March 2, 2006

To: Mike Pintz
From: David Lentz

Re: Drumwright Project/Choice of Organization

Just to give you an update.

I've looked at REITs (Real Estate Investment Trusts) which are a typical investment vehicles for large scale projects that have certain tax advantages. Seventy five (75) percent of the income from projects qualifying for REIT status have to come from, among other things, rents, interest on mortgages or gains from the sale of real property (except inventory or dealer property). My analysis at this point is that the sale of residential houses is probably inventory or dealer property. See IRC Section 856 (c) This would probably throw you out of REIT treatment unless the commercial space aspect of the deal can be formed by a separate entity (that is, have two entities-- one being a REIT for the commercial space).

General Partnerships, Limited Partnerships, Sub S Corporations and Limited Liability Companies offer the advantage of basically being nontaxable entities and as such of allowing "pass through" tax treatment directly to their partners, members and shareholders. As such income is taxed only once (at the partner, shareholder or member level) and these entities offer the further advantage of allowing partners, members and shareholder (on their personal tax returns) to write-off any losses that these <u>entities</u> incur. As such they eliminate the major disadvantage of regular C Corporation status which is that regular C Corporations are taxable entities and thus income C Corporations receive are taxed "both" when the corporation earns the income and then again when it distributes it to its shareholders.

Unless the following objections can be overcome a Subchapter S Corporation would not seem to be appropriate:

a. S Corporations cannot have more than 75 shareholders. (With some exceptions generally it can only have natural persons as shareholders).

b. S Corporations can only have one class of shareholders with respect to all rights (including rights to distributions (no preferences)) You can have some differences in voting rights however under the S rules.

c. Debt to third parties such as lenders can not be used to increase shareholder basis thereby limiting possible writeoffs

d. Shareholder agreements may restrict transferability of shares thus affecting investor liquidity.

For a project of this magnitude a possible vehicle is a Registered Limited Liability Partnership. Either general or limited partnerships can be formed using this device. (I will assume that it if this type of entity is chosen it will be formed as a limited partnership so that you can maintain control as a general partner and limit the control that the limited partners have.) The advantage of the Registered Limited Liability Partnership (an RLLP) is that it offers each general partner "full shield" protection from liability for debts and obligations of the partnership. And what is more, it shields general partners form the negligence, malpractice, wrongful acts or misconduct of any other partner, employee or agent while acting in the course of partnership business.

RLLP's get pass through tax treatment just like regular partnerships. Moreover, and unlike an S Corporation shareholder, a partner's tax basis for reporting losses allocated from the RLLP to the partner is increased by nonrecourse loans made by 3d parties to the RLLP. (This assumes that the RLLP is a limited partnership) This increases the possibility for writeoffs if there are losses—which may be helpful, especially in the early years of the project.

I am not suggesting an RLLP at this point but it is clearly worth considering. One possible disadvantage of an RLLP is that while most states recognize them, not all states do. But I believe this to be a minor disadvantage because the RLLP would be formed in Virginia and Virginia law would control, even if interests were sold in other states.

The biggest disadvantage of RLLP's, limited partnerships, general partnerships, S Corporations, limited liability companies and really any entity that is not publicly traded either over the counter or on some type of exchange, is the lack of potential liquidity that the investor has. One reason for this is that often the sale of interests in these entities often requires some sort of consent of the other members. They can't easily resell their investment if they need the cash. This may have the effect of reducing the offering value (the amount of cash that can be raised for a given expected rate of return on investment) of these investments when they are first made available. From this perspective, regular C Corporations (with their double level of taxation) are the most liquid and investor friendly and it is usually C Corporations whose stock is publicly traded. {It should be noted that securities firms do some trading in limited partnership interests and the like, but my experience has been that these trades are still somewhat cumbersome and seller's usually sell at some discount.}

A limited liability company, also remains an option. It is not taxed and is a pass through entity. As such it is not double taxed like C Corporation shareholders effectively are. There are no limitations on the type of income that LLC's can earn. The members tax basis is increased by both recourse and nonrecourse loans made by lenders, thus increasing the amount of potential writeoffs that can flow through to members. LLC's are recognized in all 50 states. There is no restriction on the type of person who may own an investment in an LLC. As such, membership interests in LLC's can be owned by corporations, other partnerships etc. This increases the pool of potential investors.

Moreover, LLC's can delegate control and management to a manager member. An LLC can be formed by one member. However, one author in 2003 noted:

> A continuing disadvantage relative to a C corporation form is the reluctance of the capital markets and other sources of debt and equity financing for businesses to warm to the notion of using a limited liability company when a C corporation could be used. The history of familiar form and structure in finance is slow to be overcome."

I don't know if this is still true. But it's important to consider.

I continue to consider this matter, but I need more information.

Could you give me more feedback on how much "equity" capital you intend to raise. How many investors you expect will invest in this project? How large will the acquisition loan be? What will the total development cost be? This all will affect whether "securities" have to be registered with the SEC and/or the SCC and if so, under which set of regulations.

Are you expecting to have operating losses in the early years of the project? (A "C" Corporation would not allow any pass through of losses to investors)