



Real Estate Report

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Ask the Advisor
How can I hold on to overleveraged
properties until the market picks up?

SILICON VALLEY OFFICE

Three Lagoon Drive, Suite 400
Redwood City, CA 94065
tel 650 / 365.4646
fax 650 / 368.4055

www.seiler.com

A Member of HLB International

SAN FRANCISCO OFFICE

220 Montgomery, Suite 300
San Francisco, CA 94104
tel 415 / 392.2123
fax 415 / 392.1720

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 easily be reduced with a little vigilance. You might, for example, adjust energy-related expenditures, such as your automated energy management system. Don't just set the start and stop times and forget about it. Rather, adjust the settings to take advantage of downtimes such as weekends and holidays.

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 is the last time you've examined your properties' monthly utility and water bills to ensure that you're 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. Do your windows really need to be washed so often? 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 fare better by adopting a predictive approach that relies on statistics and past experience to determine the optimal intervals for servicing equipment.

Other expenses worth re-evaluating include real estate taxes, insurance and interest expenses. As property values decrease, you should pay less in taxes and insurance premiums. But reassessments aren't automatic. You'll need to contact your county assessor and insurance agent for adjustments. Moreover, it may be time to refinance loans. Rates are low, and banks may be willing to negotiate if you're creditworthy.

Vacancy management

Another way to boost NOI is to decrease vacancy. Careful management can result in lower carrying costs and quicker leasing. Consider visiting all your properties regularly to check for any problems that might delay leasing — such as a leaky roof or malfunctioning security system. Keep the premises clean and free of trash and pests. Ensure that maintenance continues on the roof, HVAC system, elevator and similar components so that they're in working order for new tenants.

Consider conducting annual tenant surveys to determine whether they're satisfied and if they see areas that could be improved.

Keep in mind that, while it's important to confirm that these systems are fully functioning, they don't need to function 24/7. As with occupied space, adjust the startup and shutdown mechanisms to reduce energy costs.

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. Give tenants both your office and cell phone numbers. Also 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. ■

The feds step in

CRE loan workout guidance

With the ongoing credit crisis, 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 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 on 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 on 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 that are factors 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 for impairment analysis.

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 the statement's appendix, which describes 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.

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. Land isn't depreciable at all.

But you can typically depreciate land improvements over 15 years using 150% of the straight-line rate on the declining balance, and most personal property over five or seven years using 200% of the straight-line rate. Often, however, these property components are misclassified.

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 \$400,000 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 \$5,000 to over \$57,000.

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.

Could a cost segregation study trigger an audit?

Some business owners forgo cost segregation studies for fear of getting audited. 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. Taxpayers who perform a cost segregation study can qualify for an automatic accounting method change — a pretty simple procedure.

The bottom line is that taking advantage of a cost segregation study performed by a professional generally won't increase the likelihood of an audit, and you'll have the support to survive an audit if one occurs.

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 create a report of the assets, prepare the forms 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. ■

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, unexpected tax liability.

Raise capital

Another option to consider is taking on 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 project or business. 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 debt.

File for bankruptcy

Some owners will have to face the hard fact that it's just not advisable to hold on to their properties. To position themselves to take advantage of future economic upswings, the best option might be foreclosure and bankruptcy now.

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. ■



MICHAEL J. O'CONNOR, CPA, JD

Expertise: Services to the real estate industry. Structuring and negotiation of real estate transactions. Negotiation and development of international tax strategy.

Education: BA, Accounting, California State University, Stanislaus, 1977; JD, University of San Francisco, 1981; MS, Taxation, Golden Gate University, 1986.



MICHAEL J. SAGER, CPA

Expertise: Services to the real estate industry. Structuring of real estate transactions; developing of strategies to properly utilize IRC Code § 1031; working with high net worth individuals; negotiating with U.S. and state tax authorities to resolve complex tax issues.

Education: BS, Accounting, St. Cloud State University, Minnesota, 1974; MBA., Taxation, Golden Gate University, 1977.

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RECENT RULINGS

GIFTS OF INTERESTS IN LIMITED PARTNERSHIP DIDN'T QUALIFY FOR ANNUAL EXCLUSIONS —

The Tax Court has held that a married couple's gifts of interests in a limited partnership to their adult children did not qualify for gift tax annual exclusions because they were gifts of future interests. The court found that there were restrictions preventing the donees from presently realizing any substantial financial or economic benefit from the units.

The court stressed that, under the partnership agreement, the donees had no unilateral right to withdraw their capital accounts. Furthermore, the partnership agreement expressly prohibited partners from selling, assigning, or transferring their partnership interests to third parties or otherwise encumbering or disposing of their partnership interests without the written consent of all partners.

The court also pointed out that, under the terms of the partnership agreement, the donees could not even be properly characterized as limited partners. Rather, they were just given a share of profits.

The taxpayer failed to show that the gifts of partnership interests conferred on the donees an unrestricted and non-contingent right to immediately use, possess, or enjoy either the property itself or income from the property. The court therefore held that they weren't entitled to annual exclusions for their gifts of partnership interests.

To be sure that gifts of family limited partnership interests qualify for the annual gift tax exclusion, consider giving the donee a limited right to demand income or principal, similar to a *Crummey* power, which commonly is used to qualify gifts in trust for the annual exclusion. (*Walter M. Price, TC Memo 2010-2*)

IRC 1031 RELATED PARTY EXCHANGES — IRS INTERPRETATION INCORRECT?

Last year we reported to the readers the issuance of two Private Letter Rulings (PLRs), 200728008 and 200712013. In these Rulings the Internal Revenue Service allowed non recognition treatment for exchanges between related parties when they used Qualified Intermediaries (QI). These Rulings held that the use of an independent party, such as a qualified intermediary, was sufficient to remove the taint of the related party exchange. This is a very taxpayer friendly position.

On February 22, 2010, the Supreme Court denied certiorari, refused to hear, *Teruya Brothers, LTD. (Teruya) and Subs. v. Com.*, 580 F3rd 1038, (CA9, 2009). This case arose in the jurisdiction of the Ninth Circuit Court of Appeals, the Circuit which includes California. The facts are that Teruya entered into several agreements with third parties to sell parcels of developed property. The sales were subject to the requirement that Teruya could enter into a qualified IRC 1031 non recognition transaction. As the time to locate exchange property drew near, Teruya entered into contract to purchase some property from a related party (Times) to complete one of the exchanges. When this phase of the transaction was completed, Teruya received property more in line with its current business model from the QI, the third party received the former Teruya property from QI, and Times reported a loss on the sale of their property sold to the QI. The Internal Revenue Service (IRS) found that the main intent of the transaction was to avoid gain recognition by shifting basis between related parties. The Ninth Circuit Court agreed with the IRS.

Related Party transactions are generally subject to scrutiny. The prior PLRs were an approach whereby taxpayers could enter into related party transactions with relative safety. As taxpayers, we are now required to approach related party exchanges with more care and diligence. If we can aid in structuring a plan for a transaction like this that might work for you, please do not hesitate to contact us.

We would welcome the opportunity to help you meet your business and personal financial goals.

Please call us at 650-365-4646 (Silicon Valley) or 415-392-2123 (San Francisco) and let us know how we can be of assistance.