

Real Estate Monitor

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Financing:**Cash Flow Mortgages***By John Tax*

As the economy continues to weaken, many commercial properties may become distressed as tenants fail to renew leases or default on rent payments. In turn, landlords may be unable to make monthly or quarterly mortgage payments. In his situation, the lender may be willing to convert the loan to a cash flow mortgage rather than foreclosing the loan. Under such a mortgage, debt service payments by the borrower are based on the availability of cash flow, while deferring the portion of debt service that is unpaid until sufficient cash flow is available or until maturity (with or without compounding, depending upon the terms of the loan).

Alternatively, the owner of a distressed property may be able to sell it to a third party for a price somewhat above the amount of the existing mortgage, with the seller taking back a purchase money cash flow mortgage in lieu of cash. Cash for such excess flow mortgages present a number of important and interesting legal issues. Some of them are described below.

Recharacterization

Cash flow and participating mortgages often include attributes of a joint venture, such as sharing of profits. Will the loan be respected as a loan for state law purposes or will it be recharacterized as joint venture? Problems resulting from recharacterization include:

- **Liability.** The risk that the lender will be treated as a general partner and be liable for the joint venture's debts; and
- **Remedies.** Uncertainty as to the lender's remedies for the borrower's failure to repay what the parties have labeled a debt.

Material discussed is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

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Usury

In the case of a cash flow mortgage that does not have a fixed interest rate, an issue may arise as to whether the payments violate usury laws. The answer to this question will vary by jurisdiction, and may depend on the level of participation. In some states, participating mortgage loans generally are exempt from usury limitations. In other jurisdictions, lenders may be well advised to impose in their loan documents a cumulative cap (using the maximum permissible interest rate) on all interest payments, including all operating cash flows and capital proceeds paid to the lender that are not applied to reduce the loan amount.

Unconscionability.

Under some circumstances, the loan may be deemed to be unconscionable. Factors leading to such a conclusion include the sophistication of the borrower and whether the loan documents were negotiated at arm's length.

Negotiability

In some states, a cash flow (or participating) loan may be deemed non-negotiable so that a third party purchasing the note may be subject to most defenses that the borrower could have raised against the original lender. Under former UCC § 3104, which remains the law in a number of states, a note may be negotiable only if the interest rate can be determined from the face of the instrument. Such a condition would not be satisfied if the interest payable depends on the amount of cash flow or capital proceeds.

Negative amortization.

Negative amortization will arise when accrued but unpaid interest is

added to the loan principal. In some states, this may create legal problems for the lender. Local counsel should be consulted by a lender or seller taking back a purchase money mortgage to determine whether these or other issues exist, and if so, how they can be resolved. Many title companies will provide affirmative title insurance to address some of these concerns (e.g., recharacterization and usury).

Foreclosure.

A final concern, particularly important in the case of distressed loans, is the possibility that foreclosure may result. If the lender is entitled to a share of the proceeds from the sale of the property, the foreclosure process may become confusing. What is the lender entitled to bid at the foreclosure to take into account its share of the equity? The loan documents should (but often fail to) address this issue, and there are many possible solutions to this problem (including a prepayment premium, designed to yield a particular internal rate of return, that would apply upon acceleration).

In many loans, however, this issue is of academic interest only because there may be no borrower's equity in which the lender will share. If the buyer anticipates that there may be equity during its holding period, the loan documents should be reviewed with local counsel to determine whether this point has been adequately addressed.

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Cities: Shifting Trends

By Dan DiTieri

A report by the Brookings Institution, based on new U.S.

Census Bureau data, shows that the nation's fastest growing cities continue to be located in the South and interior West. But the estimates also show a retrenchment of the "snowball to sunbelt" population surge that is bringing modest gains to many older cities that lost population earlier in the decade. Three of the nation's nine largest cities – Chicago, Los Angeles, and San Diego – saw gains in the past year after previous declines, while their Sunbelt counterparts – Phoenix, Houston, San Antonio and Dallas – showed slower levels of growth. Chicago's modest gain was the first since 2001. Boston also saw a gain, becoming the fastest growing city in the Northeast, after losing population the year before.

These big city changes reflect broader shifts coinciding with the housing market slowdown that was just beginning as of the time of the report (July 2007). Older and coastal cities are keeping more people who in the past tended to move to suburbs or faster-growing regions. Rising gas prices and commuting costs could further accelerate the trend.

