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# Real Estate Advisor

## Avoiding the QI blues

How to safeguard  
your 1031 exchange



Brownfield development  
is good business

10 ways to cope with  
high construction costs

Breathe deeply and  
enjoy the great indoors

Ask the Advisor  
What are the pros and cons of investing  
in off-campus college housing?

# Elliott Davis

Accountants and Business Advisors

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# Avoiding the QI blues

## *How to safeguard your 1031 exchange*

Using an Internal Revenue Code Section 1031 exchange (also referred to as a like-kind exchange) to defer capital gains taxes on real estate sales has become increasingly popular for investors in the past decade. Until recently, the biggest focus of such transactions has been finding the right property to roll sale proceeds into to meet IRS rules.

But a string of scandals surrounding the questionable practices of some qualified intermediaries (QIs) — required middlemen in the 1031 exchange process — has rocked the tax-deferred real estate exchange industry. One Nevada businessman whose company acted as a QI to 1031 deals is accused of misappropriating more than \$95 million in clients' funds to back his silicone breast implant business. A Colorado lawyer disappeared in April 2007, leaving his 1031 clients searching for \$500,000 he was holding. Another QI firm declared bankruptcy, tying up some \$10 million in client funds and jeopardizing 1031 deals.

### **INTERMEDIARIES ARE LARGELY UNREGULATED**

The much-publicized cases spotlight what some investors may have overlooked: There are few qualifications to becoming a QI, and there is no oversight over what they do with clients' money. As experts in the field point out, anyone can declare himself or herself a QI, even a convicted felon.

State and federal regulators are scrambling to address the regulatory gap. In the meantime, investors looking to use this tax-deferral tool need to make sure they do their homework in selecting a reputable QI.

### **FOLLOW YOUR MONEY**

Under a 1031 exchange, a real estate seller has 180 days to invest sale proceeds in a like-kind property of equal or greater value to avoid paying current capital gains taxes. But the tax code prohibits the seller from accessing the proceeds. Instead, they must be rolled into an account until they are transferred to the new property purchase. That's where the QI comes in.



Ideally, an intermediary should put each 1031 client's funds into a segregated trust account clearly marked as not belonging to the QI. Placing the sum in a short-term investment vehicle, such as a money-market account or a bank certificate, is a good option. Under some arrangements, QIs keep the interest earned, which, along with fees for each transaction, is how they make their money.

Problems occur when QIs commingle clients' funds to create larger accounts to cash in on higher interest rates paid by financial institutions. Such practices have led to unscrupulous QIs using pooled 1031 funds for unrelated financial purposes. What's more, if an investor's 1031 funds are in a pooled account and the company holding them declares bankruptcy, that money could be lost.

### **CHECK REFERENCES AND SHOP AROUND**

Because QIs are largely unregulated, you may want to consider using one who is affiliated with a regulated entity, such as a large financial institution or title insurance company. But don't assume that such an affiliation means you don't have to engage in due diligence. As when choosing any other financial expert for your needs, you should check references, shop around, compare fees and ask plenty of questions. Talk to any bankers the QI works with, along with your CPA, attorney and brokers, to confirm the candidate's credentials.

Ask the QI about the company's claim history, financial condition, expertise, years in business, transaction volume, fund management program and, of course, specifically how the company typically handles 1031 accounts.

One resource that can help in your review is the Federation of Exchange Accommodators ([www.1031.org](http://www.1031.org)), a QI industry trade group that's striving to beef up QI oversight.

### STILL A VIABLE TOOL

While regulators and the courts sort out the QI debacle, investors will certainly continue to use the 1031 strategy that has, for the most part, gone off without a hitch for nearly 90 years. Still, a little caution in selecting a QI to handle your real estate deal proceeds is clearly the best strategy in light of the recent chicanery making headlines. 🏠

## A QI CHECKLIST

In light of recent scandals, you need to be cautious in choosing the right qualified intermediary (QI) to handle your Section 1031 exchange. Here are some key considerations:

- ❑ Require the QI to place your funds in a separate trust account with your name on it.
- ❑ Make sure the account is invested in the United States, where it's more easily accessed, and that it's FDIC insured.
- ❑ Look for a QI who is bonded and insured, and affiliated with a regulated institution, such as a large bank.
- ❑ Get referrals and check references.
- ❑ Question QIs who promise high interest rates on your funds, which could indicate high-risk placement of your money.

