

Real Estate Monitor

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By Stuart Eisenberg, CPA

In 2007, the Securities and Exchange Commission (SEC) voted unanimously to allow certain foreign companies to file financial results using International Financial Reporting Standards (IFRS) without reconciling the figures to U.S. generally accepted accounting principles (GAAP) as promulgated by the Financial Accounting Standards Board (FASB). This will hopefully attract more investment opportunities and stock listings to U.S. exchanges. However, it may also have unintended consequences for U.S. real estate businesses. While the decision to have U.S. companies stay with GAAP or move towards filing under IFRS is currently under review, U.S. real estate companies may have some challenges in dealing with inappropriate financial comparisons with these foreign companies.

The Revised Accounting Rules

Until this change, foreign private issuers preparing financial statements using a basis of accounting other than GAAP were required to include a reconciliation to GAAP in filings with the SEC. The SEC believes adoption of these amendments is consistent with its commitment to establishing a single set of high-quality, internationally accepted accounting standards to enhance investment comparisons by investors and reduce regulatory burdens on issuers. The elimination of the reconciliation to GAAP is limited to foreign private issuers preparing financial statements using the English language version of IFRS as issued by the International Accounting Standards Board (IASB). Financial statements prepared on a modified version of IFRS or another basis of accounting would continue to require reconciliation to U.S. GAAP.

In a related release, the SEC has issued a Concept Release seeking constituent views on allowing U.S. registrants to prepare financial statements in

accordance with IFRS as issued by the IASB. In the Concept Release, the SEC acknowledged the growing number of jurisdictions mandating or allowing the use of IFRS, as well as the ongoing convergence projects between global accounting standard-setting bodies, including the FASB and the IASB.

While there are several differences in the rules for revenue recognition under IFRS as compared to GAAP, the primary areas that could create a significant competitive disadvantage for U.S. real estate companies are in the recognition of unrealized appreciation in the value of investments in rental real estate properties and certain other real estate-related assets and the recognition of revenue from the structuring of lease agreements.

Value of Real Estate Assets

For Real Estate Investment Trusts and other publicly traded real estate operating companies, real estate is generally required to be carried at historical cost, whereas under IFRS it may be recorded at fair value. This difference could result in significant comparability and transparency issues for investors and analysts. Entities operating under IFRS would reflect the unrealized appreciation or declines in the estimated fair value for rental properties in current earnings and equity, resulting in a “book value” per share that more closely reflects the estimated market value of an entity’s underlying assets. U.S. real estate companies are required to recognize depreciation and, if applicable, impairment losses currently and can only recognize gains upon the sale of the assets. As a result, the book value (equity) per share for U.S. publicly

traded real estate does not reflect the market value of its investments.

Take the following example. Assume the operations of the property are the same under both GAAP and IFRS but that upon revaluation of the property, an appreciation in value of \$200,000 is determined (i.e. the historical net cost basis of the property is \$2 million and the fair value is determined to be \$2.2 million). Net income under current GAAP and IFRS is in Table 1.

The transparency issue for an investor in comparing the current market (stock) price to estimated book value per share also exists for real estate sold in the normal course of business (i.e. a real estate developer that constructs properties for sale to others). However, this situation is less problematic from an earnings comparability standpoint as IFRS requires that revaluation gains for real estate that is sold in the normal course of business be credited directly to equity, not through earnings, and losses are

charged directly through earnings (unless they reverse prior credits to equity), which more closely matches the timing of income recognition under GAAP.

Revenue Recognition

The structuring of the lease agreements could create a significant competitive disadvantage for a U.S. company, since foreign competitors may have more leeway in structuring lease agreements in order to achieve revenue recognition objectives.

For example, under IFRS a lease for the majority of a leased asset’s economic life (i.e. 50.1%) may be treated as a finance lease, assuming other conditions are met, whereas under GAAP the lease must be for 75% or greater of the asset’s life to be accounted for as a finance lease. Using the example above and assuming that the lease of the entire property is for 55% of the economic life of the asset; net income is shown in Table 2.