Midwest

The Midwest is showing positive signs of city population retention. Thirty of its forty-four cities with populations exceeding 100,000 either gained more or lost fewer people in the year ending mid-2007 than the year before. Wichita, Kansas, the region's fastest growing larger city, doubled its growth rate, and Minneapolis and Fort Wayne registered noticeable growth-rate increases. Although twelve Midwestern cities continued to lose population, five slowed their rate of decline over the prior year.

South

Several Southern cities showed substantial slowdowns in growth, with those in Florida and Texas taking the greatest hits. In the two years ending in 2007, Miami's growth rate slowed from 4.3 percent to 2.5 percent, while Orlando saw a decline from 3 percent to 1.9 percent, and Tampa experienced a two-third decline from 2.3 percent to 0.8 percent. All but two of Florida's eighteen cities showed reduced growth or faster declines in population. In Texas, Houston's growth rate fell from 4.5 percent to 1.8 percent and gains also slowed in Austin, Dallas, San Antonio and Ft. Worth.

On the positive side, Atlanta, one of the region's older cities, experienced an annual increase of 4.1 percent, the largest this decade. New Orleans had the highest growth rate (13.8 percent), partly due to the returning residents after Hurricane Katrina. Overall, about two-thirds of Southern cities with more than 100,000 residents showed reduced rates of growth or faster rates of decline, putting a damper on what had been a successful decade of growth.

West

The West is experiencing a split personality from the housing slowdown. Largest declines in growth rates are being experienced in Arizona and Nevada, with Phoenix, Las Vegas, Reno and smaller cities growing at considerably lower rates. The "winners" tend to be along the coast, with growth turnarounds in Los Angeles and San Diego. Farther up the Pacific Coast, San Francisco (with the highest growth rate in this decade), Portland and Seattle showed growth. Denver also continued its growth.

Northeast

Most Northeastern cities showed stronger population retention. In addition to Boston, these included Newark, New Jersey (the second fastest growing city in the region), as well as Lowell, MA and Stamford, Waterbury and New Haven, Connecticut. On the other hand, Philadelphia, Pittsburgh, Syracuse and several other cities registered smaller losses than in previous years. New York City continued to grow at a somewhat reduced rate.

Long Term Trend

The Brookings report points out that a single year does not alter the long-standing trend of suburbanization and movement southward. Yet the new estimates show a reprieve for many older and coastal cities that had lost residents as part of the migration to the South and West in the first half of the decade. The likelihood is that the more established cities will continue to benefit from this migration slowdown, especially if housing markets remain cool and the cost of commuting from the suburbs continues to climb.

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Mortgages: Short Sale is Taxable Income

By Robert Klein

The U.S. Tax Court affirmed the decision of the IRS that a "short sale" of real estate generated taxable income to the extent of the excused unpaid mortgage. (Stevens vs. Commissioner of Internal Revenue, TC Summary Opinion 2008-61)

Background

Eugene Stevens and his wife bought a two-story home in need of reha-

bilitation. Their intent was to rehabilitate the dwelling and then either rent the property or sell it. The Purchase price was \$256,000.00 and was financed with a bank mortgage.

Subsequently, the couple was unable to make the mortgage payments and in order to avoid a foreclosure that would have affected their credit rating, they sold the property in a short sale with the approval of the lender.

A short sale in real estate occurs when the outstanding loan against a property exceeds the market value of the property and the lender agrees to accept less than it is owed to permit the property to be sold. The Stevens sold the property for \$200,000 when the unpaid balance of the mortgage was in excess of that amount by approximately \$75,000. The lender approved the short sale subject to the following terms and conditions: (1) the bank was to receive approximately \$181,000 in satisfaction of the loan and (2) the balance of the purchase price was to pay the real estate commissions and closing costs. As a result, \$75,000 of the loan was canceled by the bank. The bank reported the amount of the cancelled debt on a Form 1099-C. This sum was not included in the Stevens income tax return for 2003.

Income Realized

The court stated the general rule that a taxpayer must include as income the discharge of indebtedness. The exception to this general rule (§108a) provides that a taxpayer may exclude income from the discharge of indebtedness only (1) if the discharge occurs in a bankruptcy case, (2) when the taxpayer is insolvent or (3) if the indebtedness is from business real estate debt.

