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The Riddle Report

Solving Problems When Selling A Commercial Property

Selling a house is usually the same everywhere. The building and the land are sold together. In fairly rare occasions, the land is leased so only the structure is sold. This is not the case with commercial property and apartments. The transfer can be done several ways. Of course, the easiest way is to sell the whole property in a single transaction. When setting a price, the factors include: quality of the tenants, strength of leases in a commercial property, volume potential if applicable, competition, tenant mix, construction, existing or available financing, and the physical value of the real estate.

All commercial properties have their own problems. A problem that always comes up in the sale of a shopping center and other retail properties is the treatment of overages (percentage rentals above the minimum guarantee). The seller wants the overages presently being paid to be treated the same as the guaranteed rentals. The buyer, on the other hand, knows that over a period of years retail sales are affected not only by general economic

conditions, but by competition within the trading area, changing neighborhood patterns, highway changes, etc., and wants to discount the overages to some degree. Ultimately, this must be settled by bargaining.

Another problem in the negotiation is the permissible vacancy rate. A vacancy rate of 5% or less for the service stores might be acceptable, but normally the buyer should make no provisions for vacancies where there are triple-A tenancies, since presumably all such space is presently accounted for by long-term leases.

Separate Sale Of Land And Improvements

The seller may be successful in finding separate purchasers for the land and the improvements on it. Ownership of the land might be attractive to a tax-exempt institution that does not require depreciation deductions and is interested in a permanent →

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This publication is not a solicitation but is an information service from this office.

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When ideas in tax and other legal areas in this publication seem to fit your situation, it is recommended that you discuss them with your professional advisor before taking action.

Solving Problems ... (continued)

investment involving no management responsibilities. On the other hand, an investor requiring immediate income who is willing to assume management burdens can be a good prospect for the buildings.

Sale-Leaseback

This is similar to the preceding, except that the seller retains the operating leasehold. A major problem in this type of deal is whether the landowner will share in any overages. The developer-lessee will normally prefer to pay a flat rental to the purchaser of the land and keep the profit from the overages. The purchaser, in such case, may demand a fairly high ground

rent, since this will represent his maximum possible return from the property.

In one case, a department store built a shopping center and then sold all but the land on which its own store was situated to an investor subject to a 10-year leaseback. In this way, the department store immediately recouped much of its cost and also reserved to itself the right to profits from operations during the initial 10-year period. The lease guaranteed the purchaser a 7 1/2% return as rental during the 10-year period; after that, the purchaser would be required to operate the center itself (or find another lessee).

Contingent Sale

This alternative has the effect of

making an institutional investor the developer's partner. The property is sold to an insurance company or similar financial institution under an agreement in which the buyer keeps all rentals until it receives a stated fixed return, and any additional profit is split equally with the developer. If the return falls below the specified percentage for any year, the buyer's unrealized return is carried over to subsequent years. This type of arrangement is normally of interest only to institutions that are willing to give up the right to some immediate income in the interests of a long-term return from the increase in the land's value. □

Using Options In Long Term Financial Planning

When most owners and investors think about options on real estate, it is usually one-dimensional. The option is just a way for a buyer to tie up a piece of property. Sometimes it is for a speculation, with the buyer gambling that the property will increase in value to a figure higher than the option price. Other times, the buyer just wishes to hold the property with a smaller investment of cash until the time is right to purchase and use it. Sometimes buyers and sellers use options for long term planning and tax considerations.

Here are some examples:

Ensure Future Sale At A Fixed Price

Suppose the owner of real

estate wishes to hold it for an additional two years when he expects to be in a much lower tax bracket. However, he would like to ensure a sale at that time at a price to be fixed now. The owner could enter into an immediate contract of sale with a delayed closing. However, this likely would be considered an immediate sale for tax purposes because the burdens and benefits of ownership would be deemed transferred immediately to the buyer.

Instead, the parties could enter into the following arrangement. The owner gives the buyer an option to purchase the property in two years at the current market price, for which the buyer pays a \$5,000 fee to the owner. The buyer simultaneously gives the owner a put option on the property with the same exercise price. In order that

the two options not be mirror images of each other, the owner pays the buyer a fee of \$2,500 and his option expires several months earlier than the buyer's option.

As a practical matter, it is virtually certain that the sale actually will take place, since either the owner or the buyer will exercise his option depending on whether market value rises or falls. Nevertheless, the (somewhat remote) possibility that neither party will wish to exercise his option should protect the parties from an IRS challenge that an immediate sale occurred. (For some authority to support this view, see *Penn-Dixie Steel Corp. v. Commissioner*, 69 T.C. 837 (1978).) →

Providing Nonrecourse Financing

Suppose a farmer wants to continue to operate his farm for another five years, until he reaches age 65. A developer wants to buy the land for a residential subdivision. The developer offers to pay \$100,000 for an option giving him the right to buy the land after five years for \$1.1 million (his projection of the market value at that time). The farmer, who needs cash, counters with an offer to give the developer an option for a fee of \$500,000, under which the developer would have the right to buy the property five years hence for 85% of the then market value, with the \$500,000 to be a credit against the purchase price.