Table 1

	GAAP	IFRS
Operating Revenues	\$ 100,000	\$ 100,000
Operating Expenses	(50,000)	(50,000)
Net Operating income	50,000	50,000
Depreciation and amortization	(25,000)	–
Fair value adjustment	–	200,000
Net Income	\$ <u>25,000</u>	\$ <u>250,000</u>

Table 2

	GAAP	IFRS
Operating Revenues	\$ 100,000	\$ –
Operating Expenses	(50,000)	10,000
Net Operating income	50,000	(10,000)
Interest income	–	200,000
Depreciation and amortization	(25,000)	–
Fair value adjustment	–	–
Net Income	\$ <u>25,000</u>	\$ <u>190,000</u>

Therefore, without the reconciliation of IFRS to GAAP for certain foreign companies, operational measurements such as funds from operations may be affected by the differences in revenue recognition policies and comparability will be affected.

Overall Impact

Although it is expected that the FASB and the IASB will achieve convergence between IFRS and GAAP by 2011 or 2012 the overall cost in terms of time, effort and financial resources will be significant to U.S. real estate entities. The impact will be greater on public, or listed, companies as they tend to be scrutinized by a wider investor base. The financial impact will take the form of higher audit fees since the auditors will now need to opine on the fair values used by the U.S. real estate entities and in the time and costs associated with obtaining the valuations.

Also impacted will be the comparability and transparency between entities due to the subjectivity involved in preparing real estate valuations. This could affect the reliability and usefulness of the financial statements. For example, based upon the valuation methodologies employed (i.e. discounted cash flow analysis vs. comparables sales analysis) the value of a subject property can vary widely. The disparity in valuation methodologies could cause incomparability in analyzing the performance and value of real estate entities.

Conclusion

A potential rule change that could level the playing field would be to allow U.S. companies to adopt IFRS in lieu of U.S. GAAP. The SEC is cur-

rently reviewing comment letters and has already hosted roundtables addressing the issue. However this change, if it were to occur, has its own issues, including a lack of accountants in the U.S. that have expertise in IFRS. A convergence of the two frameworks may be the preferable long-term solution; however, for the time being, U.S. companies will face challenges.

Stuart Eisenberg is a Partner and Managing Director of the Real Estate and Hospitality Services Practice in BDO Seidman's New York office. He can be reached at (212) 885-8431 seisenberg@bdo.com

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Real Estate Financing: How Bad Will It Be?

By Anthony La Malfa

A continuing series of discouraging news about the economy and residential real estate in particular is indicating a bad year(s) for investors and homeowners alike. What initially was primarily a "pricing collapse" now threatens to end up as the worst recession for the past half-century. The Federal Reserve Board, faced with a choice of preventing a deflationary environment or causing a sharp rise in inflation has already cut the discount rate to 3.5 percent (as of this writing) and has indicated it may repeat the drop as low as the one percent that was reached in 2001, when recession or worse last threatened.

Parallels are being drawn with the Japanese deflation of the 1990s, when home prices lost two-thirds of their value after tripling over the previous 15 years. The decline in value lasted for a total of 14 years and only recently has begun to rise slightly. As a result, home prices in

2007 in Japan were only slightly above the level of two decades ago.

Some economists believe that despite some disturbing similarities between the two housing busts, this is not likely to happen here because the Federal Reserve seems prepared to take aggressive action to stabilize housing markets. At the same time, other trends such as decline in overall productivity that supports economic growth and much lower expectations and confidence in the marketplace may mean that a relatively long period must pass before the American economy resumes growth.

Securitization Shortfall

Since builders are always willing to build and buyers anxious to buy, the problem has not been lack of either supply or demand. Instead, the problem has been one of excessive financing by lenders utilizing the mortgage-backed securities (MBS) market to distribute debt—some of which turned out to be bad debt—throughout the world. When irresponsible or badly advised homeowners on one end bought without consideration of their ability to pay, investors on the other hand bought mortgage securities that (as the ratings agencies now acknowledge) were not properly evaluated.

