

MP&S REAL ESTATE ADVISOR JUNE 2011: STRATEGIES AND SOLUTIONS FOR CONTINUING TO GROW YOUR REAL ESTATE BUSINESS

JUNE 2011

FHA LOANS TO THE RESCUE

If you're having trouble securing traditional financing for new residential projects, you might want to consider a tried-and-true source that has been somewhat overlooked in the past — the Federal Housing Administration (FHA) mortgage loan insurance programs. These programs facilitate long-term nonrecourse mortgages originated by FHA-approved lenders for certain multifamily housing projects.

Loan programs

The U.S. Department of Housing and Urban Development (HUD) offers several loan options, including:

Section 221(d)(4). This program insures mortgage loans for new construction or substantial rehabilitation of multifamily or cooperative housing for moderate-income families, the elderly and the disabled. Also eligible are single-room occupancy (SRO) projects (subject to commercial use and occupancy restrictions). You can put FHA financing to use on projects for detached, semidetached, row, walkup or elevator-type rental or co-op housing with five or more units.

The Section 221(d)(4) program has statutory mortgage limits that vary depending on the unit size, structure type and project location. The maximum mortgage value available is 90% of the HUD/FHA replacement cost estimate, for up to 40 years. Under Section 221(d)(3), however, nonprofit entities may receive loans up to 100% of the HUD/FHA replacement cost.

Section 207/223(f). This program insures long-term (up to 35 years) mortgages for the purchase or refinancing of existing multifamily rental housing, including manufactured home parks, that were originally financed with conventional loans or FHA-backed mortgages. To be eligible, a project's remaining economic life must be at least 10 years, but can't exceed 35 years or 75% of the economic life of improvements, whichever is less. Projects must contain at least five units that are outfitted with complete kitchens and baths. In addition, construction or substantial rehabilitation must have been completed at least three years earlier.

Section 231. If you're interested in rental housing for the elderly or disabled, this program insures mortgages to build or rehabilitate projects of eight or more units for up to 90% of the replacement cost (or projected value for rehab jobs). The maximum loan-to-value permitted for nonprofit entities is 100% of the replacement costs.

Section 220. This program provides insurance for loans on rental housing for urban renewal. It backs mortgages of up to 40 years on new or rehabilitated housing in designated urban renewal areas, code enforcement areas and other areas where local governments have undertaken designated revitalization activities.

The mortgages may be used for detached, semi-detached, row, walkup or elevator-type rental housing or to finance the purchase of properties that have been rehabilitated by a local public agency. Sec. 220 properties must include two or more units.

The Sec. 220 program has statutory mortgage limits, depending on unit size, structure type and project locations, as well as loan-to-replacement cost and debt service limitations. The maximum amount of the mortgage loan may not exceed 90% of the estimated replacement cost for new construction (or project value for rehab jobs).

Section 234(d). This program insures mortgages for the construction or substantial rehabilitation of condominium projects. Like the other FHA loan options, Sec. 234(d) mortgages are subject to statutory per-unit mortgage limits, depending on unit size, structure type and project locations, as well as loan-to-replacement cost and debt service limitations.

Davis-Bacon Act Requirements

If you pursue financing through any of the programs above, bear in mind that your contractors and subcontractors may need to comply with the Davis-Bacon Act (the “Act”). The Act requires contractors and subcontractors to pay laborers and mechanics employed at a covered worksite at least the local prevailing wages, including fringe benefits, for similar projects in the area.

Davis-Bacon wage rates are published by the Wage and Hour Division of the Department of Labor. Wages must be paid on a weekly basis. Contractors and subcontractors also must comply with various recordkeeping and reporting requirements.

Operating Loss Loans

With the real estate market still on shaky ground, the FHA’s insurance for two-year operating loss loans might make the programs described above even more appealing. The Section 223(d) program insures loans that cover excess expenses over project gross income during the first two years after completion of multifamily projects with a HUD-insured first mortgage. HUD may also provide an operating loss loan during any period of consecutive months (not exceeding 24 months) in the first 10 years after the date of completion.

Eligible projects can receive both loans but not for the same two-year period. Section 223(d) loan terms are limited to the unexpired term of the original mortgage.

Worth a Look

The FHA offers additional programs, including programs for nursing-home and assisted-living facilities. The requirements can vary significantly from traditional financing so meet with your financial advisor to become better acquainted with the rules and to map out your strategies.

Expediting the Process

Federal Housing Administration (FHA) insured loans typically take more time to close than traditional loans. If you need to expedite the loan process, see if your project might qualify for Multifamily Accelerated Processing (MAP). MAP is a “fast-track” processing system for the FHA multifamily mortgage insurance programs.

Lenders that participate in MAP are responsible for conducting most of the legwork, including selecting a qualified real estate appraiser and making a recommendation to HUD based upon their processing and underwriting. HUD reviews a lender’s exhibits and makes the final underwriting decision.

