

## BEING CONSTRUCTION LOAN SAVVY CAN WORK TO YOUR ADVANTAGE

It's harder today to get construction financing than it is to get conventional commercial real estate loans. But knowing what lenders are looking for can increase your chances of a smooth construction loan process.

### Different Rules

Although regular commercial loans are secured by existing cash flow, construction loans are secured by unfinished collateral. The collateral's value depends on the project's completion and estimated economic viability.

So, it's natural for lenders to seek assurances that a developer will take every precaution to manage construction risk from project inception. Lenders also want to make sure developers have enough money invested in the venture to motivate them to overcome construction problems and make the project succeed.

### Sizing up Project Worth

In the current tight credit market, lenders evaluate construction loan applications based on two factors:

**Loan-to-value (LTV).** This is calculated by dividing the loan amount by an appraiser's projection of the fair market value of the completed and occupied project multiplied by 100%. Conventional lenders look for an LTV that isn't higher than 75% to 80%.

**Loan-to-cost (LTC).** This ratio is the loan amount to the total project cost from the time of acquisition to project completion. Because lenders are often wary of preconstruction appraisals, they may also look to the LTC in their underwriting evaluation. Project costs fall into two categories: predevelopment and development. Predevelopment costs include all expenses before actual construction, including architectural, engineering, survey, legal and permit work. They can also include land acquisition and demolition costs. Development costs encompass expenses from site preparation through construction, including materials, labor, insurance and taxes.

Traditionally, lenders require that the developer have not less than 20% equity in the project. This equity often takes the form of free-and-clear land. In the current economic climate, lenders may require even higher contributions from developers.

### Divining Debt Coverage

Lenders also scrutinize the project's debt-service coverage ratio. This involves calculating the net income for the completed project to determine if it's sized appropriately for the proposed loan payments. The acceptable minimum threshold for this measure is 1.25 for multifamily transactions or commercial real estate with not less than 60% preleasing to creditworthy anchor tenants. Typically, the debt coverage ratio will be higher for single tenancy, single use properties and multitenant commercial properties.

*You can also count on your lender to size up your net-worth-to-loan-size ratio. Your net worth should be at least as large as the loan amount. Be prepared to provide lenders with information explaining where preconstruction money was spent and the sources for those funds.*

Also be aware of some of the red flags lenders look for in sizing up a project. For instance, is the land value based on its purchase price or on its current market value? If you list the land value as higher than the purchase price due to improvements, expect lenders to closely scrutinize that claim. They typically look at the site's condition and the purchase price and whether improvements by the borrower add up to the higher market value listed.

A higher value may be justifiable, for example, if the developer assembled several parcels together to form the development site, but it won't be justified for costs incurred while demolishing an existing building.

### **Construction Conditions**

Beyond the various financial ratios, expect lenders to require an array of conditions and provisions in the construction and loan documentation to ensure the project is constructed well, within budget and on time. Among the terms lenders are likely to negotiate are:

- Contract time provisions,
- Use of the property,
- Detailed costs,
- Caps on change orders and cost overruns,
- Provisions for dispute resolutions, and
- Bonding for contractors.

Lenders also want contracts that are assignable to facilitate completion of the work should you default on the loan. And they'll also consider your experience and history both in the market area and with the type of project being developed, as well as with the financial institution.

### **Going It Alone? Not a Good Idea.**

As you can probably tell, borrowing money for a construction project can be complicated. A misstep could cost you big-time. Pull together a team of advisors including your CPA and a real estate attorney to help guide you through the process.

#### **GETTING A LOAN? HERE'S WHAT YOU'LL NEED.**

To help smooth out your next construction loan application process, you'll need these documents:

- Personal and development team résumés,
- Project plans and construction contracts,
- Project cost breakdown and cash flow statement,
- Preleases where available/applicable,
- Appraisal report and warranty deed on property,
- Environmental assessment and property condition report,
- Articles of incorporation or partnership agreement, along with certificate of good standing from the Secretary of State's office,
- Three years of financial statements and tax returns for the corporation or partnership, and
- Personal tax returns and financial information.

## **FRACTIONAL FACTS: GET A SLICE OF THE LATEST RESORT INDUSTRY TREND**

Fractional ownership is one of the hottest trends in the resort industry. And with good reason: Investors enjoy most of the benefits of time-share ownership along with upscale flair and flexibility.