By one estimate, in 2007 a total of \$450 billion in new loan originations occurred. MBS apparently also account for about half of the total \$300 billion of outstanding commercial real estate debt. According to some commentators, this year CMBS issuance will drop below \$100 billion. The fact that real estate finance has come to rely so much on securitization means that the present situation is having profound effects.

With investors unwilling to buy MBS at almost any price, the intermediary lenders (banks in most cases) cannot sell their mortgage-backed paper and so must now choose between keeping the securities on their balance sheets or selling them at a loss. Neither option is appealing. As a result, additional lending by banks is likely to be sharply restricted in the near term. Ultimately, the issue is not one of overbuilding or poorly performing properties, but rather the broader issue of liquidity that has touched the entire banking sector. The inability of the holders of MBS to "mark to market" because no active trading market existed, meant that losses remained hidden until they grew much larger.

A Question of Valuation

The true problem underlying the entire residential real estate market has not been that homes were not worth what they sold for, but rather that the persons purchasing them were unable to maintain payments as interest rates rose. The rise in interest rates, in turn, was not due to the rise in general inflation, but rather the fact that the mortgages used to finance the purchases were falsely represented since the initial payments were a form of "loss leader" that brought in buyers unqualified to buy a home under normal conditions. The failure to appreciate this fact enabled the mortgages to be securitized and sold as high credit financial instruments.

Anthony La Malfa is a senior manager in the Real Estate & Hospitality Services Group in BDO Seidman's New York office. He can be reached at (212) 885-8140.

Deductions: A Q&A for Homeowners

By Robert Klein, CPA

Q: What are the most obvious tax breaks that homeowners are eligible for?

A: Deductions for property taxes and home mortgage interest can benefit homeowners who itemize deductions on their tax return.

Q: What are the not-so-obvious or often overlooked tax breaks that homeowners are eligible for?

A: Under certain circumstances, an employee or self-employed individual may be entitled to deduct home office expenses. Generally, the space in the home has to be used regularly and exclusively for business purposes.

Homeowners who incur a casualty loss may be entitled to a limited deduction. This type of loss would include damage from fire, storm or flooding. No deduction is allowed to the extent the loss is reimbursed by insurance.

Q: What tax breaks are available for a home purchased in 2007?

A: Property taxes paid in the year of purchase are deductible to the extent allocable to the purchaser. Such allocation is made in accordance with the number of days the home is owned by the purchaser. In many cases the allocation is stated in the closing document.

Expenses incurred in connection with the acquisition for such items as transfer taxes, title search, broker's commissions, appraisal fees and legal expenses should be capitalized and added to the cost of the home. Subsequent capital expenditures would also be added

to the purchase price to determine the "basis" of the house. The amount of basis is used when the home is sold to determine gain or loss on the sale.

Moving expenses for the cost of moving household goods and personal effects, in addition to travel from your old residence to your new residence, may result in a limited deduction. To be eligible, a taxpayer must satisfy a distance test, a length of employment test, and a commencement of work test.

Q: What are the new credits for energy efficient products and systems, and what are they worth? What is eligible to be applied to your 2007 tax return?

A: A credit is allowed for a purchase of qualified energy non-business property. The allowable credit is between \$50 and \$300 based upon the specific type of qualifying property purchased. The maximum credit for all years (2006 and 2007) is \$500 and no more than \$200 of the credit can be attributable to expenditures for windows.

For property placed in service after December 31, 2005 and before January 1, 2008, a tax credit for the purchase of qualified photovoltaic property and qualified solar water heating property is allowed. The qualifying property cannot be used for heating pools and hot tubs. The credit is equal to 30% of qualifying expenses with a maximum credit of \$2000 per tax year.