If approved, MAP may eliminate the need for developers to submit a site appraisal and market analysis application for new construction projects or a feasibility application for substantial rehabilitation projects.

DEALER VERSUS INVESTOR: IT’S A TAXING SITUATION

Juggling the daily ins and outs of the commercial real estate business, you might not give much thought to whether you’re a dealer or an investor. But the distinction can have a significant impact on your bottom line because of the different tax treatments associated with each category.

Why it matters

Real estate *investors* enjoy several tax advantages that aren't available to those deemed to be real estate *dealers*. Perhaps foremost, any gains on sales of investment property held long-term (more than one year) are subject to tax at capital gains tax rates.

Under Internal Revenue Code (IRC) Section 1221, real property held by a taxpayer for sale to customers in the ordinary course of a trade or business — that is, property held by a dealer — isn't a capital asset. Dealers, therefore, must treat gains as ordinary income, which is taxable at a substantially higher rate (up to 35% through 2012) than long-term capital gains (generally 15% through 2012, with higher rates applying to certain depreciation recapture).

Investors can also engage in tax-free Section 1031 (like-kind) exchanges and installment sale transactions that allow for the deferral of taxes, while dealers can't. And investors aren't required to pay self-employment tax on their gains.

It's not all bad news for dealers, though. Dealers' losses are considered "ordinary" losses; therefore, they aren't subject to the restrictions that limit the amount of capital losses a taxpayer can offset against ordinary income.

Actions Speak Louder Than Words-Dealer or Investor?

How does the IRS and the courts distinguish between an investor and a dealer for tax purposes? Generally, investors purchase properties and hold them with a long-term perspective. Dealers, on the other hand, purchase and then sell properties relatively quickly.

While the IRC does not have a "bright line" list of criteria for determining whether a taxpayer is a dealer or an investor, based on various court decisions, relevant factors used in making a determination have included:

- The extent of subdivision, development and improvements made to the property to increase sales;
- The value, volume and frequency of the taxpayer's real estate transactions;
- How long the taxpayer has owned the property;
- How the taxpayer holds itself out to the public (that is, as a dealer or as an investor);
- The nature and purpose for which the taxpayer acquired, held and sold the property;
- The nature and extent of the taxpayer's efforts to sell the property;
- Whether a business office and brokers are used to sell property;
- The character and degree of control by the taxpayer over the individual(s) who sells the property; and
- The extent of advertising the property.

You could even qualify as an investor for one property and a dealer for others, depending on how you structure your transactions.

Plan Ahead

Whether you're an investor or a dealer, your tax advisor can help you implement tax planning strategies that can assist you in structuring transactions to best accomplish your objectives, on taxes and otherwise.

REAL ESTATE SECURITIES AND YOUR RETIREMENT PLAN

The sheer number of long-term investments for your retirement plan can be mind-boggling. There's always the question: Will this investment be well suited for my long-term retirement goals?

Maybe you typically allow your investment advisor to make the decisions on what types of investments you have in your portfolio. But maybe you don't have to. That's because, as a real estate professional, you're uniquely qualified to invest in real estate as part of your personal retirement savings plan. But should you?

Why it makes sense

As a professional real estate investor or developer, you're already knowledgeable about real estate. You know what's "hot" and what's not. You have a keen sense of what will eventually turn a buck and what will likely flop. But, if you're accustomed to seeing commercial properties as current income-producers, viewing them as long-term investments for your retirement (or a child's college education) may require a shift in thinking.

And, of course, no investment advisor would advocate sticking with only commercial real estate, no matter how well you know the market or how long you've been in the business. Your portfolio still needs to be diversified among a variety of assets, such as stocks (both small- and large-cap), bonds and international securities.

This is particularly true if you're just now buying real estate securities. In many areas, real property values have nosedived in recent years, but most are likely to gain ground when the real estate market stabilizes. As a real estate professional, you also need to be careful not to expose too much of your net worth to real estate. When constructing a retirement portfolio, be sure to consider the properties you already own — including your personal residence — in the mix.

But the good news is: Real estate tends to be less volatile than stocks and doesn't necessarily move in tandem with bond or equity indexes, so it can potentially lower the overall risk of your portfolio.

Breaking it down

What types of real estate investments are well suited for a retirement plan? One option you might want to consider is commercial mortgage-backed securities, or CMBS, which are pools of mortgages secured by commercial property. They're designed so that investors receive regular payments. CMBS investments have built-in property and maturity diversification, which can help reduce the risk of losses on individual foreclosures.

Commercial real estate mutual funds are another investment possibility — in fact, they're probably the simplest and most liquid option available. Real estate mutual funds hold a varied basket of investments, which can include real estate investment trusts (REITs), real estate operating companies and cash. They have the potential to offer long-term returns and a steady current income.