# Brownfield development is good business

When it comes to development, it has never been a better time to think brown. Valuations of brownfield sites are rising. Regulations for their cleanup and development have become more realistic. Technical advances have made it easier to



calibrate cleanup processes and costs. And state and federal agencies are offering grants, loans, tax abatements and liability insurance programs to help spur redevelopment of these polluted and underused sites.

Add to that the fact that the Sarbanes-Oxley Act is expected to prompt an increase in the supply of brownfield sites available for development by prohibiting companies from warehousing contaminated land, and you've got what some describe as the "perfect storm" of positive conditions for brownfield redevelopment.

### A VAST UNTAPPED RESOURCE

The federal Environmental Protection Agency's (EPA's) brownfield program began in 1995 as a way to counter the negative impact the federal Superfund Program had on redevelopment of contaminated sites. Initially, the EPA estimated there were 500,000 brownfield sites nationwide.

Today, some 450,000 brownfield sites remain. That amounts to more than \$2 trillion in real estate nationwide, according to the *National Real Estate Investor* trade association magazine.

While brownfield rehabilitation was once the domain of specialized developers, such projects are now becoming mainstream for several reasons:

- ✓ Escalating land costs and shrinking supplies of developable green sites are heightening demand for brownfield sites.
- ✓ Such sites tend to be located in areas that are ideal for mixed-use development.
- ✓ They offer potential for lucrative development returns because they're now valued based on their end-use rather than their precleanup value.

The fact that this massive resource can be more easily tapped by savvy developers is clearly good news.

#### **A NEW COMFORT ZONE FOR LENDERS**

Brownfield redevelopment has also gained increased acceptance among lenders. While many once avoided funding projects with environmental problems, a combination of insurance protection and liability reforms has eased that lending climate. An array of environmental insurance policies provides a cap on losses if cleanup costs exceed expectations or if more contamination crops up. State and federal laws also cap or shield new owners from liability on older sites.

In fact, Environmental Data Resources, a provider of environmental risk information, found in a recent survey of commercial real estate experts that obtaining financing for brownfield projects is getting easier. Valuations of brownfield developments are increasing, so lenders are more willing to underwrite projects. In the survey, 76% of respondents attributed increased brownfield activity to a greater return on investment on such projects.

#### **THE RISKS FOR DEVELOPERS**

Of course, developing contaminated sites still poses challenges. Technology can't eliminate all the surprises inherent with remediating soil and water contamination. And developing a brownfield location can take two or three times longer to complete than a conventional project. Moreover,

brownfields require additional approvals from regulatory agencies and cleanup resources.

It's therefore important to analyze all risks thoroughly to determine if a project is feasible. Predevelopment work on these sites will require a Phase I environmental report detailing prior uses and potential contaminants. Depending on the Phase I findings, a second phase study may need to be conducted, focusing on actual pollution on the site. It's important to note that some sites may have little contamination while others may require extensive cleanup.

#### **A GOOD TEAM ESSENTIAL**

Assembling the right team of environmental experts for analysis, remediation and development is key, as is establishing a positive relationship with state and local officials. Many municipalities have programs to identify brownfield sites and facilitate their reclamation. What's more, municipal officials and residents are often less resistant to brownfield developments than they are to projects on dwindling open green space.

***A recent survey of commercial real estate experts found that obtaining financing for brownfield projects is getting easier.***

You can find a comprehensive overview of the process at [www.epa.gov/brownfields/anat\\_bf.htm](http://www.epa.gov/brownfields/anat_bf.htm). The EPA site also provides information on state programs and grant availability. Another resource is the National Brownfield Associations ([www.brownfieldassociation.org](http://www.brownfieldassociation.org)).

#### **RECLAIMING THE LAND IS GOOD BUSINESS**

Turning a contaminated industrial site into a viable development has benefits beyond the bottom line. According to the EPA, for every acre of brownfield property that's reclaimed, 4.5 acres of green space are preserved. Such developments also offer social and economic benefits to the communities in which they're located. So developing these sites can boost your company's image and further your social responsibility goals. 🏠

# 10 ways to cope with high construction costs

Commercial construction costs are expected to continue their climb into 2008. In fact, the Associated General Contractors of America (AGC) estimates that the increase will be between 4% and 6% — or at least double the consumer inflation rate — for 2007. The AGC projects that, for 2008, such increases could climb to 6% to 8%. So it's crucial that investors and developers planning construction or renovation projects sharpen their strategies to offset escalating material, energy and labor costs.

