibility of obtaining capital gains treatment for the developer with the § 351 structure.

The Leisure and Resorts Group at Gunster, Yoakley & Stewart, P.A. of West Palm Beach introduced their plan as an improvement on the § 351 transaction when Bush proposed his capital gains rate reduction last year.

The firm's goal was to form equity clubs that would produce capital gain treatment for developers without the risk of option deals or the disadvantages of § 351 transactions.

GY&S's new structure is a hybrid of the option deals and § 351 transactions. Since the club sells the memberships to members, there is initially no tax on membership sales. The proceeds from those sales can then be used to pay debt used for golf course and clubhouse construction without first paying tax.

In addition, the developer gets long-term capital gain treatment, a major advantage if Bush's capital gains proposals are passed.

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For example, assume a course construction cost of $4 million over two years; membership sales of $10 million pro rata over five years; and a $2-million basis in club property. While the § 351 transaction would create a cash drain in the early years under this scenario, the new structure requires no additional cash outlays to pay taxes. At corporate tax rates, cash flow in the first three years would be improved by almost $885,000.

If the Bush administration proposal to reduce the federal long-term capital gain rate to 19.6 percent is adopted, the new structure will produce a 30-percent tax savings of $336,000.

GY&S suggests that developers anticipating substantial profits in their club program consider this new structure to improve cash flow, reduce taxes and improve profits. Tax savings may also be available with related real estate.

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