Investing in a REIT could be a good option. A REIT is a company that owns a portfolio of income-producing real estate (an equity REIT) or finances real estate (a mortgage REIT). REITs are required to regularly distribute most of their profits to shareholders to retain their tax-exempt status. REITs may focus geographically or by type of property — for example, retail or residential. Like mutual funds, REITs tend to lower an investor's risk by owning a diverse pool of assets.

Work with the pros

If investing in real estate appeals to you as an estate planning strategy, do your homework and get advice from your advisor as well as a qualified estate planner.

ASK THE ADVISOR

Is a deed in lieu of foreclosure right for me?

The rocky landscape for commercial real estate has pushed many owners to the brink of foreclosure. For those who've fallen behind on their mortgage payments, though, a deed in lieu of foreclosure (DILF) may be a less cumbersome process.

What are the advantages?

A DILF offers several benefits to owners. The debt is *generally* forgiven completely, and a recourse borrower is released from all or part of its personal liability. Borrowers can pre-empt drawn-out and costly foreclosure litigation, and might be able to negotiate with the lender to cover certain expenses associated with transferring the property.

What can I expect from lenders?

DILFs hold some appeal for lenders, too — especially those wanting to take immediate possession. Most lenders, however, will make some demands — for example, they will typically require clear title, free of any liens, taxes or other claims or encumbrances. They generally aren't open to DILF arrangements unless the current owner lacks the financial strength to continue making payments, the owner has attempted to sell the property for a reasonable period of time, and the current fair market value is greater than the outstanding debt.

Most lenders also shy away from DILF arrangements on property with multiple liens, which foreclosure would simply eliminate. If the lender is willing to proceed despite possible lien issues, the borrower might need to provide warranties and representations that no lien claims will come against the lender based on the period the borrower owned the property. The lender might also require a new owner's title policy.

On recourse loans, lenders may require a cash payment in satisfaction of a portion of the debt. The lender, however, may wish to retain the ability to pursue the borrower and its guarantors for part of the debt.

The lender may require an environmental assessment report. Depending on the findings, the borrower might have to accept continued responsibility for future environmental liability. Finally, the lender will want to address issues related to the borrower's existing tenants.

How is the borrower protected?

Borrowers should secure a release of any personal or guarantor liability, along with a covenant to protect the borrower and its guarantors from deficiency judgments and lawsuits. Moreover, the borrower should include a provision prohibiting the lender from filing negative reports with credit agencies and requiring it to return the original promissory note.

Tax caveats

A DILF can produce unexpected tax consequences. A borrower could, for example, end up with taxable "cancellation of debt" income. So it's critical for borrowers to consult their tax advisors before making any decisions on foreclosures and DILFs.

SPOTLIGHT ON MP&S

MP&S PRACTICE LEADER COMMENTS ON THE GROWTH OF THE NONPROFIT SECTOR

The March 2011 issue of *Accounting Today* featured a special supplement that focused on the accounting industry. Mike McNee, Partner-in-Charge of the Nonprofit and Government Services Group and the Westchester Office of Marks Paneth & Shron LLP (MP&S), was asked to comment on the growth of the nonprofit sector as a specialized segment of the industry.

As the Big Four chose to reduce their focus on the nonprofit sector, this presented opportunities for mid-sized firms to expand the services they offer in this niche area. Mike noted that nonprofit clients now comprise nearly 10 percent of MP&S's entire practice. This increase has taken place over the last decade. Nonprofit and governmental entities are an important and valued service sector for MP&S.

The supplement also included *Accounting Today's* annual national ranking of the top 100 accounting firms. MP&S has risen to become the 30th largest accounting firm in the nation.

CASE STUDY: ASSESSING DAMAGES IN LOST WAGES CLAIM

When an employee is terminated, injured or for some other reason unable to work, what wages has he or she lost? What damages should be awarded? The question is central to thousands of personal injury claims each year. The answer is by no means straight forward.

Josefina Tranfa-Abboud, Director, Litigation and Corporate Financial Advisory Services, is often retained as a testifying economic expert in cases involving damages related to lost wages. At trial on a recent case, under direct examination she highlighted serious conceptual shortcomings in the plaintiff's economic expert's assumptions affecting the plaintiff's economic expert projections of lost wages. In a case study entitled "How Thoughtful Testimony from an Economic Expert Was Key in Multiple Million Dollar Lost Wages Suit," she discusses how the participation of an economic expert through economic damages analysis and testimony can make a decisive difference.

MP&S COMMENTARY AND PERSPECTIVES

Published Commentary and Perspectives from Marks Paneth & Shron Professionals contains selections of the firm's thought leadership output that were featured in leading journals, trade publications and/or our online library from the fourth quarter of 2009 through January 2011. The 20 articles in this compendium address real estate matters as well as subjects such as the new tax enforcement environment; valuation issues related to hedge fund dissolution; the boom in global start-ups and the importance of fresh-start reporting for companies emerging from bankruptcy. The collection is available in both print and electronically. To receive a complimentary copy contact marketing at marketing@markspaneth.com.

FOR FURTHER INFORMATION

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