Material prices are a major factor in escalating construction costs, depending on what you're building. Gypsum and lumber prices have eased somewhat from past spikes, holding down housing construction costs at a time when that market has cooled. But larger commercial projects are being hard hit by the soaring costs of structural steel and asphalt. The AGC has noted a nearly 40% increase in steel prices since January 2007.

Diesel fuel prices have also soared, driving up not only the operating cost of construction vehicles, but also material and equipment delivery costs.

While you can't pull the plug on skyrocketing steel prices or change the price of diesel fuel, there are some strategies you can use to help control your overall project costs. Here are 10 to consider:

**1. Form your construction team early.** Try to hire your architect, general contractor and/or a construction management firm early on, so you can ensure all the project details are hashed out and fully coordinated before breaking ground.

**2. Work with professionals who are familiar with your project's geographic area.** Local architects and contractors will be more likely to know what materials are in short supply and what's produced locally and thus can be purchased at a lower delivery cost.

**3. Have your general contractor line up subs earlier rather than later.** This will allow the



general contractor to lock in fees from the outset, saving you a lot on long-term projects.

**4. Schedule construction projects to a time when subcontractors are less busy.** Some developers report that lining up subs in the off-season can result in as much as a 10% savings on contracts, according to *Development* magazine, produced by the National Association of Industrial and Office Properties.

**5. Use leverage.** If you're working on multiple projects, use this as leverage to gain better subcontracting prices.

**6. Encourage communication.** This will help you save time and expense on the labor side of the equation because ongoing communication can head off problems before they become major construction headaches.

**7. Develop solid budget strategies.** Consider using the preconstruction phase to create several budget scenarios based on a range of design options. And then make sure your architect, designer, engineer and contractor work together to order materials early to avoid expediting fees and overtime expenses.

**8. Consider a value engineering strategy.** Value engineering looks at the function of each space

in the building project and then tailors material choices to suit those uses. For example, rather than using the same grade of flooring or carpeting throughout, more durable flooring would be slated for high-traffic areas and moderate grades for rarely used spaces. The process can help you get the best value from materials.

**9. Re-evaluate stockpiling materials.** The just-in-time strategy has been prevalent in material purchasing over the past decade, but you may want to re-evaluate the option of stockpiling materials to make sure they're there when needed. It also may be more cost-effective to warehouse some materials.

**10. Don't cut corners.** One thing you don't want to do is hire the cheapest contractor or subcontractor to cut costs. As in any other market climate, hiring the most qualified people for your project is always the best strategy in the long run.

Also ask your attorney about adding a price protection clause in all your contracts.

These are just a few ideas for better managing a construction project in the current climate of rising construction costs. Talk with your CPA to discover even more ways to harness rising costs and live to tell about it. 🏠

## *BREATHE DEEPLY AND ENJOY THE GREAT INDOORS*

Whether you own a residential property or an office building, taking steps to safeguard indoor air quality is important to the occupants' health. After all, the benefits of healthy indoor air are quantifiable beyond breathing easier. A recent study by the International Centre for Indoor Environment and Energy found that a reduction in air pollutants and better ventilation can increase productivity by 5% to 10%. Moreover, *Real Estate Weekly* notes that productivity gain from improved air quality can be a prime attraction for potential building tenants.

Air pollutants are the biggest culprit when it comes to indoor air quality. The EPA has a long list of commonly found pollutants and their sources, such as tobacco smoke; asbestos from insulation and fire-retardants; formaldehyde from pressed wood products; other volatile organic compounds (VOCs) from building materials, carpets, office furnishings, cleaning products, air fresheners, paints, adhesives, copying machines, and photography and print shops; biological contaminants from dirty vents or water-damaged walls, ceilings and carpets; and pesticides.

Inadequate ventilation systems also contribute to the problem. For example, air supply and return vents are often blocked or placed in such a way that outdoor air can't circulate properly. Improperly located outdoor air intake vents can also bring in air that's contaminated with exhaust, boiler emissions and fumes from dumpsters. And poorly maintained ventilation systems can be sources of pollution themselves.

