

Real Estate *advisor*

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Property taxes

Coming to terms with cap rates

Many cities and towns use a simple formula involving the capitalization, or cap, rate to calculate property tax assessments. The cap rate is determined by dividing the property's net operating income by its sales cost.

But what sounds easy and fair on the surface can actually work against the unwary property owner. Here's why: Although the cap rate equation involves only straightforward math, the variables going into net operating income and sales figures can make applying the formula a challenge.

Fact or fiction?

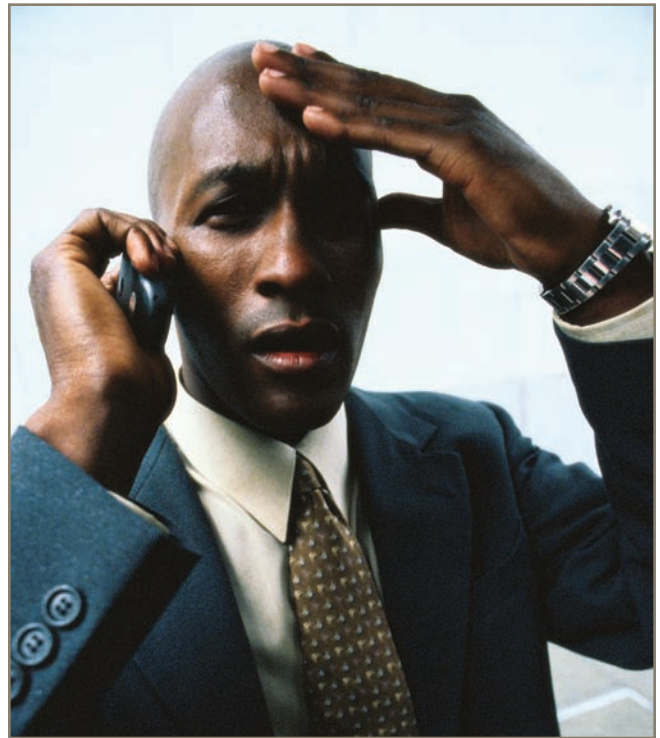
To calculate a building's valuation, the assessor first chooses several properties that seem comparable to yours and then, using those properties' net operating income and sales price, calculates a typical cap rate for the property type in your market.

The trickiest component of cap rate calculation is net operating income. Net income should include earnings, but not depreciation, business taxes or interest expense.

The trouble is, no two properties are exactly alike. They carry unique financing (or none at all), have a different mix of tenants, and generate different expenses. They're never managed the same and, unless they're both fully occupied, they won't have the same vacancy rate. There can also be differences in the accounting used. And the sales price may, or may not, have included business value.

Yin and Yang?

The trickiest component of cap rate calculation is net operating income. Net income should include earnings, but not depreciation, business taxes or interest expense. Taxes paid and depreciation taken are excluded because depreciation depends on the



initial cost paid for the property and taxes paid are often influenced by depreciation taken. Interest expense is also excluded so the property's value isn't influenced by the type, terms and amount of financing used to purchase it.

Rental income is a primary component of earnings. But which income should the assessor use? Both in-place current rents (based on current leases) and estimated rental values (open market rents) should be identified.

For example, consider the difference in value of two otherwise equivalent retail properties, one of which has tenants paying below-market rents totaling \$160,000, the other with at-market rents of \$200,000. Suppose the leases for the below-market tenants are set to expire within six months. If the cap rate for both buildings is 8%, the below-market building will be valued at \$2 million, while its market-rent counterpart will be valued at \$2.5 million. Yet the property with the below-market tenants may soon replace them with market-rent tenants, raising its value to \$2.5 million, as well.

Consider next what might happen if the expenses for the below-market building were done on a trailing (meaning the expense is recorded after it's paid) 12-month financial statement, while the at-market building financials were calculated using a trailing quarterly method. In the first case last year's expenses would be used, while in the second this year's would be used.

There also are many variables that may, or may not, be included in the expense calculation. Do the managers pay themselves a fee to run the building? Is that fee reasonable? Do they have on-site maintenance personnel who receive discounted or free rent as part of their compensation package, or do they use outside contractors to do the work? What's included in the list of expenses that appear on tax forms, such as office expenses and supplies?

When the property being valued is retail, industrial or office, the complexity of calculating net operating expenses increases dramatically. In addition to having more complex lease terms, commercial tenants build out their spaces individually. A sub shop and an upscale restaurant may both serve food, but they entail different business risks and would finish their interiors quite differently.

Who's on first?

Correctly determining a cap rate can be mind-numbingly complex. And yet, it's important that your assessor get it right when calculating property values for tax assessments. Get your financial advisor involved so you pay no more than your fair share of property taxes. ■

Let the sunshine in

Seen as expensive and impractical by some commercial building owners in the past, solar power is becoming more viable and affordable these days.

