

Real Estate Monitor

Accounting:

Services Real Estate Firms Should Expect From Accounting Professionals.....1

Deductions:

Business Expenses and Losses2

Leases:

Option to Expand Space3

Ground Leases:

Capping Rents to Protect Lenders.....5

Condo Hotel Boom:

Far From Over6

Insurance:

Terrorism and Disaster Coverage7

Accounting:

Services Real Estate Firms Should Expect From Accounting Professionals

By Stuart Eisenberg

Commercial real estate firms (such as property developers, owners, investors, managers and lenders) face unique income tax, development, and accounting issues. The best source for expert solutions to these issues are “one-stop” accounting and consulting firms that provide traditional accounting services as well as specialized experience in such areas as securitization, due diligence procedures, cost segregation, loan underwriting, market studies, and ways of accessing capital markets.

Traditional Services

At a minimum, a commercial real estate firm should make sure that its accounting and consulting firm is familiar with income tax and financial reporting requirements relating to real estate, including complex income-recognition issues. Ideally, the accounting and consulting firm should have experience with the specific types of real estate and transactions that make up the core of the client’s business. Many real estate professionals may not be familiar with the three types of reports that can be issued by an accounting and consulting firm to comply with financial reporting requirements. The three types are as follows:

- An audit is the highest level of assurance and is usually required for public companies or in connection with financing arrangements.
- The next highest level is a reviewed financial statement, which consists principally of analytical review procedures and inquiries of management.

Reviewed financial statements are common for other than closely held partnerships and less complex corporate structures.

- The third level is a compiled financial statement in which the accounting firm does not provide any level of assurance. It is normally used for closely held organizations with less stringent loan covenants relating to financial reporting.

Non-Traditional Services

Real estate companies today expect much more from an accounting and consulting firm than the services listed above. Summarized below are some of the “non-traditional” services that real estate firms look for.

- Investment securitization services, including loan file and underwriter package reviews, site inspections and financial analysis of various loans and properties in a securitization pool.
- Cost segregation studies to identify all construction-related costs that qualify for shorter federal tax lives. The result of reducing tax lives from 39 years (using straight-line depreciation) to 5, 7 or 15 years (using accelerated methods) can have a significant impact on a firm’s federal tax liability.
- Advice with regard to the formation or investment in real estate investment trusts, including UPREIT and DOWNREIT structures.
- Assistance in sale-leaseback transactions in which the owner sells property and simultaneously leases it back from the buyer.
- Evaluation of cross-border transactions.
- Business interruption and disaster recovery.
- Hospitality research.
- Business and real estate valuations.

Due Diligence Procedures

Due diligence services in connection with property acquisition, financing, or valuation has become a particularly important activity by accounting and consulting firms. Property-level due diligence consists of procedures for establishing “stabilized” results used to determine the value of the property in making the investment or lending decision. Such services typically include:

- Analysis of the historical operating results for the property to identify trends and provide explanations for anomalies between periods.
- Review of leases and other agreements with tenants to identify, among other things, the term of the lease, base rent, escalation provisions, contingent rental information (percentage rents), and concessions (e.g., tenant improvement allowances, rental abatements).
- Comparison of rental and vacancy rates relative to the market, and the operating results to published industry averages and comparable properties.
- Visits to the property to study the site, competitive properties and the neighborhood.

The bottom line is that the accounting and consulting professionals need the skills to respond to the needs of their real estate companies clients—whether the skills include engineering staff to maximize tax benefits through cost segregation studies or specialists capable of making a feasibility study to determine the need for a hotel, continuing care retirement facility or other specialized property.

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Deductions: Business Expenses

By Robert Klein, CPA

The most frequent deduction taken by business persons and investors is that for “ordinary and necessary expenses paid or incurred in carrying on any trade or business” (Code Section 62(a)). Another common deduction is “loss incurred in a trade or business not compensated for by insurance or otherwise” (Code Section 165(c) (1)). An opinion by the United States Court of Appeals for the Sixth Circuit involving an outlay of \$5 million by a restaurant developer and promoter provides a detailed analysis of the two deductions (which were denied to the taxpayer). *Tigrett v. U.S.* (05-66291) (6th Cir. 2007).

