

Real Estate *advisor*

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A new safe harbor

IRS floats a solution for dealing with bankrupt QIs

Recently, the IRS released a revenue procedure that provides a “safe harbor” for certain taxpayers who initiated deferred like-kind exchanges under Internal Revenue Code Section 1031 but failed to complete the exchanges. Revenue Procedure 2010-14 applies when the qualified intermediaries (QIs) have filed for bankruptcy and defaulted on their obligations to acquire and transfer replacement property. Under the procedure, covered taxpayers aren’t required to recognize taxable gain on such exchanges until they receive payment attributable to the relinquished property.



Rules for like-kind exchanges

Sec. 1031 allows a property owner to defer taxable gains on the exchange of an investment property (the relinquished property) for a like-kind investment property (the replacement property).

To qualify, the taxpayer must identify the replacement property within 45 days of when the relinquished property is transferred (known as the identification period). The taxpayer must acquire the replacement property within 180 days of the transfer or by the due date of the taxpayer’s return (including extensions) for the year the relinquished property is transferred, if sooner.

Sec. 1031 permits a taxpayer to use a QI to facilitate a like-kind exchange. The QI will acquire the relinquished property from the taxpayer and transfer it to a buyer. The QI then uses the proceeds to acquire the replacement

property and transfers it to the taxpayer. The taxpayer’s transfer of relinquished property to the QI and receipt of replacement property from the QI are treated as an exchange with the QI.

The bankruptcy problem

Increasingly, taxpayers have initiated like-kind exchanges using QIs, only to have the exchanges fail because the QI enters bankruptcy or receivership. This is problematic because the QI doesn’t acquire and transfer the replacement property to the taxpayer, and the taxpayer can’t obtain immediate access to the proceeds of the sale of the relinquished property because of bankruptcy rules.

The IRS has concluded that a taxpayer who in good faith sought to complete an exchange using the QI, but saw the exchange fail due to the QI’s default, shouldn’t be required to recognize gain from the exchange until the

taxpayer receives a payment attributable to the relinquished property. Rev. Proc. 2010-14 explains which taxpayers qualify for this treatment, as well as when and how to recognize gain on the disposition of the relinquished property.

Claiming the safe harbor

According to the revenue procedure, the safe harbor is effective for QI defaults occurring on or after Jan. 1, 2009, and applies to taxpayers who:

- Transferred relinquished property to a QI,
- Properly identified the replacement property within the identification period (unless the QI default occurs during that period),
- Didn't complete the like-kind exchange solely because of a default by a QI that became subject to a federal bankruptcy proceeding or a federal or state receivership proceeding, and
- Didn't have actual or constructive receipt of the proceeds from the disposition of the relinquished property or any property of the QI before the QI entered bankruptcy or receivership.

Constructive receipt occurs if the proceeds are credited to the taxpayer's account, set apart for the taxpayer or otherwise made available to the taxpayer.

Under the safe harbor, a covered taxpayer may report gain on the disposition of the relinquished property using the "gross profit ratio" method. The portion of any payment attributable to the relinquished property that's recognized as a gain is determined by multiplying the payment by a fraction, with the taxpayer's gross profit as the numerator and the contract price as the denominator.

Know your tax rights

Taxpayers might also be eligible to claim a loss deduction if the adjusted basis in the relinquished property exceeds the payments attributable to that property. In such cases, check with your CPA for advice on how best to proceed. ■

Supreme Court declines review of like-kind case

The U.S. Supreme Court has declined to review the Ninth Circuit Court of Appeals' decision in a case involving a Section 1031 like-kind exchange. In *Teruya Brothers, Ltd. & Subsidiaries*, the appellate court had held that a taxpayer couldn't avoid the code section's related-party rule by using a qualified intermediary (QI). Under the rule, gain on an exchange between related parties generally must be recognized if either property exchanged is disposed of within two years after the exchange.

In two separate exchanges of property, Teruya Brothers had transferred property to a QI, which subsequently sold it to an unrelated third party. The QI used the proceeds and additional funds from Teruya to purchase replacement property from a party related to Teruya.

