

MP&S REAL ESTATE ADVISOR: LEASING STRATEGIES YOU NEED TO KNOW ABOUT

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A NEW SAFE HARBOR

IRS floats a solution for dealing with bankrupt qualified intermediaries (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 property held for productive use in a trade or business or investment property (the relinquished property), for a like-kind 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 QI’s, 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 MP&S advisor 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 slowly shows some 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 structure the deal exactly the same way as the structure 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 prenegotiated 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, as interest rates rise, 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 legal counsel.

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 leases have turned into complex documents, both tenants and landlords should seek professional advice as they negotiate leases. 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.

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, maintenance, capital expenditures that result in cost savings, such as energy efficient equipment, and those expenditures required by law (including local laws or future federal laws). The lease should also specify what is considered a capital improvement so that there is little room for interpretation down the road.

For retail tenants, take part in their upside with leases that not only require base rent, but also provide for a percentage of the tenant's gross sales. To maximize cash flow, ensure that the tenant is required to report gross sales to you at least quarterly, if not monthly, for larger tenants. A retail lease should also contain provisions that provide for the tenant to maintain certain internal controls that will help to prevent underreporting of gross sales, including but not limited to, the use of electronic cash registers which maintain an "audit trail" of all transactions entered and allow for restrictions on who has the ability to void sales.

If the lease allows the tenant to sublet their space, the landlord should share in the subletting profits. Make certain that this point is covered in the lease agreement.

3. Incorporate an expense stop or escalation clause 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 to the extent of the tenant's pro-rata share.

Expense escalations allow an owner to bill the tenant for its pro-rata share of increases in operating expenses over a base year amount.

For commercial leases, gross-ups of expenses to reflect a specified level of occupancy (say 95% or 100%) should always be included. When calculating base year expenses, be sure to include all

escalatable amounts. While there might be a tendency to understate base year expenses, in future years the tenant could challenge the increase in operating expenses if they are being billed for an expense in the current year when there was no such like-kind expense in the base year.

4. Be ready for challenges from lease audit specialists

Tenants may call in their own lease audit specialists to help detect expensive errors in lease billings sent to the tenant. Lease audit specialists are typically hired to ensure that the tenant is charged for expenses specified in the lease only; check space measurements, and examine insurance and related party transactions.

To minimize the chances of a tenant's lease audit specialist finding a mistake, hire your own lease audit specialist to review your billing practices and procedures. Catching mistakes yourself may be far less costly than letting your tenant find them first. In fact, a lease audit specialist might uncover hidden revenue opportunities in your leases that you overlooked.

5. 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, boilerplate 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..

6. 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.

SPOTLIGHT ON MP&S

Tom Engelhardt is a 2010 recipient of the *New York Enterprise Report* "Best Accountants for Growing Businesses" award. Mr. Engelhardt, a partner in the firm's Accounting and Auditing Group, was recognized by the publication for his consulting and advisory work with a leading New York City branding agency which he helped remain financially viable during the economic crisis. Mr. Engelhardt was honored at an awards reception sponsored by Citibank on June 29, 2010 at the Trump Soho in New York.

Richard Nathan Appointed to Board of Charity Navigator

Richard Nathan, Principal at MP&S and founder of Tailored Technologies, the firm's wholly-owned technology and management consultancy, has been appointed to the board of Charity Navigator, America's largest evaluator of charitable organizations. In this role, Mr. Nathan will help set strategic direction for Charity Navigator and leverage his 25 plus+ years of experience serving the business and nonprofit communities to identify opportunities that will enable charities to use technology effectively and efficiently.

Don May Publishes Intelligence on Role of Valuation in Securities and Hedge Fund Litigation

Don May, Ph.D., Director in the Litigation and Corporate Financial Advisory Services Group at MP&S, has authored two thought pieces on the distortion of common Wall Street style valuation techniques and the critical role that proper valuation plays in hedge fund and securities-related litigation. The articles, which

published in the *Securities Litigation Report* and the *Hedge Fund Law Report*, are available in the MP&S Library.

Privately Held In Distress

Like all businesses, privately owned companies have been hard hit by the recession. Owners and entrepreneurs are struggling with a drastically reduced base of business, operations that are out of sync with the times and the overhang from an infrastructure that was built for the boom years, not the lean years.

But unlike many leaders of large businesses, private business owners are often reluctant to declare an emergency – or are in denial that one even exists. Pride and passion – the same qualities that helped them launch and build the business – can become liabilities when conditions turn bad. Lawrence Cohen, Executive Consultant at Marks Paneth & Shron, has written a white paper that explores this topic in detail. The paper is available in the Marks Paneth & Shron Library.

ASK THE ADVISOR

WHERE ARE THE HIDDEN OPPORTUNITIES IN MY LEASE?"

MP&S Real Estate Partner Susan Nadler has authored an article in Commercial Investment Real Estate that provides property owners with guidance about uncovering hidden revenue opportunities and ensuring that property portfolios are yielding maximum returns in this difficult economy.

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.

FOR FURTHER INFORMATION

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