Background

Issac Tigrett is a developer and promoter of restaurant and entertainment venues. He created the original Hard Rock Cafe in London in 1971 and during the 1990s he sought to reproduce the success of the chain using a different music theme and with the cuisine of the American South. Between 1992 and 1997, he was chairman of HOB Entertainment, Inc., the corporation formed to develop the concept. During his term as CEO, he personally incurred the \$5 million expense at the center of this litigation.

The directors of HOB were concerned that the project might not be successful; therefore, Tigrett and two others agreed they would contribute funds to cover any shortfall. Tigrett said he would contribute as much as \$5 million. The first venue for the new company was the Atlanta Olympic Games. The explosion of a bomb at the site resulted in a \$10 million loss for the opera-

tion, making it necessary for Tigrett to fulfill his \$5 million obligation. The IRS rejected his claim for a loss deduction and he began the lawsuit. The federal district court ruled in favor of the IRS and Tigrett appealed to the Sixth Circuit.

No Ordinary Business Expense

The district court was satisfied that the \$5 million payment was made in relation to Tigrett's business, but held the expense was not "ordinary." Said the Sixth Circuit, "An ordinary expense is generally one of common or frequent occurrence in the type of business involved ... a capital expenditure is one made to create or enhance a separate and distinct asset, one that may be expected to yield benefits beyond the year in which the year is incurred." The distinction is fact-specific that may turn on "distinctions of degree rather than of kind."

Here, said the court, the contribution was in the nature of a capital expenditure because it is not common, in the restaurant and entertainment business, for a corporate officer to make a personal guaranty "several times his annual salary." In addition, the trial court ruled that the primary benefit sought by Tigrett was to build the HOB brand for a forthcoming public offering of shares. This points to a capital expenditure.

The Sixth Circuit also agreed with the trial court that the key fact was the assumption of the indemnification obligation in the first place rather than the subsequent actual payment. Tigrett had made clear that undertaking the obligation was done to protect his reputation as a promoter and developer—a "capital asset" said the court.

Not Business Loss

Tigrett also argued that the \$5 million contribution was a loss incurred in a trade or business. The trial court again agreed that the payment was made in relation to his business of developing and promoting restaurant and entertainment venues, but concluded the payment was not a "loss" because it was made pursuant to the indemnification or contribution agreement entered into by Tigrett without consideration. Generally, the voluntary payment of another's loss, without any legal obligation to do so, does not qualify as a deductible loss.

Tigrett's argument was that while the contribution agreement was not the basis for the loss, the actual payment of the money pursuant to a legal obligation was a deductible loss. He cited *Putnam v. Commissioner*, 352 U.S. 82 (1956), where the Supreme Court said that a guarantor who pays a debt for another in compliance with a contract of guaranty sustains a deductible loss. Tigrett argued that when he made the payment, it was pursuant to a legally binding obligation.

However, the court ruled that Tigrett entered into the contribution agreement without consideration, assuming responsibility for a loss knowing that he would not be repaid. Thus the obligation was a gratuity and not a deductible loss. Alternatively, the repayment was an investment in a capital asset, i.e., Tigrett's reputation as an entrepreneur, which is not deductible as an ordinary business loss. The Sixth Circuit affirmed the decision of the district court denying the deduction.

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Leases: Option to Expand Space

By Brian Bader, CPA

A tenant's inability to obtain additional space is one of the most common reasons for non-renewal of a commercial lease. Owners of growing businesses often wish they had thought ahead about seeking an expansion option when they negotiated their leases. Expansion options come in a number of different formats, although all have the same purpose of assuring the tenant that additional space in the building can be obtained. At given times during the lease term.

