FEATURE | LEGAL

Highlighting the legal challenges of 2011 ...

David Anderson

Joseph Mella

Joseph Mirr

Jeffrey Serum

Real estate pros will face many legal challenges in the coming year. Four attorneys with Wausau, Wis.-based law firm Ruder Ware tackle the biggest of these issues in this feature story.

by David Anderson, Joseph Mirr, Joseph Mella, and Jeffrey Serum

While certain aspects of the real estate business will be the same, and other aspects will change and adapt, there are certain areas that will present particular opportunities and challenges for 2011.

Installation of renewable energy systems

Interest in improving the energy efficiency of developments with the installation of renewable energy generation systems continues to grow. Geothermal, wind and solar energy systems are among the most popular installations.

Renewable energy generation system installations can be attractive from a financial standpoint in part because of current tax incentives. For example, the federal government provides an investment tax credit (ITC) for eligible taxpayers equal to 30 percent of the qualifying cost of a wind or solar energy system, including installation costs (typically 10 percent for geothermal energy systems installed on commercial development).

Eligible taxpayers may elect to take the ITC as a cash grant in lieu of the credit. Commercial renewable energy projects may also benefit from an accelerated five-year depreciation schedule. Further, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 allows certain systems placed in service after Sept. 8, 2010, and before Jan. 1, 2012, to qualify for 100-percent first-year bonus depreciation. Many states offer additional tax incentives.

Federal, state and local regulations may impact renewable energy systems. In some localities, renewable energy systems may require a conditional use permit or a site permit. Height restrictions, maximum ground coverage restrictions and exterior appearance regulations are just a few of the many regulations that impact renewable energy systems. A growing number of municipalities are enacting "green ordinances," which often include system restrictions. Before proceeding with the installation of a renewable energy system, it is important to confirm that it complies with all applicable regulations. It is also important to acquire all necessary permits.

In some instances, it may be necessary to acquire easements to operate renewable energy systems on a property. For example, solar and wind energy devices often require easements to ensure sufficient access to the sun and wind. It is also important to review all private covenants and restrictions of record that may impact the ability to install and operate renewable energy systems.

Other documents to review include roof and ground space leases and related agreements, as they often allow cable, telephone and Internet service providers to install and operate antennas and other devices that may restrict a renewable energy system. Thorough due diligence is necessary to determine whether a renewable energy system is appropriate for a particular property.

Intergenerational family wealth and asset transfers

Recent changes to the federal estate tax laws, coupled with level to depressed real estate values, make 2011 an excellent time to consider transferring real estate to children and grandchildren. A variety of options exist to reduce the tax impact of such transfers.

One option is for the donor to make annual gifts of real estate or real estate interests. Under current law, a donor can make annual exclusion gifts of $13,000 per beneficiary per year free of gift tax. For example, a husband and wife who own a commercial building and have three children can each make gifts of partial interests in the building of $13,000 per year to each of their children, resulting in a transfer of $78,000 in value to their children each year gift-tax-free (6x$13,000). Repeating the process for five years means that $390,000 in value can be transferred to the next generation free of gift taxes.

In addition to annual exclusion gifts, each donor can make gifts totaling up to $5 million free of gift tax. This amount increased from $1 million effective Jan. 1, 2011.

Another option is to place real estate assets in grantor trusts. By making such transfers, the assets will be removed from the donor estate for estate tax purposes, but they are included for income tax purposes. Future appreciation of the real estate will build up tax-free in the trust, but the donor will have the use of the income. A somewhat more complicated version of a grantor trust, known as a grantor retained annuity trust (GRAT), can significantly increase the pace of such transfers.

With a GRAT, the donor can contribute income-producing real estate to the trust, but retain the right to receive an annuity payment each year for the stated term of the trust. The present value of the annuity stream is determined based on today's (historically low) interest rates. If the present value is equal to the value of the property transferred, the donor will not be treated under IRS regulations as having made a gift. However, if the GRAT assets produce a total return during the GRAT term in excess of the predetermined rate, the excess return can be moved to the beneficiaries free of gift tax.

Making partial gifts of interests in real estate can be somewhat cumbersome. However, if the real estate is owned by an entity such as a corporation, limited liability company, or limited partnership, ownership interests in the entity, such as shares of stock in a corporation, can be transferred much more easily.

When contemplating gifts of real estate or interests in real estate, it is important to determine if existing mortgages prohibit any gift or transfer of ownership without lender consent, in which case the consent should be documented in writing. Other issues to consider, which are beyond the scope of this note, include how the gift will impact on the beneficiary's basis of the property received and how depreciation will be affected. When contemplating

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Renewable energy, restructuring ownership, reviving developments top the list

a generational gift of real estate it is important to consult a qualified attorney.

Restructuring current ownership arrangements

Challenging markets have presented many of the players in the real estate arena with unexpected opportunities to reconsider the ownership structure and use of developments. Many lenders find themselves the owners of properties established as residential or commercial condominiums that are unsold or undersold, meaning few, if any, of the condominium units have been sold to third parties by the developer.

In some cases, lenders are looking at their options to remove the property from the condominium form of ownership, in essence a reverse condominium conversion. This radical step is being considered to seek more efficiencies in management and to eliminate the costs required to operate a condominium, and to increase flexibility in the layout of the structure itself, since typical condominium units are defined with specific boundaries that cannot be changed without amending their creation documents.

While condominium laws vary by state, many are patterned after model condominium laws that present similar issues when considering this process. It is important to remember that all stakeholders in the development need to be involved in the process, including any condominium unit owners and their lenders. The impact of conversion needs to be examined in light of municipal regulations, too, particularly if the condominium form of ownership was used to avoid the application of existing zoning rules. The party seeking to restructure the condominium must be familiar with the state laws covering reverse conversions and diligently follow their procedures.

Reviving struggling developments

Many developers face many ongoing challenges with retail developments. Challenges often include big box and anchor tenant vacancies, slow retailer growth, the rise of online retailing and ongoing credit problems. Tenants are seeking rent reductions and, in some instances, temporary rent abatement as a condition to extend or renew existing leases. Some developers are appealing property tax assessments of struggling developments. Given current vacancies and changing consumer lifestyles, an emerging trend is to lease retail space to non-traditional tenants such as thrift stores, pawn shops, clinics, churches, seasonal stores, day cares and trade colleges.

Although non-traditional tenants may be eager to move into vacant retail spaces, developers must consider a myriad of business and legal issues before signing the lease. On the business side, carefully review the non-traditional tenant's impact on the development's image and value. Tenant mix consideration such as parking requirements and cross-shopping generation are critical. On the legal side, developments are typically subject to various forms of private-use restrictions in the forms of recorded building and use covenants or reciprocal easement and operation agreements that in many cases limit the types of tenants permissible. In other cases, anchor tenant leases may contain exclusivity provisions.

In cases such as these, legal counsel is being called upon to work with the developers, property owners and tenants to amend the use restrictions or leases. Potential pitfalls for the unwary include the failure to bring all the necessary parties to the table for these procedures, as consent from all, including lenders and in some cases municipalities, is necessary for the modifications to be completed properly.

Conclusion

While the country is not out of the woods yet, opportunities in real estate exist. Attention to details and assistance from skilled legal counsel will help real estate professionals cope with the challenges and take advantage of these opportunities.

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