### **What's All the Buzz?**

Increasingly, large resort companies such as Marriott, Ritz-Carlton, Hyatt and Disney are adding fractionally owned rooms and residences to their resort development mix to meet growing demand for this unique ownership structure for luxury vacationing. And now, a new hybrid of fractional ownership has come on the scene: Companies are providing fractional ownership on smaller-scale luxury properties, including individual vacation homes and condos.

While the resale track record of fractionally owned developments is still untested, it's an option that a growing number of developers are considering.

## Are They Different From Time-Shares?

Don't mistake fractional ownership as just a new name for time-shares. They're two different animals.

One big distinction is that fractional owners actually "own" a slice of the property for which they are putting down money. They have deeded rights to the purchased villa, cabin or resort suite and own it indefinitely, until they choose to sell it. By contrast, time-sharing is a lease of the property that extends over a set period of time, such as 15 to 30 years.

Of course, owning the property still comes with certain restrictions. Buyers can't decorate the property to their taste. And they must coordinate their use of the premises with other owners. Which leads to another difference between fractional ownership and time-sharing: Fractional owners have more flexibility regarding when they're entitled to use the resort.

The actual process depends on the development, but fractional owners aren't restricted to the same one-week time slot each year that timesharers often are. Owners may be able to choose their visits according to a rotating priority process, or use the premises far more than the prescribed number of weeks, depending on availability. Old Greenwood Fractional Residences in Lake Tahoe, Calif., for example, allows owners to reserve vacation weeks in advance on an unlimited basis, subject to availability. At the Ritz-Carlton Residence Club in Beaver Creek, Colo., fractional owners buy a one twelfth interest, entitling them to three weeks a year. Prices range from \$195,000 to \$490,000, plus some \$10,000 in annual fees. Perhaps the most important distinction is the luxury experience.

Fractionally owned resort properties are on the A-list of the luxury resorts to which they're attached. So owners aren't just getting the advantage of a properly maintained and securely kept property; they also enjoy concierge service, housekeeping, and full use of resort amenities such as pools, spas, ski resorts and championship golf courses.

## STIMULUS ACT BENEFITS INVESTORS AND DEVELOPERS

On Feb. 13, 2008, President Bush signed into law the Economic Stimulus Act of 2008. While the act's "recovery rebate" provision has received the lion's share of publicity, three less publicized provisions could be very important to your business and personal finances:

**Section 179 enhancements.** To spur additional investment, the act increases the Section 179 limit for initial year expensing to \$250,000 (from \$128,000). The Sec. 179 expensing election allows a current deduction for newly acquired tangible personal property assets that otherwise would have to be depreciated over a number of years. The expensing election begins to phase out dollar for dollar when total asset acquisitions for the tax year exceed \$800,000 (up from \$510,000 before the act). The new higher limits apply only for calendar year 2008 or a business's fiscal year that begins in 2008. As in the past, a business can claim the expensing election currently only to offset its net income, not to reduce net income below zero.

**Bonus depreciation.** Another provision offers a special allowance for certain qualified property, generally only if acquired and placed in service in 2008. This is in addition to any such property that qualifies for Sec. 179 expensing. For eligible property, the special depreciation amount is equal to 50% of its adjusted basis. Property that qualifies for this special depreciation includes tangible property with a recovery period of 20 years or less, computer software purchased by the business, water utility property, and qualified leasehold improvement property.

**Loan limit increases.** The act also increases from \$417,000 to \$729,750 the dollar limit on loans that may be issued by the FHA and that Fannie Mae and Freddie Mac can purchase. The increases are in effect for loans made or approved for origination through the end of 2008, after which the previous loan limits will apply once again.

## **ACHIEVE FINANCIAL GOALS BY SHIFTING INCOME AND DEDUCTIONS**

Whatever your role is as a real estate professional, it's important to understand the role your tax situation plays in your business and personal finances. One important transaction involves the transfers of a partnership interest between family members. Whether it's a family limited partnership created to make gifts, or an existing real estate partnership within which transfers are being made, shifting income or deductions from one family member to another typically isn't the driving force behind the transaction. However, that doesn't mean that the income tax pitfalls or potential benefits of such a transfer should be ignored.

