



PROPERTY DEVELOPMENT
WORKSHOPS

Module 11: Legal structures for property developers

When it comes to structuring my property development business and projects, I always seek the best advice from my lawyer and accountant, and I urge you to do the same. This phase of the property development process is critical to establishing your business correctly and will have a huge impact on your funding, your investors, protection of your assets, limiting your risks and liabilities, and of course the tax efficiency of your scheme.

In considering the structure, you need to discuss the pros and cons of the following types of entities:

- Partnerships
- Joint ventures
- Companies
- Unit trusts
- Discretionary trusts

After careful consideration, you and your adviser may well decide to combine the positive attributes of two or more of the above entities to give you the best result.

I am not qualified or licensed to provide legal tax advice. However, I will flag a number of issues that you might like to consider and discuss with your advisers when choosing your structure *before* acquiring property for redevelopment. I refer here primarily to mixed-use (commercial and residential) and purely residential developments.

The main issues revolve around:

- GST on acquisition, construction and sale
- Capital gains
- Interest deductibility
- Determining which structure will maximise the tax efficiency of your scheme
- Determining whether your structure meets your financier's requirements
- Determining whether your structure attracts investors by maximising their benefits.

While you should not expect to pay no tax, ideally your advisers will counsel you on how to reduce your overall level of taxation, offset losses, claim deductions on interest and extract profit from your structure without incurring additional tax.

Significantly, if you have private investors, they will require their own independent advice on how to amalgamate their personal structure with yours for their maximum benefit. Your structure has to be 'investor friendly', otherwise you may not be able to secure their funds.



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As I mentioned in an earlier module, consider your exit strategies in the planning stage of your business. I often hear would-be developers say, 'Oh, I'm going to develop six town houses and I'll probably keep a couple.' They do not realise the implications their intention may have on their structure and their tax position. Your adviser will tell you that if you are doing property development in the true sense – that is, you are developing and then on-selling within the shortest time possible – your profits will be accounted for as revenue, but if you are developing and then holding as an investment, your profits will be accounted for as capital gains.

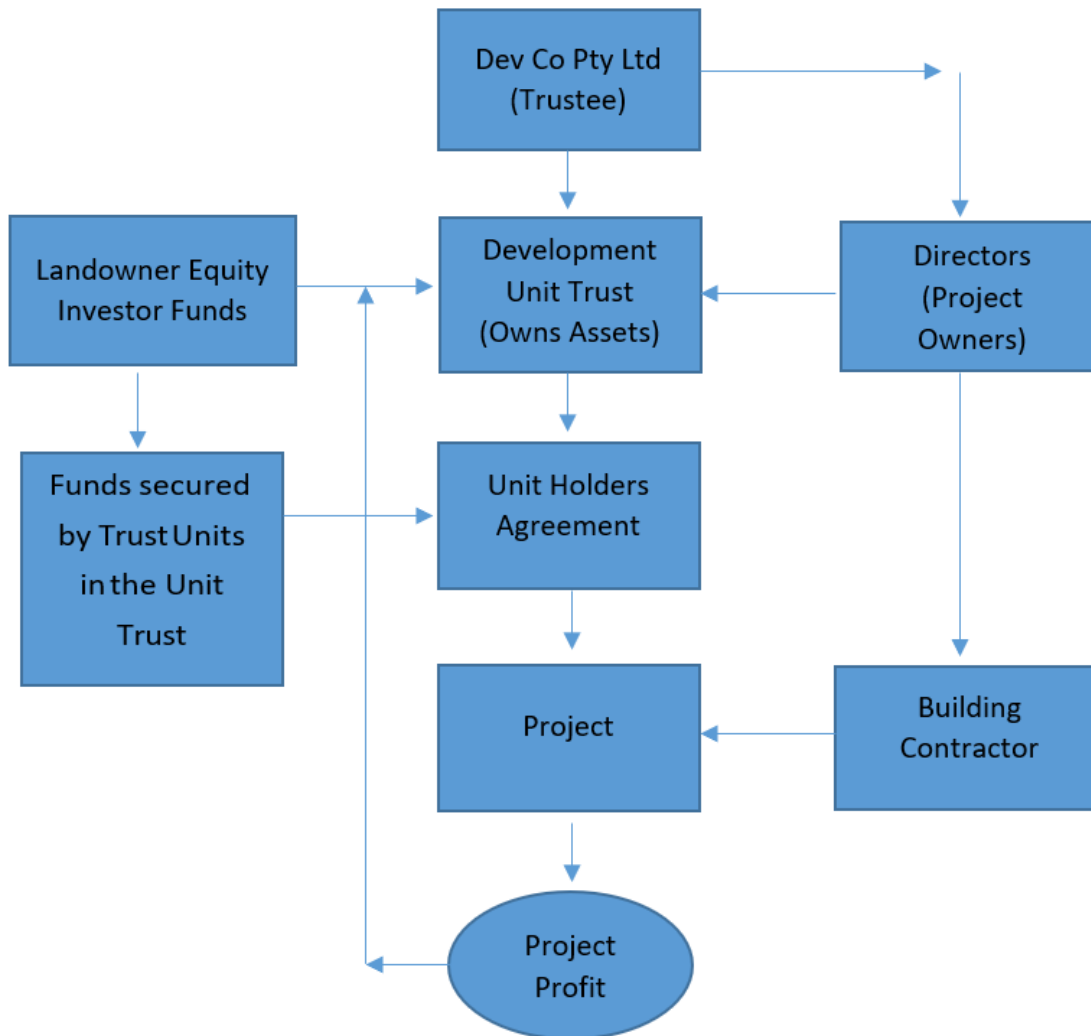
When considering the most appropriate structure, it is important to remember you will discuss with your adviser both the tax implications and the commercial aspects of your business. Your chosen entity should not only provide an improvement of your overall tax position but should also enable you to:

- Protect your assets from external claims
- Adjust income and capital entitlements
- Introduce new equity (as opposed to debt) participants
- Meet the bank's lending criteria.

My preferred structure

Over the years I have experimented with many structures and, more often than not, I now use a unit trust because it fits my business model of being able to use multiple sources of funds for development. A Unit Trust is also relatively easier and quicker to wound up at the end of a Project. Figure 1 shows what it looks like. By all means use this diagram to discuss with your Solicitor and Accountant when structuring your venture.

Figure 1: Structure of a unit trust





Legal Documentation

You will require legal advice and documentation over and above structuring as you progress through the different phase of property development. Note that often the legal advice goes hand in hand with Accountancy advice.

The ones that I use as a result of my overall strategies covered in this Course include the following, but you may require additional legals depending on your unique circumstances

- Heads of Agreements
- Deeds of Call Option
- Extensions to Call Options
- JV Agreements
- Unit Trust Deeds
- Unit Holders Agreements
- Contract of Sale
- Building Contract

Let's look at each of these in greater detail.

Heads of Agreements

As explained earlier in the Advanced Site Negotiation session in Module 4, the Heads of Agreement that I use to get "in principle" agreement with property owners, is the pre-cursor to my legal acquisition instrument which is a Deed of Call option.

The Heads of Agreement which I have developed is technically not a legally binding document but rather a memorandum of understanding (MOU) between the property owner and me as the developer in regards to, predominantly, the commercial terms of our agreement to acquire their property. It ensures that there is no misunderstanding of the terms and I utilise the document as a brief for the Solicitor draft the Deed of Call Option. This process saves valuable time and legal costs.

Deed of Call Option

The Deed of Call Option gives you the exclusive right, but not the obligation, to buy a property.

Basically it comprises :

- The purchase price
- The option fee
- The time period to exercise the option.



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In addition to these fundamentals, it contains the negotiated terms and conditions. Often these are at least as important as the three primary components mentioned above.

Module 4 Advanced Site Negotiations provides a comprehensive explanation of the call option and the relationship between these components. I have included a PDF an extract with this module for convenience.

The purchase price

Be sure to do your homework before negotiating price with the owner. Remember that property owners these days are very sophisticated. They generally know (or think they know) what their property is worth, and if they're aware that the property is going to be redeveloped for medium-density housing, for example, they will expect the price to reflect that.

As I have already mentioned, in previous Modules, you determine the residual land value of the property you want to purchase based on what you think you can achieve as the highest and best use for the land. This does not mean the bulkiest development, but rather the most profitable one that will be well received by the target market and all other stakeholders.

Obtain a sales report for the area that you are looking to purchase in. RealEstate.com and RP Data, for example, offer good reports of all sales made during the previous twelve months categorised into Houses and Home Units by postcode. These reports are valuable because they provide two important pieces of information: the approximate value of the house you want to purchase and (if you study unit sales) the approximate end values of your project once completed. This will help you determine the residual value of the site once you undertake the Feasibility. Remember, the price you agree to pay wants to be somewhere between the market value at the low end and the residual land value at the high end. Once you exceed the RLV, you will of course reduce your profits and increase your risks. Conversely, the closer you are to the market value, the more the profit margin shown in your Feasibility will increase.

