

MP&S REAL ESTATE ADVISOR: STRATEGIES AND SOLUTIONS FOR CONTINUING TO GROW YOUR REAL ESTATE BUSINESS

DECEMBER 2010

NEED FINANCING FOR A NEW PROJECT? LET TAX CREDITS COME TO THE RESCUE

When launching a new project, it might be difficult to secure financing from lenders if it would result in loan-to-value ratios that exceed current lending standards. On the right project, certain tax credits may help you generate the capital you need to bridge the gap. Here's a look at some valuable tax credits.

Housing projects

In today's environment, affordable-housing projects may be more attractive to developers because of low-income housing tax credits (LIHTCs). Under Internal Revenue Code (IRC) Section 42, the federal government gives state housing finance agencies the authority to issue LIHTCs to developers for the acquisition, rehabilitation or new construction of rental housing for lower-income residents and the provision for a 30% credit bonus for designated high-cost areas.

To qualify for the credits, a developer must:

- Rent at least 40% of the units to tenants with incomes equal to or less than 60% of the area's median income, OR
- Rent at least 20% of the units to tenants with incomes equal to or less than 50% of the area's median income.

But be wary of the compliance issues. Although it is a 10-year credit, you must conform to eligibility requirements for 30 years. You will need professional expertise to guide you in the original determination of "qualified basis" and future compliance to avoid stiff penalties.

The minimum required units must remain at the respective rental level for at least 30 years, and rent can be no more than 30% of the tenant's maximum eligible income as determined by HUD. Developers can otherwise design and manage the project as desired.

On new construction or rehabilitation projects that aren't financed with tax-exempt bonds, the annual tax credits are equal to approximately 9% of the amount of depreciable development costs for the first 10 years. The tax credits are generally about 4% for new construction or rehabilitation projects that are federally subsidized and for acquisition of eligible existing buildings.

Rehabilitated properties

Historical properties may be eligible for rehabilitation tax credits under IRC Sec. 47. The credits apply to costs incurred for the rehabilitation of qualified buildings. "Rehabilitation" encompasses renovation, restoration and reconstruction; it doesn't include enlargement or new construction.

The credits generally equal 20% of qualified rehabilitation expenditures (QREs) for certified historic structures and 10% for nonhistoric, nonresidential buildings placed in service before 1936. QREs include

the costs of work on the building, architectural and engineering fees, survey fees, and other construction-related costs added to the property basis that are reasonable and related to the services performed.

The rehabilitation must be substantial, meaning the QREs during a 24-month period (or, for a phased project, a 60-month period) must exceed the greater of the adjusted basis of the building or \$5,000.

New markets

The new markets tax credit (NMTC) program grants investors a tax credit on qualified equity investments in certified development entities (CDEs). The credit is claimed over a seven-year period at a rate of 5% of the qualified investment in each of the first three years and 6% in each of the last four years.

The CDE must make a qualified low-income community investment in the form of equity or a loan to a qualified active low-income community business (QALICB) within a year from when an investor makes the investment in the CDE. Most commercial and mixed-use development projects in low-income census tracts qualify as QALICBs.

Older buildings that qualify for such credits are often located in NMTC-qualified census tracts. Unlike rehabilitation tax credits, though, the annual dollar volume of NMTCs allocated by the federal government is capped, making the application process highly competitive.

From credits to equity

To generate equity for a project, a developer can form a limited partnership or limited liability company (LLC) with an investor. As an owner of the project, the investor can claim any applicable tax credits against its federal income tax liability.

In order to claim the tax credits, the investor must receive 99% or more of the profits from the project as well as depreciation tax benefits (which can be accelerated under a cost segregation analysis) to maximize the tax benefits to the investor and increase the resulting developer's fee. The developer, however, can structure the project so that he or she receives reasonable development and project management fees upfront, before sharing net profits with investors.

All of these tax credits are subject to recapture if certain requirements aren't satisfied. Once the credits vest, investors typically use a put option to transfer their interests in the project to the developer for a percentage of the equity they invested. If investors don't exercise their put options, most contracts allow developers to exercise a call option at fair market value.

Covering all your bases

Harnessing the power of tax credits can make the difference between a well-funded project and one that's just limping along. Beyond the tax credits mentioned, talk to your tax advisor about any federal and state tax credits that might also be available.

Trade tax credits for government cash

The American Recovery and Reinvestment Act of 2009 (ARRA) created a new energy grant program under which the Treasury Department makes payments for "specified energy property" in lieu of tax credits for renewable electricity production and solar energy. ARRA Section 1603 payments range from 10% to 30% of the property's basis, depending on the type of property.

The application deadline for construction which began in 2009 or 2010 must be submitted by Oct. 1, 2011. To qualify for the ARRA energy grant program, construction must begin before Dec. 31, 2010.

A safe harbor in the Treasury Department guidelines defines the beginning of construction as the point at which the taxpayer has incurred or paid at least 5% of the total cost of the property, excluding land and

certain preliminary planning activities. The property must be placed in service before the applicable “credit termination date,” which could be as far out as Jan. 1, 2017, for some types of specified energy property.

Specified energy property includes *only* tangible property, such as geothermal heat pumps or solar panels that is an integral part of a facility.

BE PREPARED: INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) ARE FAST APPROACHING

Since 2008, the United States has been slowly moving closer to adopting International Financial Reporting Standards (IFRS). Transitioning to IFRS from U.S. Generally Accepted Accounting Principles (GAAP) — which is seen by most experts as inevitable — could have significant consequences for real estate companies so be prepared for major changes.