The court here said the property was held a investment property for the production of income but said “we cannot, for lack of sufficient facts, determine whether the exclusion for business real property indebtedness might apply.” Since the burden was on the Stevens to establish one of the exceptions to the general rule and they were unable to do so, the court ruled in favor of the IRS. Thus, the Stevens must report income of \$75,000 resulting from the short sale. In addition, the Stevens were subject to an accuracy-related penalty pursuant to §6662(a).

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Credit Default Swaps: Role in Subprime Mortgage Collapse

By Anthony LaMalfa

A relationship not generally understood by many investors is that between credit default swaps and the subprime mortgage crisis. A credit default swap (CDS) is a form of credit derivative, i.e., a method whereby a lender can shift part of the risk of owning mortgages to another party. Specifically, the owner of the mortgages makes a payment (or a series of payments) to another party in exchange for the promise of the other party to pay a specified sum in the event of a default by the mortgagors. The party receiving the credit protection is the “buyer”, while the party providing credit protection is the “seller”. In short, a CDS is a form of insurance whereby the seller either takes delivery of the defaulted mortgages or pays the buyer the difference between the face value and the recovery amount of the mortgages.

The credit risk thus is transferred from the buyer to the seller. (Credit default swaps also can be used as a form of speculation by hedge funds and other market operators.)

Merrill Lynch Transaction

In what may have been the largest credit swap transaction ever, Merrill Lynch (buyer) agreed to unwind \$3.7 billion of insurance it had bought on its mortgage holdings in exchange for a payment of \$500 million from a subsidiary of XI Capital to close out an insurance contract. As reported in the New York Times (August 10, 2008), the transaction had some remarkable elements. Perhaps the most remarkable was that Merrill Lynch received only 13 cents on the dollar for the mortgages, reflecting their tremendous loss of value. Apparently the reason Merrill Lynch did not receive the full amount of the swap insurance was that the XI Capital subsidiary, Security Capital Assurance, had seen its credit rating cut to junk earlier this year so that the likelihood the company could fully satisfy its insurance obligation seemed unlikely. This emphasizes that these deals are only as good as the party on the other side of the swap.

True Value Revealed

Since the full amount of the insurance was not paid, the transaction gave the mortgage market an idea of the true valuation of the mortgage-related securities covered by the insurance. However, not every swap will be valued at 13 cents, since each transaction will reflect different probabilities as to the likelihood of future payment on the mortgages and their maturities. As an example, another bond insurer unwound a \$1.4 billion insurance obligation at 61 cents on the dollar.

According to Eric Dinallo, New York’s insurance superintendent, valuations of many CDSs remain highly optimistic on the books of the bond insurers. He said the Merrill Lynch deal resulted from the fact that the insurer, Capital Assurance, might have been subject to a regulatory takeover had Merrill insisted on the full amount of the insurance, in which case Merrill may have received no payment at all on the policy. As of last September, a total \$656 billion in credit insurance on structured finance products had been written, of which about \$126 billion covers mortgage holdings. On the other hand, total resources by the insurers to pay any claims stood at \$54 billion. Mr. Dinallo believes that so-called “naked swaps” (by companies that lack the full funds to pay off claims) should be disallowed and that such swaps can be made only by insurers who can fully cover their obligations in the event of claims.

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Leases: Auditing Revisited

By David Tevlin

The emergence of outsourcing by major corporations of most or even all of their real estate functions has been a significant development within the real estate industry. This continuing trend shows no signs of letting up and has witnessed many positive results, also with some negative realities. Many corporations now benefit by having large national real estate firms provide a wide array of services and functions that were not previously performed or were performed internally at a substan-

dard level. Having a national real estate firm provide a cadre of services allows highly qualified experts to handle a host of concerns that many corporations could not monitor effectively. However, hidden costs and a downside do exist. One major downside is the possibility that the overall picture might be ignored by having each task handled by a specialist with only one objective – the completion of a particular assignment.

The Broker-Provided Lease Process

Most national brokerage firms undoubtedly possess large in-house staffs that provide as a comprehensive and full administrative function. In terms of the lease document itself, brokerage firms now regularly use in-house staff to abstract, review, and interpret thousands of leases each year for their clients, usually in a highly effective manner. This exercise, better known as a “desk audit”, does have significant limitations and drawbacks, however, if not also followed up with on-site field inspections when warranted.

