

## **REAL ESTATE ADVISOR: STRATEGIES TO MAINTAIN — OR GROW — PROPERTY VALUES JUNE 2010**

### **COMMERCIAL REAL ESTATE LOAN WORKOUT GUIDANCE**

With the ongoing credit crunch, even borrowers that remain creditworthy — despite a decline in their financial condition — have been challenged by the reluctance of some lenders to pursue workouts for commercial real estate (CRE) loans.

Federal bank regulatory agencies have responded by releasing the Federal Financial Institutions Examination Council's *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, which encourages "prudent" workouts that will benefit both the financial institution and the borrower. The statement also provides guidance to assist bank examiners when they evaluate lenders' efforts to renew or restructure loans to creditworthy CRE borrowers. (The policy was issued in October 2009 and reissued in February 2010.)

#### **The prudent workout plan**

One critical component that an examiner will require for a restructured CRE loan is a "well-conceived and prudent workout plan." The plan must scrutinize current financial information of the borrower and assure the collection of principal and interest.

The statement explains that the key elements of a workout plan include updated and comprehensive financial information of the borrower, real estate project and any guarantor; current valuations of the collateral supporting the loan and the workout plan; analysis and determination of appropriate loan structure (such as the term and amortization schedule), curtailment, covenants or remarking requirements; and appropriate legal documentation for any changes to loan terms. Borrowers that provide data related to these elements to their lenders upfront might expedite negotiations.

#### **The borrower's repayment capacity**

Under the statement, a bank examiner's review of a CRE loan will focus mainly on whether the borrower is able to repay the loan. Major factors include the borrower's willingness and capacity to repay the loan under reasonable terms and the cash flow potential of the underlying collateral or business.

When assessing a borrower's repayment ability, the examiner will consider:

- The borrower's character, overall financial condition, resources and payment record,
- The nature and degree of protection provided by cash flow from business operations or collateral, on an overall basis that considers how the borrower's total debt obligations will affect cash flow,
- Market conditions that may influence repayment prospects and the cash flow potential of the business operations or underlying collateral, and
- The prospects for repayment support from any financially responsible guarantors.

Savvy borrowers will present their lenders with strong evidence related to all of these factors.

#### **The value of collateral**

The federal regulators' statement squarely places on lenders the responsibility for reviewing current collateral values to ensure their assumptions and conclusions are reasonable. A new or updated appraisal, whichever is deemed appropriate, should consider current project plans and market conditions when developing the workout plan.

Specifically, the appraisal is expected to consider whether there has been a material deterioration in the performance of the project or conditions for the geographic market and property type; variances between actual conditions and original appraisal assumptions; changes in project specifications (converting a

planned condo project to an apartment building, for example); loss of a significant lease or a take-out commitment; or increases in presales fallout.

According to the statement, a new appraisal may not be necessary if a lender's internal evaluation appropriately updates the original appraisal assumptions to reflect current market conditions and provides an estimate of the collateral's fair value using impairment testing analyses.

### **The statement and your workout**

Borrowers that understand bank examiners' expectations for lenders (as outlined in the federal policy statement) may be better able to navigate workout negotiations by preparing the necessary financial data in advance. For further guidance, borrowers can review Attachment 1 of the policy statement for examples of several types of prudent CRE workouts, including renewals or extensions of loan terms, extensions of additional credit, and restructurings with or without concessions.

#### **Valuing income-producing properties**

In some circumstances, bank examiners will need to determine the degree of protection provided by a restructured loan's collateral, which may result in adjustments to the collateral's value. According to the statement recently released by federal bank regulators (see main article), when reviewing the reasonableness of the facts and assumptions used in valuing an income-producing property, examiners will evaluate:

- Current and projected vacancy and absorption rates,
- Lease renewal trends and anticipated rents,
- Effective rental rates or sale prices, considering sales and financing concessions,
- Time frame for achieving stabilized occupancy or sellout,
- Volume and trends in past due leases,
- Net operating income of the property as compared with budget projections, reflecting reasonable operating and maintenance costs, and
- Discount rates and direct capitalization rates.

The statement instructs examiners to give a reasonable amount of deference to assumptions that were recently made by qualified appraisers. In some instances, an examiner may decide that an updated appraisal is needed to sufficiently evaluate these factors.

