

PERSPECTIVES ON REAL ESTATE LAW

LEGAL GROUNDS

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Sec. 1031 exchanges

Know the rules for
depreciating MACRS property

Need to finance
multifamily properties?
FHA loans to the rescue

Turbo due diligence for
today's real estate investors

Working it out: Deeds
in lieu of foreclosure

Minimize the costs
of your change orders



SEC. 1031 EXCHANGES

Know the rules for depreciating MACRS property

Section 1031 exchanges in the commercial real estate arena generally involve property subject to the modified accelerated cost recovery system (MACRS). If you receive MACRS replacement property in a Sec. 1031 — or like-kind — exchange, you must comply with the IRS's final Treasury Regulations for determining the amount of annual depreciation allowed.

The IRS issued the regulations in late February 2009 in response to past inconsistencies in how property was depreciated. Some owners depreciated replacement property with the same depreciation method, recovery period and convention as the relinquished property; others depreciated replacement property as if it were newly placed in service. The regulations recognize the basis as comprising both a depreciable exchanged basis and a depreciable excess basis in the replacement property.

Depreciating the exchanged basis

Basis remaining in relinquished property in a Sec. 1031 exchange is known as the *exchanged basis*. The recovery periods and depreciation methods used for the exchanged properties determine which depreciation rules apply to the exchanged basis.

For example, if the relinquished and replacement properties used the *same* recovery period and depreciation method, the replacement property is depreciated going forward applying the same period and method used for the relinquished property. If *either* the recovery period or the depreciation method for the replacement property is the same as the recovery period or the depreciation method for the relinquished

property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined using the recovery period or the depreciation method that is the same as that used for the relinquished property. The regulations provide additional rules for other scenarios that may arise in these types of exchanges.

No depreciation is allowed for MACRS property that you dispose of in a Sec. 1031 exchange in the same tax year that you placed the property in service. If you dispose of replacement property in the same tax year the relinquished property is placed in service, no depreciation is allowed for either property.

Depreciating the excess basis

Any amount received in a Sec. 1031 exchange that exceeds the exchanged basis is called *excess basis*, or “boot.” Boot can occur when cash is exchanged in addition to the relinquished property.

If excess basis exists, the regulations treat it as property placed in service by the acquiring taxpayer in the year of replacement. Depreciation for excess basis is thus determined using the recovery period, depreciation method and convention prescribed by the regulations applicable to the property at the time of replacement.

Suppose you own an apartment building that was placed in service in 1995. In 2009, you exchange the apartment building (which has an adjusted depreciable basis of \$1 million) and \$3 million in cash for an office building.



The resulting basis in the office building is \$4 million. You would figure the depreciable exchanged basis of \$1 million under the rules outlined in the regulations. The depreciable excess basis of \$3 million is treated as put in service in 2009 and depreciated according to the method, recovery period and convention prescribed by the regulations.

Opting out

It's possible to elect to opt out of the final regulation's two-basis approach. You might do so if you want to avoid the cost and complications of compliance or if the replacement property has a shorter life or more accelerated method of depreciation than the relinquished property.

If you opt out, the entire basis in the replacement property (both exchanged basis and excess basis, if any) is deemed to have been placed in service at the time of the replacement. The adjusted depreciable basis of the relinquished MACRS property is treated as disposed.

A tangled web

The regulations also address Sec. 1031 exchanges involving land or other nondepreciable property, as well as depreciation for deferred exchanges. They do not, however, cover allocation of basis among multiple properties in a Sec. 1031

The continuing appeal of Sec. 1031 exchanges

Section 1031 exchanges have been popular for years because the transactions allow property owners to exchange investment properties without incurring immediate tax liability. Any capital gains tax is deferred until the replacement property is sold.

Under Sec. 1031 of the Internal Revenue Code, if you exchange business or investment property solely for business or investment property of a like kind, no gains or losses are recognized. If, however, you receive additional non-like-kind property or money as part of the exchange, a gain is recognized to the extent of that additional property or money. The IRS defines "like-kind property" as property of the same nature or character, even if the items differ in grade or quality.

exchange. If you're involved in any of these types of exchanges, consult a qualified tax attorney to ensure you comply with the IRS's final regulations. ■

Need to finance multifamily properties?

FHA LOANS TO THE RESCUE

When confronted with a tight credit market, owners and developers of multifamily properties may need to consider different financing sources. One such source is the Federal Housing Administration (FHA) loan programs. FHA programs generally offer long-term, nonrecourse mortgage loans with favorable terms for multifamily housing, as well as for nursing homes and health care facilities. The loans are available for qualifying new construction, substantial rehabilitation projects, and acquisitions or refinancings.

How FHA loans work

Under the FHA programs, loans are made by private lenders, but the FHA provides the mortgage insurance. Because of its role as insurer, the agency imposes strict requirements on loan processing and underwriting.

Typically, the developer submits a site appraisal and market analysis (SAMA) application for new construction projects or a feasibility application for substantial rehabilitation projects. After the Department of Housing and Urban

Development (HUD) issues a SAMA or feasibility letter for the project, the developer submits a firm commitment application through a HUD-approved lender.