Fixed Right of Expansion

The most direct method of granting an expansion right is an option to lease additional space, either contiguous to the tenant's existing space or elsewhere in the building, at one or more times during the lease term. Since the landlord will not keep space vacant on the possibility that the option will be exercised, the landlord must have the right to relocate other tenants (or in some cases to terminate or buy out existing leases) in the event the option is exercised. In the case of a long-term lease, the landlord may be willing to grant more than one expansion option; if this is done, the expansion space and the time of exercise for each separate option should be clearly stated in the lease.

Notice of Exercise

The lease should specify the period of notice the tenant must give of its intention to exercise an expansion option. Tenants always want to minimize the notice period so as to be as certain as possible of the need for the additional space. The landlord will want to lengthen the notice

period because an existing tenant who must be relocated needs sufficient notice to do so. The more specific the space covered by the expansion option and the shorter the time period in which the landlord must provide the space, the longer will be the notice period required.

Location of Expansion Space

Contiguity of the initial space and the expansion space is usually a primary concern for the tenant because of the inherent efficiencies in operation. In addition, contiguous space can more readily be subleased if the tenant seeks to do so at a future date. Some tenants may be satisfied with additional space on the same floor, while others may not be unduly concerned if the space is on a separate floor. In some cases, a tenant may be willing to accept expansion space in a separate building owned by the landlord. The less specific the tenant's demand, the more likely the landlord will agree to the expansion option and the shorter the required period of notice.

Term of Expansion Space

Ordinarily, the expansion space will be leased for a term that ends on the same date as does the initial lease. However, it is possible that a tenant may want an expansion area for a limited period that ends before the initial lease or indeed, one that extends beyond the initial lease. Any such provision should be carefully spelled out in the option clause.

Expansion Space Rent

The rent for the expansion space is likely to be the rent paid for the initial premises plus accrued escalations. Alternatively, the landlord may want the rent to be the market rent for comparable space at the

time the option is exercised if this is higher than the initial rent. If rents have declined in the interim, the tenant can choose not to exercise the expansion option unless a lower rent is negotiated.

Terms of Expansion Lease

The option provision should make clear that the lease for the additional space will include the same terms as the existing lease unless otherwise specified. Both parties should carefully examine the existing lease to be sure that no inappropriate clauses (such as the expansion provision itself) are included in the new lease. The landlord may insist that the new lease contain new clauses relating to security or environmental matters that then are part of the landlord's standard lease or that are required by law.

A tenant unable to obtain a fixed option to expand has one of two alternatives: a right of first offer or a right of first refusal. In addition, two other expansion techniques are the automatic pickup and the sublease.

Right of First Offer

The right of first offer requires the landlord to notify the tenant of the availability of space in the building (or in designated portions of the building) and to grant the tenant an option to lease the space prior to the landlord entering into a lease with a third party. The new space can be at the same rental as the existing space or at a rent to be negotiated when the right of first offer is exercised. Other lease provisions can be identical to those in the original lease or amended to reflect new provisions in the landlord's standard form lease.

At the very least, this imposes an obligation on the landlord to negotiate in good faith even if the land-

lord would prefer a new tenant to take the space. The provision granting the right of first offer should specify whether the right can be exercised only once or whether it will survive a non-exercise by the tenant following one (or more) notification(s) by the landlord of space availability.

The right of first offer can be in addition to a fixed option to expand. A landlord often will insist that a fixed option be exercisable only at certain times and with respect to certain space, since the option hinders the landlord's ability to freely lease space in the building. On the other hand, a right of first offer merely obligates the landlord to negotiate terms when and if space is available.

Right of First Refusal

A right of first refusal (RFR) requires the landlord to notify the tenant of an impending lease on designated space and grant the tenant an option to lease the space under the same terms as offered by the landlord to the third party. Third parties generally dislike RFRs (if they know about them) because the third party's negotiating efforts may end up benefiting the existing tenant.

As with other options, it should be clear whether an RFR will survive a non-exercise of the right by the tenant, either with respect to the particular space or to other space in the building. As with a right of first offer, the RFR can be combined with a fixed option to expand, each being exercisable at different times during the lease term. A tenant with an RFR should try to assure it has adequate time to respond to the landlord's notification of an impending third party lease. A large corporate tenant often needs the time to obtain internal approvals necessary to exercise the option.

