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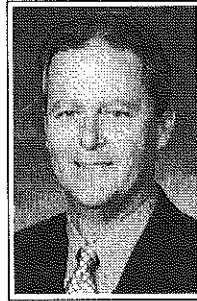
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## Combining Build-To-Suit With A Tax-Free Exchange

There is a great deal of control that can be exercised over the type of property to be received in a tax-free exchange. In one case, the taxpayer designed a brand-new building for himself to replace property to be given by him in exchange. In addition, the taxpayer provided financing for the new building's construction.

Since this was a different idea, the problem was presented to the IRS as whether the taxpayer could act as both lender and exchanging party or whether his actions amounted to a purchase of the new property (which would force him to recognize gain on the property given up).

The taxpayer owned an office building but needed additional space. An unrelated party, Mr. Smith, offered to buy the building but the taxpayer wanted a tax-free exchange to avoid the tax on the large increase in value on the property.

The taxpayer located land suitable for construction of a new building. Smith agreed to negotiate a ground lease, construct the building according to the

taxpayer's requirements, and then enter into an exchange.

Smith and the landowner entered into a lease that provided as follows:

- Either Smith or an assignee of the ground lease could construct the improvements.
- The ground lessee could mortgage its leasehold interest but the landowner agreed it would not mortgage its fee interest.
- After five years, lessor and lessee each had the option to purchase or sell the land for a fixed amount specified in the lease.
- On the date of the tax-free exchange by Smith with the taxpayer, the ground lease would have a remaining term of 30 years or more (which would make the leasehold qualify for a tax-free exchange).

The taxpayer and Smith then entered into an exchange agreement under which Smith agreed to construct the new building according to plans and specifications approved by the taxpayer. The taxpayer could make changes to the plans →

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

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- New Uses For Apartments And Commercial Buildings
- Improvements On Apartment Properties Will Increase Values

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.

## Combining Build-To-Suit...*(Continued)*

before and during construction and had the right to approve costs under contracts to which Smith, the architect, the developer, or any affiliate was a party. The taxpayer could also approve the general contractor and other parties.

At the closing of the exchange, the taxpayer would convey the old building to Smith in exchange for his assignment of his ground leasehold, including the new building.

The exchange would not take place until the building was substantially completed. Its exchange value was Smith's construction costs, including fees, construction loan interest, real property taxes, and insurance. Once Smith had spent a specified amount on the project, the taxpayer would provide construction loan financing to Smith on a nonrecourse, interest bearing basis.

At or before the closing, Smith would repay to the taxpayer as much of the construction loan as was required to equalize the exchange value of the new and old buildings.

Two other relevant provisions in the exchange agreement were the following:

- **Right to cancel.** The taxpayer had the right, before the execution of the exchange agreement and the commencement of construction, to make environmental, zoning, and similar reviews of the land and cancel the entire arrangement if the results were unsatisfactory. In such event, the taxpayer would reimburse Smith for his expenses incurred.
- **Leaseback.** Immediately after the exchange, the taxpayer would lease back from Smith for 10 years (at a fair rental) the portion of the old

building that contained the taxpayer's computer data center.

In its Letter Ruling, the IRS noted that courts have given taxpayers great latitude in structuring exchange transactions. For example, taxpayers may oversee improvements in land to be acquired and advance money toward the purchase of the property to be acquired in the exchange.

On the basis of the facts described in the Ruling, the IRS concluded that Smith's risks of ownership with respect to the new building were substantial enough so that a true exchange would result; put another way, Smith was not acting merely as the taxpayer's agent.

The risk of ownership included the following:

- Smith's obligations under the exchange agreement, including the construction of a building to the taxpayer's requirements.
- The taxpayer's rights as a lender with respect to the financing.
- Smith's obligation to spend a specified amount before the taxpayer would be obligated to provide financing.
- Smith's liability before the exchange for any claims made with respect to the construction or related contracts.
- Smith's obligation under the lease.

The ability of the taxpayer to exercise significant control over the design and construction of replacement property while still qualifying for a tax-free exchange broadens the attractiveness of an exchange in permitting a taxpayer to avoid recognition of the appreciation in value of the original property. ■

## New Uses For Apartments And Commercial Buildings

Real estate obsolescence has been an increasing problem. When we think of obsolescence in its usual sense, it is the natural result of a growing and changing society. It reflects *functional depreciation*, a property that became outmoded or excess because there was no demand for that type of space. Examples might be gas stations or bowling alleys, which while still used, suffered from a change in demand. In today's rapidly

changing society, many newer buildings are found by their owners to be functionally obsolete while still new or even when just completed.

Obsolescence is also caused by *economic and social depreciation*, usually resulting from changes in neighborhood which makes the original use of property no longer suitable. An example would be an apartment property in an area that has become commercial. ➔

### Three Choices Available

The owner of a property that suffers from obsolescence can handle it three ways. The building can be demolished to hold the land for future use; the building can be boarded up to "mothball" it until demand revives; or convert it to another use. Demolition or mothballing means an indefinite period of continuing losses. Conversion offers the possibility of renewing cash flow, but will require a new capital investment.

### Apartment Properties

One type of property has successfully made a conversion in some locations. The residential-style commercial property or apartment property located in a commercial area can be in difficult financial condition. The solution can be conversion to the extended stay hotel. Many conversion opportunities exist in downtown locations. The property must be located close to feeder business that attracts extended-day business travelers.