Q: When is the best time to start preparing to take advantage of these homeowner tax benefits? (In other words, to claim these write-offs/deductions, what are the deadlines to take action)? What is

the calendar timetable to do certain things (throughout the year)?

A: Most taxpayers are on the cash method of accounting. Accordingly, these deductions and credits are for amounts paid during 2007. Homeowners can review and accumulate the information for the amounts incurred and paid during the year, and claim these items on their 2007 tax return prior to the filing due date (April 15, 2008 or October 15, 2008 if an extension of time to file is made).

Q: To maximize every loophole and tax advantage, is it always best to hire a professional to do your taxes, or can most of these benefits be claimed by filing the taxes yourself?

A: Taxpayers with property taxes and mortgage interest falling under definition of qualified residence interest can prepare their own return with appropriate tax software. However, taxpayers may wish to consult with a tax professional when more complex situations are encountered such as home office, casualty loss, acquisition of home, or energy credits.

Q: What are some important things homeowners should be aware of before they attempt to claim a tax write-off/deduction?

A: Homeowners should retain documents supporting tax deductions and credits. Annual statements are often received reflecting annual property taxes and mortgage interest paid during the year. If a home was purchased during the year, the closing statement should be reviewed for items impacting income taxes.

Homeowners should also be aware of the home mortgage interest rules. A full deduction is

allowed for interest on debt used to acquire, construct or improve a residence to the extent the debt does not exceed \$1 million. Other mortgage interest on the home is deductible to the extent the mortgage does not exceed \$100,000. These debts must be secured by the residence. The above limits are cut in half for married taxpayers filing separately.

Q: Any other important considerations regarding homeowner tax breaks to consider?

A: The above does not describe the situation when the house is rented by the homeowner. Special tax rules apply when the home or vacation home is rented for part of the year.

In addition, the above does not describe the rules for the sale of a principal residence. Up to \$500,000 of gain on a joint return (\$250,000 on a single or separate return) can be excluded. The exclusion is available each time a principal residence is sold, but only once every two years.

Robert Klein, CPA is a Tax Partner in the Woodbridge, New Jersey office of BDO Seidman. He can be reached at (732) 750-0900.

**Real Estate Workouts:
A Game Plan**

By John Tax

The maelstrom of issues affecting the world of finance to date have not negatively impacted these major real estate sectors: apartment, office, warehouse and retail. Apartments actually may benefit from home ownership turmoil; office buildings remain in demand and warehouse properties are stable due to continued strong international trade. Retail, the most susceptible to consumer cutbacks, appears relatively unaffected thus

far. Nevertheless, continuing disclosures of unhealthy practices increase the risk of financial problems for less-than prime properties. This means that lenders (and investors) should be alert for signs of distress and be prepared to take prompt action to “work out” problems with real estate loans.

Early Recognition

Often times, the most difficult first step is the recognition of a potential problem and properly assessing its severity. Early recognition often permits considering alternatives that later are no longer feasible if the situation persists. For example, short-term loan relief in the form of interest accruals by a lender or use of outside professionals to solve a particular management problem may produce significant rewards. Unfortunately, problems often have a way of surfacing all at once. From the lender’s point of view, it may well be worth concentrating efforts on a few large loan exposures rather than attempting to solve all loan problems at once. Working out a \$500 million loan may be no more time consuming than working out one a fraction of its size, whereas the benefits to the lender obviously are much greater.

Loss Exposure

A critical early step in any work out is to determine if the value of the property exceeds or is less than the outstanding loan balance. If it is more (so that a cushion of value exists), one course of action may be to sell the property at once before market conditions deteriorate further. If a borrower has several loans with the same lender, excess value in some properties can be used to collateralize the remaining ones and offset possible future losses. In this

way, the lender may be willing to carry the distressed properties while recovery efforts are carried on while waiting for market recovery.