Automatic Pickup

A landlord unwilling to grant a fixed option, right of offer or right of first refusal nevertheless may agree to make additional space available to the tenant at a future date, even though the landlord may have to keep the space vacant for a period of time, provided the tenant agrees now that it will take the space. Such an automatic pickup provision (also known as a put-of-space) imposes a present obligation on the tenant to lease the space under specified terms at the future date. Since the tenant cannot be sure it will need the space, it should agree to this only when vacant space is at a premium.

Subleasing as Expansion Option

A tenant determined to have future space available for expansion can take the ultimate step of leasing at the outset all the space it believes will be required, with the landlord's consent to sublease the space currently not needed. This gives the tenant maximum flexibility for future growth, because the tenant can structure the sublease terms as it wishes. However, this puts the tenant in competition with the landlord in marketing space in the building. For this reason, it can prove to be an expensive way to meet uncertain future space needs.

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Ground Leases: Capping Rents to Protect Lenders

By Alvin Arnold

Although inflation seems no threat for the immediate future, sophisticated landowners entering into

long-term ground leases are not likely to make the mistake of agreeing to a fixed ground rental. Instead, a landowner will anticipate receiving a growing income stream tied not only to future increases in the inflation rate but more specifically to the increasing value of the leased site. The three methods utilized by landowners to capture the capital appreciation of ground-leased properties are:

- Escalation keyed to a price inflation gauge.
- Periodic reappraisals.
- Participation rents.

Escalating base rents with an inflation measure provides the landowner with at least a hedge against a rising price level. However, considering the paucity of prime development sites in many cities today, the increased value of well-located real estate is likely to exceed the inflation rate over the full term of a ground lease. Thus the landowner is more likely to want the rental stream adjusted periodically based on independent appraisals of the leasehold (with the provision that in no event will the rent ever be decreased).

The frequency and parameters of the appraisals will be a matter for negotiation. Also negotiated will be the basis of the appraisal. The landowner will want the property appraised for its highest and best use, regardless of the current use, while the developer will want the appraisal to be based on the current use, even if the zoning regulations in effect at the time of the appraisal permit a more profitable use. Yet a third approach in the case of a shopping center or other rental project is to tie the ground rent to rises in the lessee's rental income.

Leasehold Lender's Concerns

Each of the escalation methods just described creates a problem when the fee interest is not subordinated to a mortgage taken out by the ground tenant. In the event the ground tenant defaults on its mortgage and the lender takes over the lease, it would be responsible for complying with all lease obligations, including rent payments. The lender most likely would try to sell the leasehold promptly in order to recoup as much as possible of the balance of its loan. However, if no sale can be negotiated, the lender might have the burden of substantial rent payments. For this reason, the ground tenant might be unable to obtain financing, thus frustrating the ground lease transaction at its inception.

Reducing Risk by Capping Ground Rent

There are a number of ways to reduce the risk to a lender of excessive rent escalations. One is to place a fixed ceiling on the escalator, whether it is tied to an inflation index or periodic reappraisals. The lender then knows the maximum rent amount and can determine its loan accordingly. The landowner, however, may not want to assume the role of prognosticator in estimating the level of prices decades in the future.

A second solution that may satisfy both the landowner and the leasehold lender is to cap rent increases or establish a fixed rent schedule during the term of the leasehold mortgage. This provides the lender with the certainty it requires while giving the landowner the ability to extract the true rental value of its property when the leasehold loan expires. Alternatively, a lender may require that the rent escalators in the lease be subordi-

nated to its loan so that if the lender ever takes possession of the leasehold, it need pay only the initial ground rent (or a rent calculated under a more favorable escalation provision.)

Participating Rents in Lieu of Escalation

Another way for a landowner to capture the future appreciation of the land while protecting the leasehold lender from excessive rents in the event it takes possession is by substituting a rent participation clause for ground rent escalation. A typical method, because easiest for the landowner to monitor, is to tie increases in the ground rent to gross rentals paid to the ground tenant by sublessees. This may be acceptable to the leasehold mortgagee since increases in the ground rent will be matched by the increase in rents received by the subtenant.