The appellate court rejected Teruya's characterization of the transfers as deferred like-kind exchanges and affirmed a tax deficiency of \$4 million.



Loan assumptions

Think of them as an alternative source of financing

Even as the economy shows signs of crawling back from the brink, the credit market for commercial real estate (CRE) has remained tight. Some buyers that wish to close CRE deals are taking a nontraditional approach to financing: They're assuming the sellers' loans. The loan assumption process is somewhat complicated, but it can provide an advantageous option in a formidable credit market.

A detailed process

The basic idea behind a loan assumption is straightforward: The property buyer assumes the seller's existing financing on, for the most part, the same terms. Here's how the process should work:

1. The buyer must obtain copies of all the loan documents for the property and review their terms and conditions. If the buyer believes it can comply with those terms, it reaches out to the lender. The lender then sends an information package addressing the required deliverables and fees, among other information. Some loan agreements contain provisions — such as equity transfer restrictions — that are inconsistent with the borrower's operating structure or future plans. If so, ask for modification of the loan documents.
2. Assumed loans are typically securitized, and securitized loan documents usually include strict requirements related to the structure of the borrower. In a loan assumption, the lender will want the buyer/loan assumer to correspond exactly with the entity described in the original loan documents. Deals involving a Section 1031 (like-kind) exchange should be brought to the lender's immediate attention, because specific time constraints and ownership issues apply.



3. For most loan assumptions, then, the buyer creates a single-purpose entity (SPE) to carry out the transaction. SPEs legally separate real estate collateral from the buyer's other operating assets, which makes the property less vulnerable if the parent company files for bankruptcy. If the loan documents require multiple levels of SPEs, the buyer can often satisfy lenders by forming a single-member limited liability company (LLC), with the buyer's existing entity as the single member.
4. The buyer completes an assumption application and makes any necessary deposits. It may also be required to provide certain indemnification; its formation documents; biographical information on the buyer's principals and guarantors; the purchase agreement with the seller; tax data; insurance coverage; and financial statements.

Note that some loan documents provide pre-negotiated assumption rights that allow the initial borrower to transfer the property and loan to a buyer under specific circumstances. The lender will probably require payment of a transfer fee (for example, 1% of the loan amount), payment of the lender's legal and administrative expenses,

and approval of the buyer's financial condition and expertise in real estate management.

Some pros, some cons

Like most financing vehicles, loan assumptions come with both advantages and disadvantages. For example, if a seller's loan documents already convey the right to transfer the property and assign the loan, the buyer isn't likely to encounter too many roadblocks when attempting to assume the loan. That saves time and money.

A buyer might also save time and money because the loan *assumption* process can be quicker than a loan *origination* process. At the very least, the buyer might not need to assemble and provide as much documentation for a loan assumption as it would for an origination. Further, if current interest rates are high, a loan assumption can provide a backdoor way to secure a below-market rate. The existing loan may have more attractive rates and terms than a buyer could now secure.

Keep in mind, though, that loan assumptions are rarely a sure thing. Even in a best-case scenario, where the loan documents provide assumption rights, lenders generally decide whether a buyer is qualified to take over a loan. And, in the absence of prenegotiated assumption rights, lenders can change loan terms — not only boosting the rate, but also imposing strict requirements related to oversight, cash management or reserves.

Proceed with caution

A loan assumption is worth considering when pursuing funding needed to close a deal, but it calls for caution and care. Buyers must closely scrutinize the loan provisions, loan assumption agreement provisions and any additional documents that the lender requires. And then they must confirm that any changed loan terms are reflected in the necessary documents. To ensure your next loan assumption goes smoothly, work with your real estate expert and your attorney. ■

7 leasing strategies you need to know about

Commercial and residential property owners occasionally need to get back to the basics of leasing to ensure that new leases are airtight, as well as to determine whether leases that are already in place are still producing the maximum revenue allowed. This article provides seven strategies to help you accomplish both.

