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Business Planning

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A "FLIP" OR "CARRIED INTEREST" DEAL

One party identifies a nice property and has the smarts to turn a profit on it. Another party has money and wants to invest it. Here's a classic way to structure their deal.

Peter Promoter finds a great property that, with just a little work and a modest investment, can be sold for a lot more that its current price. Mo the Money Guy is willing to invest the necessary cash. They organize a new LLC. Peter contributes $1,000 and his option to buy the property, Mo contributes $1 million. The LLC borrows the rest of the purchase price, buys the property and takes out a construction loan to spruce it up.

Peter might or might not get a "**guaranteed distribution**" (like a salary) from the LLC to live on during the deal.

Mo gets a "**priority return**," maybe 8% when the prime rate is 3.25%. The priority return is paid on the invested capital.

The first **distributions** are paid 1% to Peter, 99% to Mo. Distributions cover the priority return until it is paid up to date. The next distributions return capital to the investors.

When Mo has his priority return all paid up *and* has received back *all* of his invested capital, the "**flip**" occurs. In a buy-and-sell deal, this probably happens when the LLC sells the property and repays its loans. In a buy-and-hold deal, it might occur when the LLC refinances the property, pays off the construction loan and distributes the borrowed cash to the members.

After the flip, Mo and Peter share all distributions 50-50. (Even if there are ten money investors, Peter might get 50%.)

Their voting interests are probably 99 votes for Mo and one vote for Peter until the flip, and then they would vote 50-50. Until the flip, Mo can remove Peter as manger, but Peter would remain a member and Peter's interest in

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distributions would still increase at the flip.

There are many versions, but this is the stripped down, classic flip. It is useful for projects outside of the real estate world, too.

In a private equity group or a hedge fund, the promoters might get 20% after the flip, not 50%.

Peter's interest in profits is a "**carried interest**." He does not get any carried interest unless the deal turns a profit. His guaranteed distribution, if any, would be ordinary income to him. Anything else he receives as a distribution would be taxed to him as capital gain. If the proposed "carried interest" legislation is enacted, Peter's flip interest would be ordinary income.

Do you want to discuss your deal? We can help you quickly structure a deal, prepare a term sheet, and document your transaction.

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