Desk audits actually represent only the first step in a truly effective lease audit process. By reviewing the lease and comparing actual charges to relevant indices and industry standards, as well as comparing previous years’ billings, a desk audit can unveil discrepancies, and on occasion, pinpoint a specific cause or issue that can result in identifiable savings. However, this type of occurrence is far from the norm. Most successful desk audits create a starting point from which to begin, rather than end, the lease audit process. A loose comparison might be that of an experienced crime scene investigator, who upon

showing up a crime scene, uses all the tools at his disposal before reaching conclusions as to the actual course of the events.

Once a thorough desk audit has been properly performed, an informed decision can be made as to whether the investigation warrants continuing with a full lease audit that involves a detailed review on-site of the landlord’s (or property manager’s) books and records, or perhaps just asking the landlord to supply additional information in order to tie up loose ends.

The Problem

Over the past several years, the evolution of the corporate real estate industry has resulted in many changes. One major change has been mergers or consolidations of many real estate service providers into larger more comprehensive organizations better suited to provide enhanced levels of service to more and more companies, both U.S. and globally. While the concept seems sound, when these massive real estate firms also own, manage, lease and provide capital financing, it becomes apparent that an element of independency has been lost or at a minimum, compromised. The issue then arises as to whether this creates a conflict of interest, notwithstanding the many positive benefits of an outsourced real estate process. Most corporations probably just look the other way. While it is recognized that the major real estate firms employ dedicated and talented professional staffs, that fact remains that the firms, by and large, are representing dozens of other landlords or in some cases the same landlord for which a lease audit is being undertaken. While most real estate brokerage firms firmly assert

that these competing functions are being performed independently by separate sectors of the company, the potential conflict of interest cannot be denied. In the world of corporate due diligence and cost verification procedures that has been greatly augmented by the Sarbanes Oxley Act, is it not prudent that an independent lease audit expert be retained to review what for most corporations is the second largest corporate expenditure?

Audit Follow-Ups

Lease auditing has traditionally been regarded as a sub-set within the lease administration function that includes brokerage, facility management and project management. It is the author’s understanding, based on inquiries to companies using major brokerage firms for their lease administration, that desk audits, if performed at all, usually result in little or no recommendations for further audit reviews of the property manager’s books and records. It has been the author’s experience that audits of 15 to 25 percent of larger properties (over 20,000 square feet) normally result in requests for further clarification from the landlord to ascertain whether billing of the lease has been fair, accurate, and in accordance with both the actual lease document provisions and generally accepted industry practices for the geographic area.

By utilizing the services of an independent lease audit firm to handle the periodic review and performance of leases, business tenants can be assured the lease administrator or auditor is clear of any conflicts. An added benefit is having a second set of eyes

reviewing these important documents for accuracy and correction.

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Home Sale Exclusion: New Provision

By Robert Klein

An individual homeowner can exclude up to \$250,000 (\$500,000 if married) on gain realized on the sale of a principal residence. To be eligible for the exclusion, the home must have been used as a residence for at least two of the five years ending on the date of sale. An individual or couple owning more than one home could double the value of the tax deductions by careful timing, i.e., living in one home for two years, selling it and excluding up to \$500,000 of any gain, then moving into the second home and

treating it as a new primary residence and selling it after two years and once again taking the exclusion. The new housing law, in order to prevent such a double exemption, provides that a homeowner cannot exclude the gain from a sale that includes periods of "non-qualified use." This includes any period (beginning in 2009) when the home is not used by the homeowner as a principal residence. Use of the home as a vacation home, or as a rental property, would be considered to be nonqualified use.

Examples

Example 1. Assume a person buys a property on January 1, 2009, for \$400,000, and uses it as rental property for two years while claiming \$20,000 of depreciation deductions. On January 1, 2011, the person converts the property to a principal residence. On January 1, 2013, the person moves out and sells the property for \$720,000. As under

present law, the \$20,000 gain attributable to the depreciation deductions is included in income. Of the remaining \$320,000 gain, 40 percent of the gain (2 years divided by 5 years), or \$128,000, is allocated to nonqualified use and is not eligible for the exclusion. Since the remaining gain of \$192,000 is less than the maximum \$250,000 exclusion, the \$192,000 is excluded from income.

Example 2. Assume an individual buys a principal residence on January 1, 2009, for \$400,000, moves out on January 1, 2019. On December 1, 2021, the property is sold for \$600,000. The entire \$200,000 gain is excluded from gross income, as under present law, because periods after the last qualified use do not constitute non-qualified use.

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