1. Work with the experts

Because real estate contracts have turned into complex documents, both tenants and landlords must seek professional advice as they negotiate lease contracts. For new leases, be sure to work with a real estate attorney or accountant with experience dealing in the kind of property you're

leasing. Experts who lack specialized knowledge might be unaware of the lease language necessary to protect your property.

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2. Cover all the details

Your tenants' rent may cover the basic cost of owning and maintaining a building, but what about bills for items such as roof repair? Make sure



the lease specifies who will pay for utilities, real estate taxes, insurance and maintenance. Always check tenant references, require security deposits and add escalation clauses based on the consumer price index (CPI) to hedge against inflation risks.

For commercial renters, take part in their upside with percentage leases wherein rent equals a base flat rent plus a percentage of the tenant's gross sales.

3. Incorporate an expense stop to protect profits

Landlords can protect profits by designating an expense stop in leases that are not yet in place. This item is simply a maximum level of expenses to be paid by the building owner. Any building costs in excess of the expense stop are the responsibility of the tenant.

4. Put everything in writing

It may sound so simple that you don't want to think about it, but written agreements can resolve many disagreements before they happen. Oral contracts or amendments aren't likely to hold up in a court of law, especially if the parties involved can't agree on what the terms of the contract actually were.

5. Be ready for challenges from lease specialists

Tenants may call in their own specialists to help detect expensive errors in lease agreements that are in place. Specialists are typically hired to find math errors, ensure that the tenant is charged for expenses specified in the lease only, check space measurements and examine insurance and real estate taxes.

To minimize the chances of a tenant's specialist finding a mistake, hire your own lease specialist. Catching mistakes yourself may be far less costly than letting your tenant find them first.

6. Reexamine and revise standard lease agreements

Laws are changing so rapidly that leases should be revised every few years. Landlords wanting to stay current with recent trends and legal decisions are finding that preprinted, "cookie-cutter" forms no longer work. Also, you may have trouble convincing a tenant to accept changes on a modified preprinted form and lose out on a deal entirely. Have your lease agreements professionally updated regularly.

7. Include an out-of-court dispute resolution process

As a general rule, neither landlords nor tenants enjoy going to court when disputes arise. By agreeing in the lease to use mediators for dispute resolution, you can keep disputes out of court and, possibly, animosity out of the landlord/tenant relationship. Mediators can save time and money — not to mention aggravation.

In contrast to arbitration, where a judge hears both sides and single-handedly decides the outcome, mediation provides a neutral platform where both parties can air their grievances and work out suitable arrangements themselves, with a third party's help. When mediation is finished, you'll both walk away feeling that you received a fair shake. ■

Ask the Advisor

Will conserving water really help me save money?

If you're like many property owners and managers, you want to do your part to help the environment and conserve resources. The good news is that some green measures, including water conservation, can also help your bottom line by reducing your bills.

Taking baby steps

Significant savings can be accomplished by taking simple steps. Start by checking for leaks in your building. The Building Owners and Managers Association (BOMA) says that even small leaks can cause the loss of seven gallons of water each day per toilet. More extensive toilet leaks might result in the loss of more than 100 gallons every day. Fortunately, leaks in toilets, faucets and showerheads can usually be repaired quickly and at little cost.

Reduce water usage by installing low-flow aerators on faucets. According to BOMA, these devices can save between half a gallon and more than four gallons of water per faucet per day. Displacement devices, such as toilet inserts, offer similar savings because they limit the amount of water used by consuming space in the tank. Like aerators, the devices typically cost just a few dollars.

Simple and inexpensive changes

Cooling towers that form part of a building's HVAC system account for significant water usage, but you can make changes to reduce that use and, in turn, your water bill. Adjusting the tower float valve assemblies and tower condensers will reduce bleed-off. Plus, you can collect and use the runoff water for landscaping purposes.

Adjusting water pressure will produce positive returns, too. Install pressure-reducing valves near the water meter to cut the amount of water used and avoid losing water to leaks in stressed tubes

and valves or burst pipes. Also, pay attention to outdoor sprinkler systems. According to BOMA, you can reduce consumption by as much as 10% by installing soil moisture sensors.