Market Forecast

If a lender is considering restructuring a loan or if distressed property is to be carried by the lender, an in-depth analysis of the current market is crucial. A few of the questions to be asked are whether the property will realistically support the revised loan terms and whether a market upturn can be anticipated that will eliminate negative cash flow from the property.

Property Evaluation

It is also crucial to determine whether a problem lies with the property itself or with a weak market. Inherent weaknesses such as poor visibility and access or ill-conceived design may prevent any significant improvement in cash flow even when the market begins to recover. Of equal importance is the physical condition of the property and the extent to which deferred maintenance has occurred. Often, this requires the services of an outside engineering firm.

Property Management

Both the lender and owners must decide whether a property is effectively managed and the effect of a change in management. However, if the present managers are considering market conditions, replacing them may be ill-advised and it should not be automatically assumed that such a change is desirable.

New Construction

When a distressed property is under construction, special concerns apply for a lender, who must first deter-

mine the quality of construction to date and the extent of any cost overruns. The possibility of a diversion of funds to other projects must also be investigated. The lender should determine whether contractors and subcontractors have been paid in a timely manner and whether they are committed to the project if a change in ownership occurs.

The Borrower's Role

In addition to looking at the market and the property, a lender must take a close look at the borrowers to determine the extent of their financial woes. If they are more concerned with working out financial problems than supervising construction or management of the property, the lender may be well advised to insist that a condition of any work out be that new ownership take over.

Inside Staff vs. Consultants

A lender should be careful to assign staff members who have the expertise and experience to deal with work out situations. Particularly complex workouts may benefit from a team approach. Outside consultants should be used to supplement the lender's own staff. Often, the decision of how to deal with a problem loan requires a different orientation than that of the lender itself. A consultant can offer this perspective as well as expertise about the specific problem.

John Tax is a Director in the Real Estate and Hospitality Practice in BDO Seidman's New York office. He can be reached at (212) 885-8027.

Leases:

The Takeover Gambit

By Dan DiTieri

When a new office building is completed, the landlord often is under pressure to fill the space as quickly

as possible in order to meet a pre-leasing requirement of the take-out lender, to pay operating expenses or for other reasons. One way to obtain a tenant is to assume an existing lease in another building in exchange for the tenant's agreement to move to the new building.

However, the current landlord, anticipating the possibility of such a takeover attempt, may have included in the lease an anti-raid provision that accelerates all future rent in the event a takeover occurs. Alternatively, the current landlord may threaten a lawsuit for unfair interference with a contractual relationship. Dealing with these issues is discussed below.

Takeover Lease

On its face, a takeover lease transaction is fairly straightforward. In exchange for the tenant's willingness to sign a lease in the new building, the new landlord agrees to assume all obligations under the existing lease. The new landlord takes the risk that he will be unable to sublease the existing space (either because this requires the landlord's consent or a subtenant cannot be found). The new landlord must be satisfied that the terms of the new lease justify the expense he may incur until the old lease expires.

If the tenant enters into a takeover agreement, the following issues should be covered:

- *Commencement of landlord's obligations.* When does the new landlord's obligation to pay rent under the existing lease begin? This often is when the tenant commences rent payments under the new lease.
- *Tenant's past due obligations.* The new landlord usually will not be responsible for any of the tenant's

unpaid obligations under the existing lease.

- *Treatment of sublease profits.* In the event the new landlord subleases the existing space, the parties must decide if any portion of the rent will be given to the tenant. The new landlord may be willing to share any potential profit in exchange for a limitation on his total liability under the existing lease.
- *Obligation to restore premises.* If the old premises must be restored to its original condition at the end of the lease term, and the new landlord makes no further alterations, the tenant should be liable for the restoration cost. If the new landlord alters the premises in order to re-rent it, the parties may agree to share the cost.

Anti-Raid Provision

A tenant wishing to enter into a take-over lease may be thwarted by an anti-raid clause in the existing lease. Such a clause permits the landlord to treat the vacating of the leased premises as a material breach, causing all future rent to become immediately due and payable or have other penalty provisions. Unless the remaining lease term is very short, this could prove too great a burden for the new landlord to assume.