The Real Estate Services Group at Marks Paneth & Shron can offer guidance on a variety of matters related to workouts. In addition to economic and financial analyses, we can advise on the tax issues associated with workouts, foreclosures, bankruptcies and other complex transactions.

## **KEY STRATEGIES TO MAINTAIN — OR GROW — PROPERTY VALUES**

Commercial real estate has been hit hard by the recession, and many owners have struggled with falling property values. By implementing some simple property management strategies, you can help maintain or even increase the value of your properties. Here's how.

### **Cost reduction**

The value of commercial real estate often is a function of the property's net operating income (NOI). NOI equals gross rental income less vacancy and operating expenses. One way to maximize NOI is to reduce expenses.

Commercial properties are often ripe with expenses that could be reduced. You might, for example, adjust energy-related expenditures, such as your automated energy management system. Don't just set the start and stop times but also adjust the settings to take advantage of downtimes such as weekends and holidays if you don't already do so.

A surprising amount of energy is consumed overnight, when buildings are essentially unoccupied. Train your cleaning staff to turn off lights when they finish a room, or install sensors that will automatically turn them off. Copiers, printers and other office equipment should also be turned off at night. And building fans and motors probably don't need to run nonstop around the clock.

Reducing energy costs may also fuel tenant satisfaction. In fact, research indicates that environmentally friendly practices improve tenant satisfaction, while simultaneously boosting property value. A recent tenant satisfaction survey conducted by Kingsley Associates found that 44% of respondents ranked a sustainable green building operation as "important" or "very important."

Speaking of tenants, when was the last time you examined your properties' monthly utility and water bills to ensure that you have been charging your tenants properly for their consumption? Be sure to watch for unusual spikes in usage.

It can also pay to revisit your service contracts. Rebidding or renegotiating contracts may lead to cost savings, particularly if you take advantage of economies of scale by hiring the same contractor to service multiple properties.

Reconsider your internal maintenance, too. Do you take a preventive approach to maintenance, abiding by a time-based schedule? You might consider adopting a predictive approach that relies on statistics and past experience to determine the optimal intervals for servicing equipment.

Other expenses worth evaluating include real estate taxes and insurance. If property values decrease, you should pay less in taxes and insurance premiums. But reassessments aren't automatic. You'll need to contact your certiorari attorney and insurance agent for adjustments.

Moreover, it may be an opportune time to refinance debt. Rates are lower than they were 5 years ago, and banks may be willing to negotiate if the property is above water and the borrower is creditworthy.

### **Tenant retention**

It's much more economical to hold on to existing tenants than to land new ones. Retaining tenants requires keeping them happy.

Regular communication is critical. Answer your phone and respond to e-mails promptly. Consider conducting annual tenant surveys to determine whether they're satisfied and if they see areas that could be improved. At the very least, a survey shows that you value the tenants' opinions.

Your employees will probably constitute the front line of tenant relations. So, develop an incentive structure that encourages them to provide outstanding service. And then reward and recognize those who go the extra mile.

Finally, remember that janitorial and HVAC issues usually top the list of tenant complaints. By keeping a close eye on these services, you can preempt many problems.

### **Beyond mere survival**

You've made it this far, even saddled with declining property values. Now's the time to start thinking about how you can increase NOI, and therefore, value — in an improving or stagnant market.

## **USE A COST SEGREGATION STUDY TO ACCELERATE DEDUCTIONS**

As a real estate professional, you've undoubtedly looked for ways to get faster write-offs from your properties in order to minimize income taxes in this sluggish economy. Well, there's good news: If you've recently purchased or built a new building, or even substantially remodeled an existing building that you own, faster write-offs are only a cost segregation study away.

### **Why a cost segregation study?**

Real estate can be segregated into four basic categories of property: buildings, land, land improvements and personal property. Buildings are generally depreciated over 27.5 (residential rental) or 39 (commercial) years using the straight-line method, whereas land isn't depreciable.

On the other hand, you can typically depreciate land improvements over 15 years and most personal property (furniture, fixtures, certain equipment) over five or seven years. Often, however, these property components are misclassified as part of the cost of buildings.