Option fee

Regardless of what you may have heard, there is no standard option fee. It may be as low as a token consideration of, say, \$1.00 to make the deed of option legal; in my past agreements I have found it somewhere between 0.5% and 0.75%. Generally, I would not pay more than that as an option fee and I would always make it part of the purchase price on settlement.

It is better to have a low option fee as it reduces your risk considerably. For example, if your DA is refused, you are limiting your losses, even if it means paying slightly more for the site, as long as you can justify it through your Feasibility.

Once you have offered the landowner their dream price for their property, their priority is for you to honour the purchase and exercise the option. What I have found is that if I explain to the owner that I want to keep the option fee as low as possible and spend the money instead on making sure I get the DA so I can settle, they are amenable. I have their buy-in.



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Option period

When you're negotiating an option, bear in mind that the longer the option period, the more valuable it is for a number of reasons, including the fact that the risk is reduced. The DA can be obtained before the option period runs out, therefore making the site easier to sell. It also provides, if necessary, for the time required to take a matter through the Land and Environment Court (LEC) or its equivalent, depending on where you are.

If you are going to sell the option agreement, provided you have included this in your terms and conditions, the buyer will want to have the maximum period of time to maximise their ability to add value and increase notional equity without the burden of holding costs. In turn, your 'early harvest' – the fee you will take for putting the deal together – will be maximised. Note, by the way, that you need to include the fee you intend to claim in your Feasibility as part of the land acquisition costs, so the buyer of the option does not have to take this out of their profits.

All three items – purchase price, option fee and option period – should be negotiated simultaneously to give you the best overall agreement to suit the situation. So, for example, a longer option period may mean a slightly increased purchase price; a large option fee may mean a slightly reduced purchase price; and so on.



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Terms and conditions

The terms and conditions you negotiate will depend on the property you want to acquire and the unique set of circumstances that exist between you and the landowner. However, there are a number of Ts and Cs that must be included in any option agreement where you're intending to redevelop or you risk making the option worthless.

First, the parties to the option must be identified. Always include with your entity the words 'and/or its nominee'. This is critical if you intend to change the name of your entity to your development company, for instance, so you don't pay double stamp duty. More importantly, it allows you to sell the option to someone else. Ideally you will have been following the site to order strategy outlined in a previous module, and you will have a buyer ready and waiting to buy the option from you even before the ink is dry.

Second, the owner must consent to allow you, and by default your nominee, to lodge a development application with the council. The terms must also provide that you and your consultants will have access to the property for the purposes of preparing the DA application.

Once you have secured the site you can move on to the next step, which is obtaining approval to develop, thereby creating additional or notional equity.

Extensions to Call Options

Generally speaking, you will have an extension built into your Call Option agreement. For example you could have a call of option period of 18 months with an option to extend a further 12 months. However, if for some reason you have run out of time because of unexpected delays, you may have to re-negotiate a further extension. This is not recommended and will leave you open to exorbitant demands by the land owner. However, if you are successful in negotiating the extension you will require your solicitor to prepare an amendment to the original Deed of Call Option to underpin the agreement.

JV Agreements

JV agreements in my mind are very risky and are fraught with danger if your legal documentation is shoddy. I would recommend you discuss this strategy at length with your legal advisor before committing.

Unit Trust Deeds



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As mentioned, I generally use a Unit trust for my development projects and Unit Trust Deed is the instrument you will require to bring the Unit Trust into existence. Your solicitor will be able to provide you with examples and explanation of the functions of the deed.

Unit Holders Agreements

The Unit Holders Agreement underpins the Unit Trust Deed, and identifies the parties or Unit Holders in the Trust, their contributions and agreed returns. It also outlines each of the Unit Holder's obligations and it is a critical legal document that must be clear and unambiguous. Making sure that this document is drafted correctly will mitigate future disputes amongst the unit holders.

Contract of Sale

The contract of sale for the property that you are acquiring should be attached to the Deed of Call Option. It is the normal Contract of Sale, however, it may contain certain special conditions depending on the terms and conditions that you have negotiated. Having the Contract of sale attached to your Option makes it more robust as a legal agreement.

Building Contract

Generally you would use a standard issue building contract suitable for the type of build you are about to undertake. However, there are always certain special conditions which are unique to a development and agreed between developer and builder. It is critical to have an experienced solicitor review or draft your building contract. The money and time spent upfront in getting the building contract right will save time, money and unnecessary angst during the construction phase.