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Condo Hotel Boom: Far From Over

By Dan DiTieri

Over the past decade, condominium hotels have become a recognized segment of the hospitality industry, as the concept of “own and rent” became increasingly popular. However, the rapid increase in the number of “condotels” has raised concern about an imbalance of demand and supply and the possibility of a “bust.” However, Rick Davis, of the law firm of Greenberg Traurig, writing in the Hotel Yearbook 2007, takes a very optimistic view of the future of the new hospitality format, particularly those projects aimed not at the investment community but rather at individuals who see a condo hotel unit as a combination of vacation facil-

ity and real estate investment that can generate a modest return of rental income from a sponsored rental program.

Past History

Historically, contractions in the condo hotel business date back to the first boom in the 1970s and were almost entirely due to the failure to produce investment returns consistent with expectations. In contrast, today’s condo hotel is not aimed at the investment community but rather at a market that values more highly part-time use of the unit along with a share of rental income at least sufficient to offset holding and operating cost. Wealthy baby boomers also see benefits in having bragging rights to participating in a project in a major resort destination.

Avoiding Securities Losses

The modern approach of designing condo hotel projects so that offerings are not deemed securities under federal and state laws, as well as the use of disclaimers that are defenses against future claims of misrepresentations, make it unlikely, if not impracticable, for a project to unwind, says Mr. Davis. Even if a project proves disappointing from a rental revenue point of view, the continued availability of the unit to the owner and the potential of future appreciation remain attractive benefits to the owner.

Intermediary Structures

One trend to watch is the creation of intermediary structures between the condo hotel itself and a new world of purchasers organized by entrepreneurs who see the opportunity to create ownership organizations and “clubs” by rolling up individual units that are purchased directly from the developers. The trend

builds on the popularity of fractional condo offerings, destination clubs, and other forms of leisure ownership to attract an even broader demand for resort-type ownership. While some projects impose rules making such “roll-ups” difficult to achieve, many other projects have no objection to them. Alternatively, some developers design projects that include such a fractional program.

Risk of Litigation

Mr. Davis discounts fears of extensive litigation, including class actions, resulting from the failure of rental income to meet owner expectations. He points out that the structuring and documenting of condo hotels over many years, guided by the need to comply with federal and state security laws, renders the likelihood of such actions extremely remote. Most condo hotel offerings are designed to avoid the application of security laws. For example, no representations are made about rental or investment returns, and buyers confirm in writing that no expectation exists of making a profit from a purchase of a unit notwithstanding participation in a rental program in which some amount of income might be derived.

This result is further supported by the fact that in most cases, participation in a rental program sponsored by the developer is voluntary, with the buyer having the option to rent the unit directly or through a real estate agent or not to rent at all (in those cases where local government regulations do not require that a unit be rented or made available to the public).

Fractionalized Condo Hotel

A significant new trend is the fractionalizing of condo hotels. This is done by offering a purchaser the

opportunity to buy less than a full interest in a unit at a significantly lower price but with the same opportunity to participate in a rental program to the extent of a partial interest. Such an interest is a form of time-share or fractional ownership often regulated by statute. Marketing costs for fractional projects generally are higher than for full ownership units because more sales must be made. However, marketing costs have come down in recent years, and in many cases the extra costs are more than offset by the expansion of the available market, particularly in high profile resort destinations.

Marketing Decisions

Once having made the decision to construct or convert an existing hotel to a condo-hotel, the developer must make a number of choices in addition to those mentioned above. These depend in part on whether the hotel will be 100 percent condo units (in which case it is a "hotel" only in the sense that the owner units are available to guests for a portion of the year) or if it will consist of partly condo units and partly rooms solely for guests.