First, not only are rising energy costs making solar power more attractive, but federal, state and even local tax incentives have emerged to help defray the cost of installing solar systems. Incentives include:

- A federal tax credit of 30% of the cost of a solar power system used for heat or hot water,
- A federal tax deduction of up to \$1.80 per square foot for building owners who make improvements (including solar) that save a minimum of 50% of heating and cooling energy (so long as the system is installed between Jan. 1, 2006, and Dec. 31, 2008, though Congress may extend this — contact your tax advisor for the latest information), and
- State and municipal incentive programs that offer an array of tax credits and loans.

What's more, solar energy system providers are developing new technologies, as well as new ways of packaging solar power as a service, that can make it a much more attractive option for building owners. A growing number of system providers have come up with a way for building owners and developers to take advantage of more affordable solar power without dealing with the details or the up-front costs.

These companies are offering power purchase agreements (PPAs), under which the solar company installs a system on a commercial building but retains ownership of it, including maintenance responsibility. You simply purchase the solar-generated power at an agreed-upon price. Because the PPA providers can take advantage of tax incentives, they're able to offer such power at a competitive rate.

Such "solar-as-a-service" arrangements offer the benefits of installing your own solar system — including reduced carbon emissions and positive public relations — without the logistical and operational headaches.

For more information on tax incentives and solar energy options, go to energystar.gov, or consult your tax advisor.

Moving real estate swaps forward with reverse exchanges

Many real estate professionals are familiar with Section 1031 (or like-kind) exchanges. Using this tool, you can typically avoid current capital gains taxes by deferring tax until you sell the replacement property. But certain requirements under Sec. 1031 can make it difficult to successfully complete the process. That's when a reverse exchange may come in handy.

Deadline challenges

The IRS sets two deadlines for real estate owners who want to swap one investment for another without becoming subject to immediate capital gains taxes.



First, you must identify the replacement property within 45 calendar days after you close the sale of the original or relinquished property. Second, you must close on the replacement property within 180 calendar days of the sale of the relinquished property, or by the due date for the tax return covering the year in which you did the transfer.

Miss either of those deadlines and the exchange generally won't qualify for tax deferral.

Turning things around

To alleviate some of the stress of those deadlines, consider purchasing the replacement property first and then parking it with a qualified intermediary (QI) — a third-party company that holds sales proceeds and titles for investors doing exchanges.

This process is referred to as a *reverse* 1031 exchange and it comes with two caveats:

1. You can't own both properties at the same time, and
2. You can't exchange one property for another property you already own; the replacement property must be a new purchase.

In a related transaction, you park the property you're selling with an Exchange Accommodation Titleholder (EAT), typically a limited liability company that's set up by your QI to hold the property until you complete the exchange. Some companies refer to this process as "parking" or a "parking transaction." At closing, the EAT transfers the replacement property to you and the property you're selling to its new owner.

This type of exchange can help you take advantage of real estate bargains. Suppose you find an undervalued property you'd like to buy, but first need to sell another property to fund the deal. Obviously, you'd like to avoid paying capital gains tax on the first sale, so you use the services of a QI to set up an EAT. The EAT purchases the replacement property on your behalf and you exchange it for the property you want

to relinquish. The EAT then holds the relinquished property until you find a buyer for it.

Keep in mind that you may be responsible for carrying the costs on two properties during the time your relinquished property is on the market. Also, you must complete the transaction within 180 days.

Or, suppose you've identified a property you'd like to buy in an exchange, but the property isn't as valuable as the one you're selling. If the replacement property you buy costs less than the relinquished property you sold, you'll owe capital gains taxes. So consider raising the value of the replacement property by making

improvements to it. With this type of exchange deal, the EAT holds title to the replacement property while you make the necessary improvements.

Putting it into reverse

Reverse exchanges aren't without drawbacks. For example, when you transfer title from your own business entity to an EAT, you may have to pay local or state transfer taxes on two property transfers. But in many situations, the benefits of a reverse exchange outweigh the drawbacks. Because reverse exchanges can be difficult to maneuver, make sure you talk with your real estate or financial advisor before entering into any transactions. ■

Office sector offers some hope for long-term prospects

A weakening U.S. economy, financial market turmoil and rising vacancy rates have had commercial real estate investors and tenants sitting on the sidelines throughout 2008. But while no sector of the commercial market is immune to price and market cycles, the office niche is perhaps best situated to withstand the down slope.

Getting to the root of the problem

Unlike the recession in 2001 and 2002, today's commercial market issues have arisen from dysfunction in the capital markets rather than overbuilding. Eventually, the capital markets are likely to right themselves, and the currently constrained supply of new building will likely result in tighter vacancy rates. Supply and demand for office space will likely again become the determiner of market value, unlike the current market, in which the lack of capital has reduced the number of buyers in the market.

When the flow of capital from commercial mortgage backed securities cut off in late 2007, sales volume dropped precipitously. In the first four months of 2008, \$18.5 billion in office buildings were sold,

compared to \$95 billion during the first quarter of 2007, according to the National Association of Realtors (NAR).

The NAR predicts net absorption in 2008 of 31.1 million square feet of office space in the markets it tracks, including the leasing of new space coming on the market and space in existing properties.

Office property purchasers turned to commercial banks, insurance companies and portfolio lenders for funding. Those capital sources also influenced sales, because banks typically prefer to focus on small and midsize properties, rather than putting large amounts of capital at risk in single transactions.