A cost segregation study identifies property components and their cost, allowing you to maximize your current depreciation deductions by using the shorter lives and faster depreciation rates available for the qualifying parts of the property. For example, if \$4,000,000 of assets were reclassified as seven-year vs. 39-year property, your depreciation deduction in the first year, assuming the building was placed in service around midyear, would increase from around \$50,000 to over \$570,000.

### **Classifying property**

There are no hard-and-fast rules for distinguishing personal property eligible for accelerated depreciation from structural components that must be depreciated as part of the building. The answer depends on a number of factors, including how the property is affixed to the building, whether it's designed to remain in place permanently, and how difficult it would be to move or remove.

Examples of personal property that can qualify for a faster depreciation deduction include decorative fixtures, cabinets and shelves, movable wall partitions, carpeting, security equipment and so forth. Even certain plumbing, wiring, and heating and air conditioning vents and lines — which you'd normally think of as part of the building — may be eligible for shorter lives if they're specifically required for equipment that has a shorter life (such as wiring for the security system). You can also depreciate the allocated portion of certain capitalized indirect or overhead costs — such as architectural and engineering fees.

Examples of land improvements you can isolate with a cost segregation study include parking lots, sidewalks, fences and landscaping.

### **Be mindful of limitations**

Consider a cost segregation study when you buy, build or remodel — or when you have done so within the last few years. But be mindful that the overall benefit of a cost segregation study may be limited in certain circumstances, such as when the business is subject to the alternative minimum tax (AMT) or is located in a state that doesn't follow federal depreciation rules. Passive activity loss rules can also defer the benefits.

The cost of the study generally pays for itself if the building or remodeling expenditures are fairly substantial and were completed or purchased fairly recently.

### **Bring in the experts**

Because cost segregation studies have so many variables, it's critical that you retain the services of a cost segregation expert. He or she will work with a valuation professional to tour the property and inventory its components to create a report of the assets; prepare the necessary forms to be filed with the IRS requesting an automatic change in accounting method and crunch the numbers. If you've bought, built or remodeled property fairly recently or are in the midst of doing so today, you owe it to yourself to explore how a cost segregation study can help you reap faster tax write-offs.

#### **Could a cost segregation study trigger an audit?**

Some business owners forgo cost segregation studies for fear of getting audited although, typically, a cost segregation study does not trigger an audit. But you'll be well prepared for an audit if the cost segregation study is performed by an experienced and competent tax or financial advisor.

Marks Paneth & Shron's dedicated real estate advisors have extensive experience with cost segregation studies, ranging from residential rental properties and warehouses, to premiere office buildings, to

complex multi-billion dollar power plants. If you would like to determine if you would benefit from a cost segregation study, please feel free to contact your MP&S advisor or anyone in our Real Estate Services Group.

## **SPOTLIGHT ON MP&S**

### **Business Solutions for Privately Held Companies and Their High-Net-Worth Owners**

Marks Paneth & Shron has assembled a team of specialists to advise high-net-worth owners of privately held companies. Our professionals are fully conversant in the unique needs of companies in this space and can help identify problems, particularly in the current economic climate, and assist in making the appropriate business decisions when principals face turnaround scenarios.

### **International Accounting Training**

Working with the new organization Acumen Global Training LLC, MP&S specialists provide US and international accounting training. Instruction is offered on a wide variety of topics including International Financial Reporting Standards (IFRS) and International Public Sector Accounting Standards (IPSAS) as well as fraud and forensic accounting. Courses are customized to meet the specific needs of each business.

## **Thought Leadership**

### **Reducing IT Expenses**

With the economy hurting the donor base of nonprofit organizations, charities need to reduce expenses and allocate the optimal amount of resources to achieving their mission. Richard Nathan, MP&S Principal and President of the firm's wholly owned subsidiary, Tailored Technologies, which provides external technology and management consulting services, has written an article for the *Philanthropy Journal* to help nonprofits evaluate their existing information technology environment reduce inefficiencies and achieve cost savings.

### **IFRS Roundtable**

The globalization of financial markets has intensified the need for a unified set of accounting principles. As the US braces for the roll-out of International Financial Reporting Standards (IFRS), companies face the benefits and challenges of implementing a single standard. Along with panelists from around the US and abroad, Steven Henning, Partner-in-Charge, Litigation and Corporate Financial Advisory Services, discusses the key arguments that support a global convergence of accounting principles.