In some cases, local zoning laws may require the hotel to be partly hotel rooms so that more visitors will come to the area and therefore benefit local business, and also because transient occupancy taxes (TOTs) often are an important source of municipal income. Another consideration for the developer is whether the location attracts a sufficient number of tourists to justify additional hotel rooms. If the decision is to have regular hotel rooms, the developer has a choice of several options with regard to the "hotel" part of the facility. The developer can retain ownership of the hotel, creating a long-term income

stream, or sell the property for an immediate profit. If the developer retains ownership, a hotel management company is likely to be hired; this will require detailed negotiations with respect to fees as well as operating procedures.

Another significant issue relates to the common areas utilized by the condo units. Most often, the space is owned by a homeowners association (HOA). Many states have passed legislation governing HOAs and a developer must be careful to abide by the rules set forth.

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The Hotel Yearbook 2007 is published by Wade and Company of Switzerland (yearbook@wade-andco.com).

Insurance: Terrorism and Disaster Coverage

By David Tevlin

This year two significant insurance issues will be before Congress: the continuation of the Terrorism Risk Insurance Act (TRIA) and the need for a similar program to cover natural disasters, such as the series of severe hurricanes in 2005. A report by the Realtors Commercial Alliance of the National Association of Realtors (NAR) titled "Commercial Real Estate Insurance: Meeting the Challenge" summarizes the issues.

TRIA

The September 11th, 2001 attack on U.S. soil resulted in estimated losses of \$40 billion to American businesses. The following year, Congress passed the Terrorism Risk Insurance Act to insure that terrorism insurance was available to all businesses and to allow time for the reinsurance market to expand its capacity to cover possible future losses.

TRIA established a federally backed reinsurance mechanism that defined a "trigger point" at which the federal government would cover significant portions of damages from a foreign-sponsored terrorist event. TRIA was an acknowledgment that if private insurers were forced to bear all the risks of future terrorist events, the result conceivably could bankrupt the insurance industry.

With the backstop in place, insurers then were required to make conventional risk coverage available to policy holders under the same terms and conditions of other property-based coverage. The program applies also to a number of other coverage lines, including nuclear, biological, chemical and radiological perils, as well as worker's compensation.

Renewing TRIA

TRIA is scheduled to expire at the end of this year. Creating a permanent backstop solution will be a high priority in the current Congress. The report notes that 14 other nations recognize that private markets cannot undertake the entire risk of a terror attack and each has a permanent terrorism insurance law.

If TRIA is not renewed, the consequences for commercial real estate would be serious, says the report. Many small businesses and property owners might be unable to secure the policy limits required by lenders. Without terrorism coverage, mortgage loans will be difficult to obtain and the risk of loss will be shifted to business owners and investors and would negatively impact the price of commercial real estate.

Other Solutions

The report notes that a number of groups are seeking to devise solutions that would combine a federal

backstop with some increased participation by private markets. One such plan, put forward by the Real Estate Roundtable in 2006, is called "Homeland Security Mutual" (HSM). This could be either a state-chartered mutual reinsurance entity or some form of pool in the U.S. Treasury. HSM would create a layer of private capital between primary insurers and the federal government. The report says that a growing consensus within the insurance industry believes that without a reinsurance backstop, insurers will largely exclude this type of coverage in future policies.

National Disaster Insurance

The Realtors Commercial Alliance Report notes that eight of the top

10 property and casualty losses in U.S. history occurred between 2000 and 2004. As a result, some insurers have left the market altogether, while others have cancelled existing policies or significantly raised premiums. As a result, real estate owners in some parts of the country now face the same problem in obtaining natural disaster insurance as they do for terrorism insurance. As a result, the NAR, working with other groups, is seeking to have Congress define a comprehensive natural disaster policy.

In the last Congress, a number of bills addressed the issue of such insurance. The bills were of two kinds: One type supports a federal backstop and one does not. Most proposals involve a three-layer plan:

policies sold by insurance companies; state or regional catastrophe pools to provide reinsurance; and a national mega-catastrophe fund that backstops for additional losses. Several other bills propose changes in the tax code that would reduce the burden on insurers and property owners. The NAR itself does not now have a position on a federal backstop for national disaster insurance.

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