A lease may contain such a provision when the continued presence of the tenant is important to the landlord, for example, if the tenant is a prestigious national company or if the building's tenants are engaged in a specific type of business. An anti-raid clause may be included in shopping center leases when the particular tenant mix is important for the center's success. Even in the absence of these con-

siderations, a landlord will not wish to see a number of vacancies in the building, even though rent continues to be paid.

Lawsuit Against Raiding Landlord

In the absence of an anti-raid clause, a landlord may consider a lawsuit against the raiding landlord for inducing a breach of lease. In many states, a person can be liable in damages because of wrongful interference with another person's contract or business relationship. However, a landlord who loses tenants due to raiding by another landlord usually cannot recover damages for inducing a breach of lease because every building owner is entitled to act in his best interest. Liability exists only if the building owner acts fraudulently or maliciously; for example, when he induces a tenant to move by making a false claim that the existing premises are located in a building that is in dangerous condition or that is slated for imminent condemnation or demolition.

Dan DiTieri is a senior manager in the Real Estate Practice Group in BDO Seidman's New York office. He can be reached at (212) 885-8378.

Mortgage Fraud: Title Company Disclosure Duty

By Alvin Arnold

A Texas court of appeals, overruling summary judgment for a title company, held that a genuine issue of material fact existed as to whether the title company had a duty to disclose to the mortgage lender facts that may indicate possible fraud. *Home Loan Corporation v. Texas American Title Co.*, 191 S.W.3d 728 (Court of

Appeals of Texas, Houston 4th Dist.).

Background

Texas American Title Company (TATCo) acted as settlement agent for the closing of a home mortgage loan funded by Home Loan Corporation. Home Loan then sold the loan in the secondary market, but the borrower made no payments on it and Home Loan was obligated to repurchase it. It then filed suit against TATCo, alleging that TATCo breached its fiduciary duties to Home Loan by failing to: (1) inform Home Loan that the seller of the loan had requested that over half of the seller's proceeds be paid to the mortgage broker; (2) inform Home Loan (after the preceding request was denied by TATCo) that the seller had asked TATCo to pay the proceeds directly to the mortgage loan broker and that TATCo had agreed to comply; and (3) accurately disclose on the HUD-1 settlement statement how the proceeds had been disbursed. The parties filed cross-motions for summary judgment, disputing whether such duties were owed or had been breached. The trial court granted TATCo's motion and dismissed the action.

The appellate court noted that the parties treated TATCo as if it were an escrow agent rather than a settlement agent in the transaction, even though no formal escrow agreement was entered into. However, the court said for purposes of this case, no legal distinctions exist between the two types.

The court also said that a title company that accepts funds for disbursement in a closing transaction for a fee owes the party remitting those funds a duty of loyalty, a duty

to make full disclosure, and a duty to exercise a high degree of care to conserve the money and pay it only to those persons who are entitled to receive it.

TATCo Position Rejected

TATCo argued that it was not required to disclose the seller's requests as to disposition of the funds, as TATCo was to remain impartial without favoring either party. It further argued it had no obligation to police the affairs of the parties or report suspicious circumstances unless it had actual knowledge of fraud.

The appellate court rejected these arguments, noting that no Texas decision had directly addressed limits on the scope of an escrow or

settlement agent's fiduciary duty of disclosure. Further, no rationale supported limiting an escrow agent's fiduciary duties to the terms of the contract. The court said that full disclosure is required for all material facts known by the title company that might affect the rights of the lender, buyer and seller. In short, under current Texas law, a title insurer's fiduciary duty of disclosure is broadly interpreted.

The court reversed the trial court's summary judgment on Home Loan's claim for breach of fiduciary duty, but remanded that portion of the case to the trial court on the issue of damages.

Alvin Arnold is the editor of the Real Estate Monitor. He can be reached at (212) 885-8235.

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