The lender considers, among other things, market need, zoning, architectural merits, the borrower's capabilities and community resources. If program requirements are met, HUD issues a commitment for insurance to the lender.

Once insurance is secured, the lender structures the loan into Government National Mortgage Association (GNMA) mortgage-backed securities. The insurance and the securitization allow lenders to sell the securities to replace the loan capital. Interest rates on the loans are determined by the rate of return required by investors. Upon sale of the security, the rate is fixed, and the loan can close.



Although closing an FHA loan may require more time than does a traditional closing, the process has been streamlined in recent years and may prove easier than you expect. And some projects might be eligible for Multifamily Accelerated Processing (MAP), a “fast-track” processing system for FHA multifamily mortgage insurance programs.

But these aren’t the only loan programs available under the National Housing Act.

Condo developments

Under Section 234(d), the FHA is authorized to insure blanket mortgages for construction or substantial rehabilitation of multifamily projects that will be sold as individual condo units. The program has statutory per-unit mortgage limits that vary according to unit size, structure type and project location.

Rental housing

The Section 221(d)(4) program, which applies to “profit-motivated” sponsors, insures mortgages to facilitate new construction or substantial rehabilitation of multifamily rental or cooperative housing for moderate-income families and the elderly. Insured mortgages may be used to finance detached, semidetached, row, walkup or elevator-type rental or co-op housing with five or more units. The program has statutory mortgage limits that vary according to unit size, structure type and project location. Borrowers can receive a maximum mortgage of 90% of the HUD/FHA replacement cost estimate, for up to 40 years.

Section 223(f) insures mortgages to purchase or refinance existing multifamily rental projects originally financed with or without federal mortgage insurance. The project must contain at least five residential units, and construction or substantial rehabilitation must have been completed at least three years earlier. In addition, there must be at least 10 years of economic life left to the project to qualify.

The Section 231 program is designed to ensure a supply



of rental housing suited to the needs of the elderly. HUD insures mortgages made by private lenders to build or rehabilitate multifamily projects of five units or more for up to 90% of the Federal Housing Commissioner’s estimate of value after completion.

Health care facilities

Section 232 insures mortgages to support the construction and substantial rehabilitation of nursing homes, intermediate care facilities, board and care homes, and assisted-living facilities. The facilities must accommodate 20 or more residents who require skilled nursing care and related medical services or those who, while not in need of nursing home care, require minimum but continuous care. Assisted-living facilities and board and care facilities must contain at least five one-bedroom or efficiency units.

Although closing an FHA loan may require more time than does a traditional closing, the process has been streamlined in recent years and may prove easier than you expect.

Section 232/223(f) allows for the purchase or refinancing, with or without repairs, of existing assisted living and nursing facilities not requiring substantial rehabilitation. The program allows for fixed rate financing of up to 40 years for new and rehabilitated properties and up to 35 years for existing properties without rehabilitation. The maximum loan amount for new construction and substantial rehabilitation is 90% of the estimated value of physical improvements and major movable equipment. For acquisition and refinancing of existing projects without rehabilitation, the maximum amount is 85% of that value.

A wealth of options

Other FHA loan programs also may be available to owners and developers, depending on the project, but many nontraditional requirements may apply. Plan ahead and verify the applicable criteria if you’re going to pursue FHA financing for your project. [1]

TURBO DUE DILIGENCE FOR TODAY'S REAL ESTATE INVESTORS

Like so many other aspects of financing in this market, commercial real estate investors' due diligence requires more effort than it did in the past. That's because yesterday's assumptions about rent growth, lease renewals and vacancies won't necessarily stand up in an unpredictable economic environment.

Today's due diligence demands more than objective financial data; it also calls for some old-fashioned, on-the-ground sleuthing before you buy a property.

Standard due diligence

Due diligence should, at a minimum, always include reviewing:

Financial data. Request at least three years of balance sheets and profit-and-loss statements, all loan documents (such as notes and mortgages), tax returns and bills, and information on all capital improvements.

Insurance and title policies. Examine all policies and their riders, any related risk assessments, and claims history.

Tenants and leases. Obtain a certificate of occupancy and information on tenant mixes, and scrutinize existing leases to determine tenant obligations and your continuing obligations. A rent roll showing security deposits and rental payments is vital.

Your due diligence also should routinely examine other key areas, including:

- » Area demographics,
- » Competing rental and occupancy rates,
- » Availability of similar properties in the area,
- » Proposed and renovated properties in the area,
- » Environmental status of the property, as well as adjacent properties,



- » Physical conditions (such as elevator, HVAC, security, telephone and sprinkler systems),
- » Pending claims,
- » Americans with Disabilities Act compliance, and
- » Applicable zoning and usage regulations.

But don't stop here. The financial returns you seek turn on more than historical data. You need to get out of the office to confirm that your expected returns are likely to materialize.

Beyond the data

Top-notch sleuthing begins by personally checking out the property and the surrounding neighborhood. Visiting the neighborhood will give you a better idea of the nature of competing properties, traffic patterns and any characteristics of the area that could affect your assumptions. If neighboring property has undergone upgrades, for example, it could affect market rents or require additional capital outlays for your property.