To attract the five-or-more-night guest, the hotel should provide the following: (1) studios and one and two bedroom suites that are larger than the standard hotel room; (2) a fully equipped kitchen; (3) a private outdoor entrance; and (4) at least a minimum amount of public space, including meeting rooms and restaurants.

Residence Inn by Marriott, the extended stay lodging chain, has plans to expand by conversion of nonhotel properties into its brand of residential hotels that primarily serve travelers staying for five or more nights. Rental or condominium apartment buildings as well as retirement communities are examples of the types of properties that might be suitable for conversion. The company estimates that 20% of its expansion goal will be met through conversion of nonhotel properties or the acquisition of hotels

To date, most Residence Inns are low-rise suburban properties near corporate developments and office parks, but the chain also operates high-rise hotels, converted from other uses.

### Commercial Offices and Banks

Bank buildings can be surplus because of bank failures and mergers. Office buildings may be vacant because of the movement of some businesses to the suburbs. Because these properties usually are in excellent locations, they are candidates for conversion.

Office buildings that are designed for smaller tenants can be suitable for residential use because many of the office units approximate the size of apartments. They may not be suitable for industrial or warehouse use because the struc-

tural support for that use may be lacking.

The banks and thrifts often have large floor space like theaters. These can be easily converted to restaurant use, retail or a public facility. The high ceilings in banks can be appropriate for adding a mezzanine level to increase the amount of usable space.

### Theaters

With modern multi-plex theaters being developed in malls, the older conventional theater offers interesting possibilities in downtown and suburban areas. These buildings are usually well constructed and have that unobstructed interior space. Since the trend has been away from the downtown locations, the theater can often be purchased at a bargain price.

In Louisville, Kentucky, an old movie theater was converted to a 150 seat restaurant. Some of the success was attributable to some unique features of the theater:

- Many local people had attended the theater over many years and had formed a sentimental attachment to it that carried over to the restaurant.
- The 5,000 square feet was large enough for a good-sized restaurant. The theater had a parking lot, a good downtown location and unique architectural features.

The theater property was a perfect place for the conversion. When the seats were removed, the large open space was left. The area of the stage became an open kitchen. The lobby became a 50-seat bar.

The sloping floor of the theater might be seen as a problem. In this location, the dining room was divided into three descending platforms, each one seating about 50 people. Dividing the area up also created a more intimate atmosphere.

Other examples of theater conversions:

- **A catering hall.** The open interior can become one or more large-functional rooms.
- **Apartment house.** In one location, the theater became an three-story apartment house after installing new floors and cutting windows into the walls.
- **Commercial Building.** By dividing the building space into two stories and making use of the basement for below-ground stores or amusement facilities, the building can be converted to commercial use.
- **Factory.** The large open space and high ceilings of a theater may be suited to light manufacturing. ■

# Improvements On Apartment Properties Will Increase Values

The value of an investment property is based directly on the income from the property. For apartment owners, the way to increase rental income and gain a bigger return on investment is to improve the property. One way to reduce vacancies and increase rentability of apartment units is to make them cleaner, brighter, fresher, more comfortable and homey than other apartments in town.

Sometimes these two objectives can be in conflict. For instance, an improvement designed to attract tenants may cost so much that the amount of necessary rent increase makes the units harder to rent.

## The Factors In The Decision

Here are some ideas about the factors that come into the decision to make alterations, or remodel the apartment property:

- Take a hard look at the rent schedule to see what the vacancy situation is now, if there are any concessions or giveaways currently in effect in the building, and the prospects for renewals. The answers can provide some answers about the timing of renovations.
- Painting both exterior and interiors is a good and inexpensive way to make a property look instantly better. This usually yields an immediate and satisfactory return on the cash cost. Experts recommend the use of lots of white and soft colors. If you think about using wallpaper or wallcoverings for a more formal effect, realize that they cost more initially, but may last longer than paint.
- If you replace carpets, drapes and appliances, the appearance of the unit is dramatically improved and the chance for rentability increases. These costs, however, cannot usually be recouped quickly by means of a higher rent charge.
- Adding some recreational facilities can be a way to attract tenants. At some properties, a

jogging track might be provided at a fairly low cost. Other exercise equipment such as horizontal and parallel bars can be inexpensive. Providing saunas, indoor exercise rooms, aerobic exercise areas or swimming pool are expensive and may not be justified by either an increase in rentability or return on investment.

- Take care if any kinds of exercise facilities are added, check with your liability insurance agent to determine the protection needed against litigation from injuries.
  - Adding barbeque pits and picnic tables if space is available can inexpensively attract tenants.
  - Remodeling a kitchen or bathroom is always expensive. If your kitchens and bathrooms are now very outdated, they may be costing you lost rentals. If the funds to do the remodeling must be borrowed, making the determination of the amount of increase in rent will take careful calculation. Try to recover at least the financing costs within the first term of the lease.
  - Sometimes a washer and dryer rental company will totally refurbish the laundry room as part of the opportunity to install their coin-operated equipment. The owner of the property can make the property more attractive and rentable without any cash outlay at all.
  - In some apartment properties, recreation rooms have been converted into a day-care center staffed by a licensed day-care operator. The room might be divided for use by both young children and elderly people. It becomes a source for additional income for the owner and a drawing item for working mothers and for workers who care for elderly parents. Again, check your liability insurance!
- Always keep tabs on the condition of the property. Make repair and improvement decisions promptly. If conditions deteriorate, it can lead to costly projects later. Keep very alert to what the competition is doing and always try to stay competitive with them. ■



*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.*