### **Audit Might Be Best Choice for US Taxpayers in Voluntary Disclosure Program**

In a recent *Tax Analysts* article, David Gannaway, Director, Litigation and Corporate Financial Advisory Services, discusses why US taxpayers who enrolled in the IRS voluntary disclosure program may find it in their best interests to challenge the IRS penalty through an audit.

## **People in the News**

### **New Head of MP&S Westchester Office**

Michael L. McNee, Partner-in-Charge of the MP&S Nonprofit and Government Services Group, is now also the Partner-in-Charge of the firm's Westchester office, which is located at 660 White Plains Road in Tarrytown. *The Westchester County Business Journal* ranks Marks Paneth & Shron as the 7th largest firm in Westchester.

### **MP&S Director Receives AICPA 2010 Outstanding Discussion Leader Award**

Managing Tax Director Rob Lyons has received the American Institute of Certified Public Accountants (AICPA) 2010 Outstanding Discussion Leader Award. This award recognizes the discussion leaders who achieve the highest overall instructor knowledge and presentation scores in leading AICPA seminars. Recipients are eligible for the award after teaching four different courses at least two or more times during

the CPE year (May-April). Minimum overall instructor knowledge/presentation skills scores are 4.80 on a 5.0 scale.

### **Leading Tax Specialist Joins the Firm**

Jeanne Goulet has joined Marks Paneth & Shron as a Senior Consultant in the Tax Practice. With more than 25 years of experience in both industry and public accounting, she possesses a deep understanding of the tax issues related to e-commerce and the internet. She is also very knowledgeable about international tax matters including worldwide tax planning and transfer pricing and served as an advisor to the Organisation for Economic Co-operation and Development.

## **ASK THE ADVISOR**

### **How can I hold on to overleveraged properties until the market picks up?**

Many owners and investors are juggling unprofitable projects and properties that are saddled with debt that exceeds their value. They may want to hold on to the real estate because of its potential long-term value but find that refinancing isn't a realistic option. Other options, however, are available.

#### **Restructure debt**

Renegotiating with the lender to obtain extended terms is often the preferred option. By reducing your payments now, you might be able to stay current and recoup the property's value when the market improves.

But, debt restructuring that includes the forgiveness of debt can result in taxable cancellation of debt (COD) income for the debtor and, in turn, an unexpected tax liability, if not structured properly.

#### **Raise capital**

Another option to consider is admitting a partner who can help you pay down the debt. Additional capital could also provide a financial bridge between the loan amount and the property's value, opening the door to refinancing.

Partners ranging from institutional investors to friends and family can improve the balance sheet and help you hold on to the property, albeit at the cost of forfeiting a portion of any eventual profits. The ultimate tax cost of the transaction should be weighed against the immediate benefits.

#### **Partner with your lender**

Your lender might be willing to exchange debt for equity in the property. Again the arrangement could lead to COD income for the partners (although some exceptions might apply).

The partnership is considered to have paid off debt in exchange for the fair market value of the interest conveyed to the lender — any excess is deemed forgiven of debt.

#### **Consider whether bankruptcy is the right option**

Some owners will have to face the hard fact that it might not be advisable to hold on to their properties. When the property is subject to recourse debt or there are personal guarantees in place, the best option might be to file for bankruptcy.

Deciding whether to file for bankruptcy calls for some extensive legal and financial analysis with input from attorneys and valuation and tax experts. You must consider all of the assets that will be exposed to creditors, as well as the assets' ability to generate immediate or future income.

You may conclude that simply disposing of another asset will allow you to satisfy your debt service obligations on the overleveraged property.

#### **Don't go it alone**

Each of these options comes with some complicated tax implications. Work with a qualified tax advisor to determine the best route to position you to take advantage of a market turnaround in the future.

## FOR FURTHER INFORMATION

If you have any questions, please contact **Harry Moehringer**, Partner-in-Charge of the **Real Estate Services Group** at 212.503.8904 or [hmoehringer@markspaneth.com](mailto:hmoehringer@markspaneth.com) or any of the other partners in the MP&S Real Estate Services Group:

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Additional information on the Marks Paneth & Shron Real Estate Services Group can be found at [www.markspaneth.com](http://www.markspaneth.com).

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