If the developer accepts, the farmer, in effect, has received a \$500,000 loan repayable in five years, assuming the option then is exercised by the developer. In

consideration of the "loan", the farmer will pay "interest" equal to 15% of the property's fair market value at the end of five years. If the market value then is \$ 1.1 million, total interest would be \$165,000 (15% of \$1.1 million) or about 6.6% annually.

The developer might be willing to accept this offer because of the following benefits to him:

- He will get a 15% discount if the option is exercised;
- The entire \$500,000 will be credited against the purchase price; and
- He is protected on the downside, since the exercise price will drop if market value in five years is less than projected.

Of course, if the option is not exercised by the developer, the farmer gets \$500,000

outright. Thus, the developer is not likely to agree unless he is very sure he wants the property. (If the property rises in value, the developer must pay more; but given the \$500,000 cash credit plus 15% discount, it is highly unlikely that he would end up paying more than the \$1.1 million value originally placed on the property.)

Note: The risk in the transaction is that the IRS might challenge it by arguing that exercise of the option by the developer is a foregone conclusion, since the option price is a fraction (85%) of fair market value at the time of exercise and also because the \$500,000 fee is credited against the purchase price. The developer's position is that his business is highly speculative and that a recession or high interest rates could prevent exercise of the option. □

The Insurance Owners Must Require Tenants To Carry

Insurance coverage must be addressed by both landlords and tenants. For the run-of-the-mill daily problems, a landlord must have the maximum coverage for the building and the tenant's leases. The tenant must cover the business with coverage that will protect it. What if you have a small disaster that is easily repaired, but you lose a tenant because he was not covered for the damage inside the business?

Consequential Loss Coverage

A fire or other peril may cause a financial loss other than that resulting from direct destruction of the property. Such losses

are called "consequential losses" and include those resulting from the loss of use of the property destroyed, such as interruption of business, and property loss from indirect connection with the hazard rather than from direct destruction. The types of insurance against consequential losses include:

- Business interruption insurance.
- Delayed profits insurance, which covers the loss of profits that result from a delay in the completion of the construction.

- Leasehold insurance, which covers a tenant's financial loss if the lease is canceled as a result of fire or other insured peril.

Business Interruption Insurance

A business interruption policy normally embraces both loss of income and "added expense" protection. The latter may be the more important because it reimburses the tenant for the special costs associated with obtaining substitute equipment and (if temporary space is needed →

Insurance ... (continued)

elsewhere), the cost of renting such quarters. To the extent that the tenant's profits are adversely affected, notwithstanding the ability to continue operations, protection is furnished by the loss-of-income feature of this coverage.

Business interruption policies can be more effective with appropriate endorsements that enlarge the covered causes of loss and extend the period of indemnity. Two examples are the following:

- **Nonbuilding damage.** The standard policy only covers losses attributable to a casualty to the building itself. If damage extended to telephone and data service lines located outside the building, resulting losses to the tenant would be covered only under an appropriate endorsement to the policy.
- **Extended restoration.** The standard policy limits the indemnity period to the time needed

to restore the building to its pre-casualty condition. This may be less than the time needed for actual restoration, for example, when local law requires the reconstructed building to meet updated code standards. The policy coverage can be extended for this purpose by endorsement.

Lease Termination Insurance

When casualty damage is so extensive that the landlord can cancel the lease, the tenant may incur loss because it is unable to lease elsewhere on comparable terms. Leasehold interest insurance protects against such loss. The loss is equal to the discounted present value of the difference between (1) the rental specified in the lease and (2) the higher market rent for comparable space, projected for the balance of the lease term, including all renewal option periods. □

Your Real Estate Investment

Knowing what you can do in some investment situations can be the difference between an annual profit or loss in your currently owned commercial property or the one you intend to acquire. How you acquire it can be important.

The professional commercial real estate broker is in the position to represent a client in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. This real estate practitioner stays aware of current tax laws and court decisions in order to structure transactions, but does not give legal or tax advice (unless he/she is also an attorney or a certified public accountant). In any complex

transaction that might result in changes in any owner's legal or tax situation, the other members of the "consulting team" should be the owner's attorney and/or tax advisor. We always recommend consulting with these professionals during the planning and closing of major real estate transactions. All can affect taxes and estate planning.

We are the heart of your professional team, creating the real estate transactions that will be needed to expand your estate. Let's get together to evaluate your present portfolio of properties, or review your plans for future acquisition.

Starting with your present position and your goals for the future, we can set out moving directly toward achieving those goals. □



A CCIM is a professional real estate practitioner with proven technical expertise in commercial property. A CCIM is a person truly committed to the fundamentals of effective commercial-investment brokerage. The CCIM has completed a full schedule of Post Graduate Level Courses in investments, taxation, development and marketing all types of commercial-investment properties. The designation of Certified Commercial-Investment Member is unquestionably the highest degree awarded in the commercial-investment real estate practice.

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