Underlying data points to trends

In addition to financing components, it's important to look at underlying market fundamentals when examining any potential asset class. By the middle of 2008,

The real story in retail

The announced closing of 600 of Starbucks' 7,100 company-operated stores and its decision to open fewer than 200 new stores in fiscal year 2009 seem to typify the struggles of the 2008 retail market. But not all the news is gloomy.

The National Association of Realtors (NAR) is projecting retail vacancy rates will edge up only 10 basis points to 9.3% by the end of 2008, and that rents will hold nearly steady, rising 1.3% over 2007 levels.

While transaction levels in the markets that the NAR tracks were running at a pace in early 2008 that would result in about \$30 billion in sales, net absorption of retail space could grow to 18.2 million square feet, up from 12.9 million in 2007, according to the association.



the office market was seeing flattening rental rates, rising concessions and increases in subleasing. For the first time since 2003, the overall office market showed negative net absorption of -3.2 million square feet.

The NAR predicts net absorption in 2008 of 31.1 million square feet of office space in the markets it tracks, including the leasing of new space coming on the market and space in existing properties. That's slightly more than half of the 60 million square feet absorbed in 2007.

Of course, asset class and location play a big part in individual market absorption rates. NAR Chief Economist Lawrence Yun attributes much of the

national slowdown in 2008 to new space coming online and the challenge of back-filling older Class B and Class C buildings.

At least one real estate investment firm — Prudential Real Estate Investors — attributes rising vacancy rates to areas with high concentrations of financial services and housing-related employers, as well as suburban office markets, where jobs are both added and cut first. With vacancies doubling in markets such as Phoenix and West Palm Beach, Fla., it's clear that the housing market downturn has been spilling over into commercial real estate — including the office market — in some areas.

No one disputes the fact that office vacancy numbers have been rising in 2008 and are likely to continue to do so until the economy recovers. Yet, national numbers can be misleading, because real estate is an inherently local business. For example, while rental rates are falling in markets such as Detroit, Orange County and San Jose, they're rising in the Bay Area, San Antonio and South Florida.

What should prudent buyers do in such a market? The answer is simple: Exercise caution. Knowing where the market decline and saturation are will greatly enhance the market share of your property and your capacity to weather economic downturns going forward.

Decreased supply

What no one can predict is how long the credit crunch in both commercial and residential real estate will last.

And yet, it's exactly that credit crunch that may make the best case for long-term investment in the office market. Investing in real estate requires capital, and capital is in short supply; therefore new office building projects will likely be restrained in the near term. Falling supply in the property pipeline today could lead to a reduction in supply in the long term, creating a market with fewer options for tenants and investors.

The fallout

The crimp in the pipeline for new projects, increasing construction replacement costs and the return of capital from both domestic and foreign investors should protect the office market from the type of battering it took during the last recession at the turn of the millennium — as long as the economy doesn't shrink dramatically, pulling tenant demand down with it. ■

Ask the Advisor

Should I use lease options to manage and sell my properties?

The lease option is becoming increasingly popular with both property owners and prospective homebuyers. And, as long as you make sure all the terms of the lease option agreement (also known as a Single-Family-Rent-to-Own option) are clearly spelled out, it can be a good tool to help you weather the downturn in home sales.

Lease options 101

A lease option is an agreement between a buyer and seller that allows the buyer to lease the property for a period of time with an option to purchase it at the end of the lease period. The contract traditionally extends from one to three years.

The tenant/buyer pays the seller a lease option fee for the right to purchase the house on or before the agreed upon date at a predetermined price. The fee can be substantial or a token amount, but it's generally nonrefundable. Often, the tenant will agree to take on at least some maintenance responsibilities for the property. Most lease option agreements provide for a portion of the monthly rent to go toward the purchase price. Rent payments under lease options tend to be above the market rate to provide for this contribution.

As an incentive for the tenant to maintain the property, many sellers allow the tenant to recover a portion of the lease option fee (comparable to a renter's security deposit) if the sale doesn't go through.

Both parties benefit

One of the reasons why lease options are popular is that both parties can benefit from the transaction. For the seller, a lease option:

- Provides rental income from a property that might otherwise be vacant,
- Helps attract a market-rate buyer in a sluggish market or for an otherwise hard-to-sell property,
- Secures a stable tenant with a vested interest in keeping the property in good condition, and

- Provides financial compensation in the form of a forfeited lease option fee if the sale falls through.

For the buyer, the lease option offers:

- A way to get into a home in today's difficult credit climate,
- Time to clean up any credit problems while living in the home,
- A forced savings plan, because a portion of rent goes to the home purchase, and
- A chance to build equity.

As with any real estate contract, get legal advice on how to structure a lease option agreement. Make sure the contract clearly states that it's *first and foremost* a landlord-tenant relationship and that the option is only a right to purchase the property if certain conditions are met. Spell out any penalties to the would-be buyer for forfeiting that right.

A good option

In today's sluggish housing market with little appreciation in home values, the lease option can be a good strategy for sellers to get premium rent and a stable tenancy. ■



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.

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