When developing a project, protect your building's future occupants by using indoor construction materials that emit low levels of VOC vapors, and low-maintenance floorings that will reduce the need for harmful cleaning solvents. Make sure the ventilation system is properly designed, and install operable windows to increase access to fresh air. For existing buildings, maintain the ventilation system and minimize the spread of toxic chemicals by providing janitorial operations with a separate ventilation system and sink for mixing concentrated cleaning agents.

For a more extensive list of indoor air quality factors, consult the EPA's comprehensive guidelines, "IAQ Building Education and Assessment Model (I-BEAM)," at [www.epa.gov/iaq/largebldgs/i-beam/index.html](http://www.epa.gov/iaq/largebldgs/i-beam/index.html).

# Ask the Advisor

## What are the pros and cons of investing in off-campus college housing?

Investors increasingly see college housing as a viable option in today's cooler real estate market. In fact, off-campus housing has gained attention from several large institutional investors over the past few years. Fueling the trend is the fact that demand for student housing isn't tied to the general performance of the real estate market. It's linked, instead, to college enrollment figures and the availability of on-campus housing to accommodate that population.

### CAPITALIZING ON THE DEMOGRAPHICS

Demographics on those factors are favorable for investors. According to the National Center for Educational Statistics, college enrollment in the United States is expected to climb by 13% between 2004 and 2015, topping 20 million by 2015.

At the same time, on-campus housing supplies are falling behind. A recent study by Deutsche Bank AG's RREEF research division in New York concluded that campus-housing capacity at four-year colleges fell to 24.8% of undergraduates in 2004 compared to 32.2% in 1990. Tighter budgets for many education facilities mean they simply don't have the funds to develop more housing to keep pace with increasing enrollment.

So, those who invest in student housing in college communities enjoy a captive renter base and high occupancy rates. They can also charge higher rental rates than those in noncollege rental settings. That can translate into better returns with less risk.

### LIVING WITH THE DOWNSIDES

As you might expect, there are some potential downsides to investing in college housing:

- ✓ Leasing activities are linked to the school year,
- ✓ Income is tied to a single population segment,
- ✓ Turnover is high, and

- ✓ You'll likely have difficulties with collecting rents, keeping neighbors happy, and coping with student wear and tear on properties.

Still, investors are finding merit in this segment. Clearly, you'll need to research enrollment, housing demand and university housing construction plans for the area in which you are considering buying property.

### FOLLOWING THE OPPORTUNITIES

Public colleges often offer a better opportunity for off-campus housing. And some states, such as Texas, California and Florida, are seeing greater off-campus demand than others.



You'll want to avoid communities in which large investors, such as publicly traded American Campus Communities, have facilities or plans on the drawing board. Such mega facilities can eclipse smaller real estate investments. You may even want to select towns where student-housing demand is steady but limited to avoid future competition from such investment goliaths.

As for individual properties, choose ones that are close to campus or on bus routes. And make sure zoning, neighborhood restrictions and parking aren't problematic.

### FINISHING YOUR EDUCATION

As you zero in on a particular college community, it's a good idea to check the college Web site and touch base with officials at the institution to gain insight into housing expansion plans and off-campus housing demands. 🏠

**In the real estate industry, the numbers are big and so are the risks. Poor timing, bad advice, even small oversights can have substantial consequences. Whether you're a developer or an investor, Elliott Davis' Real Estate Group helps keep your business grounded.**

Our team puts its deep industry knowledge and experience to work for you with customized solutions based on your specific situation and requirements. With our network of locations throughout the Southeast we deliver personalized service wherever your business lands.

### **ACCOUNTING SERVICES:**

Our team reviews your historical financial statements, evaluates trends, pinpoints strengths and weaknesses in your financial and operational business performance, and makes certain you're receiving the right kind of financial information to run your business and ensure tax compliance. We provide not only traditional credit, review compilation, and tax preparation services but also forecasts, projections and acquisition evaluation and accounting.

### **BUSINESS ADVISORY SERVICES:**

Our Real Estate group helps you consider and structure various alternatives to maximize return on investment. A sampling of our services include: 1031 exchange consulting, cost segregation studies, revenue recognition and cost allocation techniques, tax credits, and business entity planning and organization choice.



To learn more about Elliott Davis and how we can help you position your company for sustained profitable growth and continuing success, call us at 800-503-4721 or visit [www.elliottdavis.com](http://www.elliottdavis.com).

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