When you check the property itself, make sure you look at the individual units. You may discover that a unit has a layout that could make it difficult to lease or require tenant improvement costs. You could find that a tenant is suffering a business downturn, which might result in nonrenewal of the lease.

While visiting, take time to interview the tenants. Come armed with a list of questions for all tenants, as well as customized questions for each one. Your goal? To ferret out any dissatisfaction with the property or management that could affect renewal decisions or deter new tenants. If possible, consider interviewing representatives from the corporate level, where leasing decisions are made.

Beat the rush

The consequences of inadequate due diligence can prove great, so you need to take measures to ensure the process isn't rushed. Require at least 30 days to perform due diligence, beginning with the delivery of all requested information. And include language in the purchase agreement that expressly specifies the triggers for the beginning and close of the due diligence period.

Real estate investors need both subjective and objective information to perform an effective due diligence analysis that's tailored to specific properties. A comprehensive analysis is the best way to increase the odds that your actual returns will mirror those predicted. **■**

WORKING IT OUT: DEEDS IN LIEU OF FORECLOSURE

With tenants going out of business and property values plummeting, some owners are facing foreclosure. If you find yourself in this situation, consider pursuing the "deed in lieu of foreclosure" (DILF) option.

A DILF offers owners several advantages. First, the debt is generally forgiven, and, if dealing with a recourse loan, the borrower is released from all or part of its personal liability. Second, the borrower avoids potentially costly and time-consuming foreclosure litigation. And, finally, the borrower may be able to negotiate for the lender to pay the taxes, title charges and other expenses related to the transfer of property.

A DILF can benefit the lender, as well. The lender secures immediate possession of the property, rather than being forced to wait for litigation to play out. And, as soon as the deed is recorded, the lender can put the property on the market. Like the borrower, the lender will save on attorney and litigation costs. With a DILF, the lender also avoids the hassle of receivership, which reduces the risk of losing tenants and allows the lender to receive all of the project's income.



Lenders usually will require clear title, free of any liens, taxes or other claims or encumbrances. In the case of multiple liens, the lender may find it easier to proceed with foreclosure, which would eliminate any liens. If the lender opts for DILF despite potential lien issues, it will probably insist on warranties and representations that no lien claims will arise against the lender based on the period you held title.

Finally, the transaction will stand up only if truly voluntary, in the absence of pressure, duress or undue influence by the lender. Therefore, the transaction should originate with the borrower making a written offer to the lender. The lender then provides written acknowledgment stating any conditions before it will accept the deed.

Be aware that a DILF can carry certain tax implications. It could, for example, result in taxable "cancellation of debt" income. Check with your attorney before making any workout decisions.

MINIMIZE THE COSTS OF YOUR CHANGE ORDERS

Creeping construction costs can make it challenging for owners to stay within budget and maximize profits, and change orders are often the main culprits behind such costs. To keep change order costs under control, you should address several issues early on in the construction contract negotiations, with an eye toward shifting the risk to the contractors.

Critical contract provisions

Although the American Institute of Architects' contract documents are commonly used, don't simply accept the forms without negotiation. These provisions are especially relevant to the effect of change orders on your bottom line:

The cost formula. The construction contract should describe the method for determining the cost of a change order, including a cap on the contractor's overhead and profit. The contract, for example, could employ a recognized industry standard or a custom formula.

Force majeure. Force majeure events are generally considered beyond the contractor's control and entitle the contractor to extra time, which can lead to additional costs for the owner. Use the contract to define the types of events that qualify as force majeure.

For instance, a form contract may refer to "adverse weather conditions not reasonably anticipatable" that were "abnormal." How will "abnormal" be assessed? The contract should provide the clear answer. It also should ensure the owner won't be forced to absorb costs the contractor reasonably could have predicted, such as weather delays during a historically rainy season.

Authority to issue change orders. The contract must delineate the individuals who have the authority to issue change orders on the owner's behalf. An owner won't be responsible for the costs of unauthorized change orders and may be able to reject the work as not conforming to plans and specifications.

Be aware, however, that an owner can waive certain change order requirements based on conduct. For instance, if the contract clearly states that Bob is the only one who can authorize change orders, but you routinely pay change

orders that have been authorized by someone other than Bob, you may be waiving this provision.

Form of change orders. Insist that the contract require that change orders be in writing. You'll then have no duty to bear the costs for changes not in writing. But, as indicated above, if you routinely pay change orders that aren't in writing, you may be waiving your right to enforce the contract's written change order provision.



Dispute resolution. The contract should provide a vehicle for resolving disputes between owners and contractors so that work can continue. Construction contracts often provide that the architect will serve as a neutral party and evaluate the merits of a change order.

In such cases, the parties would agree to accept the architect's determination during construction and reserve the right to seek refunds and additional compensation after completion. It's also a good idea to include attorneys' fee recovery clauses in the case of such postproject litigation.

First things first

The contract negotiation phase represents the point at which you have the greatest ability to contain change order costs. Don't let the opportunity slip away to establish unambiguous and enforceable standards for shifting the costs of foreseeable risks to the contractor. []