The dawn of IFRS

Earlier this year, the Securities and Exchange Commission (SEC) announced that, come 2011; it will present a new roadmap for the transition to IFRS for public companies in the U.S. While this transition for U.S. public companies will not be required prior to 2015, in May 2008, the American Institute of Certified Public Accountants (AICPA) approved the use of IFRS for nonpublic companies.

At the same time, the Financial Accounting Standards Board (FASB) has been working with the International Accounting Standards Board (IASB) to *converge* IFRS and GAAP. Under this initiative, the two boards are striving to improve both sets of standards by narrowing the differences between them. While the SEC regulates only public companies, its adoption of IFRS could very well accelerate the adoption of IFRS by nonpublic companies, just as many provisions of the Sarbanes-Oxley Act did. Users of private businesses’ financial statements, such as lenders, may demand the use of IFRS so they can better assess the companies’ financial position, cash flows and performance. Fortunately, a pared-down version of IFRS for small and midsize businesses is available.

Potential effects

Adoption of IFRS could have widespread repercussions for financial reporting by real estate companies. Historically, IFRS has placed more emphasis on fair value than historical cost, requiring greater valuation expertise. In addition, GAAP is rules-based and prescriptive, and it comes with mountains of authoritative guidance; IFRS is principles-based and requires more judgment.

IFRS financial reporting could affect several critical areas, including:

Compensation. Different rules regarding revenue recognition could change the amount of commissions and performance incentives that are calculated based on revenue.

Investment properties. IFRS allows a company to account for investment properties either at historical cost or at fair value (FV) with unrealized gains and losses reported in earnings. Note that even if a company opts to continue with historical cost, it must still disclose the FV of the properties in footnotes, which could affect lenders’ assessment of the company’s creditworthiness.

Debt covenants. Covenants based on measurements under GAAP may need to be revised under IFRS.

Impairment of assets. GAAP takes a two-step approach to determine impairment losses while IFRS employs a one-step test that can lead to earlier recognition of losses. Further, under IFRS, long-lived assets must be reviewed annually for reversal indicators and an impairment loss must be reversed if recovery occurs. Under current GAAP, while impairment losses must be recognized, no subsequent write-ups are allowed if the value of the property increases in the future.

Real estate sales. IFRS lacks GAAP's detailed rules regarding accounting for sales of real estate. It treats such sales largely as it does sales of other assets with recognition triggered by the transfer of risks and rewards of ownership.

Making the transition

Transitioning to IFRS will take time and resources — likely more than you expect. Getting an early start might ease some of the associated headaches. The specialists in the Litigation and Corporate Financial Advisory Services Group at Marks Paneth & Shron are well qualified to provide comprehensive IFRS consulting services. Our firm can help real estate companies plan, prepare for and successfully transition from GAAP to IFRS.

SPOTLIGHT ON MP&S

John Bonora Receives CFF Credential

Director John Bonora has been awarded the Certified in Financial Forensics (CFF) credential by the American Institute of Certified Public Accountants. The CFF credential is granted to CPAs with considerable professional experience in financial forensics.

The Importance of the Forensic Accountant

Bankruptcy is rampant. According to the United States Bankruptcy Court, there were 1.4 million bankruptcy filings in fiscal year 2009, a 32 percent increase over 2008. Bankruptcy filings for 2010 are higher still. In a recent white paper, Director Sareena Sawhney discusses why forensic accountants should be an essential part of the bankruptcy team.

ASK THE ADVISOR

How are reportable income and deductions determined?

Determining rental income and deductions for federal tax purposes isn't always as straightforward as it might seem. Without an expert's eye keeping watch, sources of taxable rental income can be overlooked and deductions can be overstated. If such mistakes are uncovered in an IRS audit, they could prove costly.

Rental income

"Rental income" refers to more than just monthly rent payments. The IRS defines it as any payment received for the use or occupation of property, which can include:

Prepaid rent. This is any amount received *before* the period it's supposed to cover. Prepaid rent is included in rental income in the year received, regardless of the period covered or the method of accounting used.

Security deposits. Those held as final payment of rent are considered to be advance rent and included as rental income when received. If you keep part or all of the security deposit during any year because a tenant hasn't fulfilled the lease terms, that amount is included in your income for that year.

Lease cancellation penalties. The amount received upon cancellation constitutes rent. Therefore, it's included in your rental income in the year received.

Expenses paid by the tenant. If your tenant pays, for example, a garbage removal bill — when the lease doesn't oblige the tenant to do so — and deducts the amount from the normal rent payment, that amount is considered rental income. You can, however, take an offsetting deduction for the garbage removal expense.

Property or services received in lieu of rent. These are included in rental income at their fair market value.

Allowable deductions

Certain rental expenses are deducted from rental income, including mortgage interest, property tax, operating expenses, advertising, maintenance, utilities, depreciation and repairs.

But you can't deduct the cost of improvements that will add value to your property, prolong its useful life or adapt it for new uses. The cost of those improvements is recovered through depreciation.

You can deduct expenses paid by a tenant, as well as the fair market value of any property or services received in lieu of rent, if they're deductible rental expenses (and not required to be depreciated).

Peace of mind

The twists and turns in the U.S. tax code can create uncertainty when dealing with rental income and deductions. But a tax professional who's well versed in real estate matters can bring clarity to your tax situation. To ensure your own peace of mind, work with a pro.

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 or any of the other partners in the MP&S Real Estate Services Group:

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