### **Throwing a Wrench in the Works**

Recent changes in the "kiddie tax" law have whittled away at the benefits of shifting income to lower tax bracket youngsters. Nevertheless, there are still opportunities to shift taxable income from a higher-income tax bracket taxpayer to a lower one. This can be an added bonus for many business-motivated or estate planning strategies. Be aware, however, of the pitfalls of transferring partnership or limited liability company (LLC) interests that own rental real estate, which is expected to operate at a loss for tax purposes for a period of time. For one, you may be transferring losses to a taxpayer who doesn't have enough income to absorb the loss or to one whose tax benefit would be at a significantly lower rate. For example, if you're in the 35% tax bracket and you shift \$25,000 in annual losses through a gift to your 24-year-old daughter in the 15% tax bracket, there's a 20% differential in tax rates, resulting in \$5,000 less tax benefit from the loss. Even worse, your daughter may not be able to currently deduct any of the loss because of the passive activity rules. You may have other passive income or qualify as a real estate professional for whom losses are deductible. But if your daughter isn't involved in the business, she may not have other passive income and typically won't qualify.

### **Giving While Avoiding Problems**

Fortunately, you can still make a gift of a partnership or LLC interest and avoid any unintended income tax problems. One way is to make gifts via an "intentionally defective" trust. Instead of transferring the interest to an individual, you transfer it to a trust designed to be an effective transfer for gift and estate tax purposes, but not for income tax purposes. So, while you have given away the asset, you (as donor and grantor of the trust) continue to pay tax on the income or get benefit of the losses from the interest owned by the trust. Another way around potential income tax problems is to create a special allocation of losses within a partnership or LLC. Unlike S corporations, partnerships or LLCs are flexible and aren't required to allocate income or loss in the same proportion as ownership. A 17% owner, for example, doesn't need to be allocated 17% of the current year loss, as long as the agreement provides otherwise. However, the allocation must have "substantial economic effect" as described in the tax law. At some point in the life of the partnership, these allocations must either reverse themselves or cash distributions must follow the tax allocations. Because the IRS may scrutinize these allocations, involve your CPA and attorney in the process of drafting the partnership agreement.

### **Planning Saves the Day**

The income tax impact of a transfer can be significant. While income taxes typically won't be the driving force behind a transaction, they shouldn't be ignored either. With a bit of additional planning, you can make sure that you won't get an unpleasant surprise when income tax time arrives.

## **ASK THE ADVISOR**

### **Are medical office buildings a good investment now?**

The medical office building segment has emerged as an attractive investment option in the highly competitive office real estate market. Why? The biggest reason is that the baby boomers are fueling, and are expected to continue to fuel, a demand for health care services.

### **Facts Are Facts**

According to the U.S. Census Bureau, the United States will have 77 million people over the age of 55 by 2010, up 29% from 2000. And the Bureau expects the over-55 population to jump to 98 million by 2020.

As medical service businesses continue to expand to serve that population, so too will demand for office space to house them. A recent study by the National Association of Realtors (NAR) found that the health care service sector is expected to be the fastest growing office-using employer through 2014. The NAR projects that 1.9 million office-using health care jobs will be created in the next decade.

### **Trends Buoy Demand**

Several other trends in health care also are increasing demand for medical office space. Shorter hospital stays mean more patients get follow-up care in medical office settings, for example. And with improved medical technology, more medical procedures are being performed outside hospital settings in medical office facilities.

With these trends, the medical office sector has evolved from a minor side business for hospitals to an independent real estate niche. Investors only began to notice this subset of the office market a few years ago. Prior to that, the medical office sector had remained largely unnoticed, partly because it lacked the glamour of towering, glass-encased office buildings and partly because it required somewhat unique features—including more complex plumbing and power capacity.

In the past few years, the prices for medical office buildings have escalated as investors and developers have recognized the potential of the niche. But that hasn't put a damper on occupancy rates for, and yields on, medical office buildings.

### **The Tenant Factor**

The typical tenure of a medical office tenant is 11 to 14 years, according to the *National Real Estate Investor* magazine, making the medical office market more stable than the general office segment. Tenant retention rates for medical office buildings tend to be higher because physician groups often locate near hospitals and are reluctant to move from an established location.

Moreover, while medical services can sometimes be affected by fluctuating Medicare reimbursement policies, physician groups are expanding the revenue producing services they offer to include noninsured services, such as cosmetic procedures. Also, the growing population in need of health care is expected to offset such reimbursement setbacks.

### **Time to Set Sail**

If you're concerned that you may have missed the first wave of the medical office building market, Andrew Uchida of real estate services giant CB Richard Ellis offers this consolation: "The first large wave of baby boomers to reach 65 is 10 years away. Investors have not missed the boat."

If you have any questions, please contact **Harry Moehringer, CPA, Partner-in-Charge** of the Marks Paneth & Shron LLP Real Estate Group at 212-503-8904 or [hmoehringer@markspaneth.com](mailto:hmoehringer@markspaneth.com).

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