Do your employees and tenants clean walkways, parking lots, floors and other surfaces with a hose? Instruct workers to use brooms, vacuums, mops and steam cleaners, and, according to BOMA, you can save up to 80 gallons of water per activity.

Conserving through less consumption

Cutting your energy consumption will save water, even if it's not water you use directly. For example, just think of the massive amounts of water needed to generate power. By using less energy, you can help conserve the utility companies' water and keep more money in your pocket through reduced energy bills.

But success depends on the water conservation efforts of your tenants, employees and vendors. Consider offering a financial incentive for tenants to reduce consumption by charging a water usage surcharge based on actual consumption, if lease agreements permit. ■





In the real estate industry, the numbers are big and so are the risks. Poor timing, bad advice, even small oversights can have substantial consequences. Whether you're a developer or an investor, Elliott Davis' Real Estate Practice helps keep your business grounded.

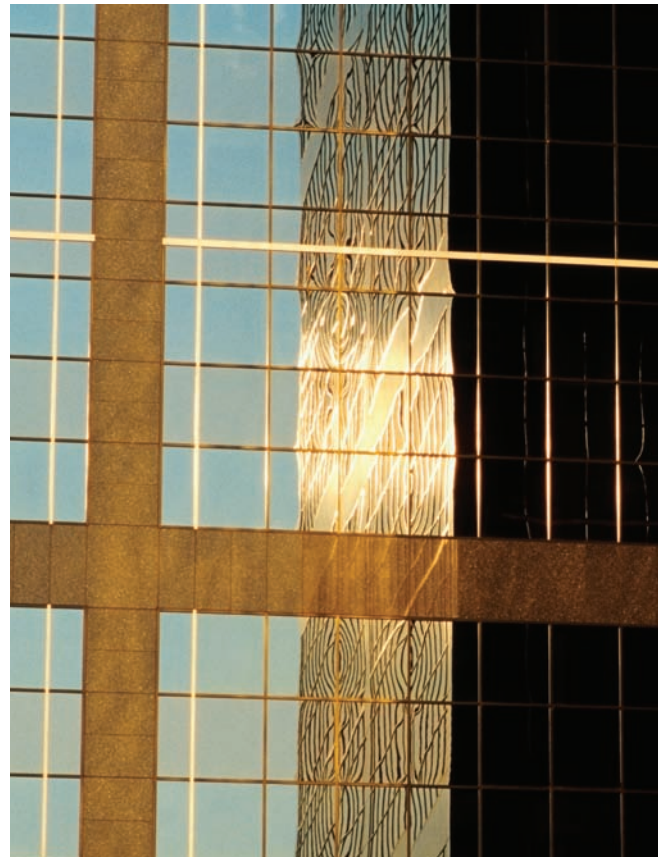
Our team puts its deep industry knowledge and experience to work for you with customized solutions based on your specific situation and requirements. With our network of locations throughout the Southeast we deliver personalized service wherever your business lands.

ACCOUNTING SERVICES:

Our team reviews your historical financial statements, evaluates trends, and pinpoints strengths and weaknesses in your financial and operational business performance. We make certain you're receiving the right kind of financial information to run your business and ensure tax compliance. We provide not only traditional credit, review compilation, and tax preparation services but also forecasts, projections and acquisition evaluation and accounting.

BUSINESS ADVISORY SERVICES:

Our Real Estate Practice helps you consider and structure various alternatives to maximize return on investment. A sampling of our services include: 1031 exchange consulting, cost segregation studies, revenue recognition and cost allocation techniques, tax credits, and business entity planning and organization choice.



With offices located throughout the Southeast, members of the Elliott Davis Real Estate Practice can respond quickly to their clients' needs. Please contact us at 1-877-340-6802 to tell us your real estate goals and learn how we can help you achieve those goals, or visit us online at www.elliottdavis.com for more information.