

IN THE SPOTLIGHT

**Leasehold Financing:
It's Good to Have
Options***Including a Lender's
Baseline Requirements for
A Lease to be Financeable
In a Ground Lease*

By Jay Melnick

Let's face it — we all like instant gratification. However, as current market conditions force us to sober up from years of economic over-indulgence, there is a need to discard those practices that may previously have seemed perfectly reasonable. It is now clear that these practices were not in fact properly thought-out or sufficiently disciplined to provide for true long-term stability or future success. This article discusses one particular concept in commercial leasing, which, if properly addressed and negotiated up front, is likely to benefit both the landlord and the tenant by providing greater security and increased credit possibilities in the years to come — namely, leasehold financing.

**LEASEHOLD FINANCING AND
WHAT IT IS**

Leasehold financing is secured by a mortgage on the tenant's interest under a lease. As with fee-based financing, the lender in a leasehold financing transaction will record a mortgage or deed of trust against the collateral property, but in the case of leasehold financing, should the

*continued on page 3***Tax Issues for Real Estate Leasing by
Tax-Exempt Organizations***Developing and Leasing Vacant Land*

By Michael J. Huft

The first article in this series, published in March 2009, examined the issues involved when a tax-exempt organization leases improved property to one or more parties, for example a research building owned by a university leased to one or more private businesses. The primary issue examined in that article was whether or not the lease payments to the university constituted, in whole or in part, payments for services provided to the tenants, rather than purely payments for the rental of real property.

The article herein examines the issues involved when a tax-exempt organization owns a tract of vacant land that it wishes to develop and lease, so as to realize a stream of income from the land greater than would be realized by a simple sale or lease of the unimproved property. The third and final article in this series will examine the special cautions that must be observed if the real estate is debt-financed.

REVIEW OF UBIT

As described more fully in the earlier article, the federal tax code imposes a tax (referred to as the unrelated business income tax, or "UBIT"), computed at the corporate income tax rate, on the unrelated business taxable income ("UBTI") of most exempt organizations. An unrelated business is any trade or business, the conduct of which is not substantially related to the performance by such organization of the functions that constitute the basis of its exemption from tax. The tax code provides for the categorical exclusion from UBTI of income from certain enumerated sources or arising from certain activities, including all rents from real property, provided that the determination of the amount of such rent does not depend in whole or in part on the net income or profits derived by any person from the property leased.

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Trouble in Lease Land

A Guide to Retail Lease Workouts

Part Three of a Three-Part Article

By M. Rosie Rees

Parts One and Two of this article discussed a variety of methods to keep the tenant operating. The conclusion herein addresses lender issues and tax considerations.

LENDER ISSUES

Once the landlord has decided to modify a lease for a troubled tenant or a troubled center, it must first check its loan documents. The landlord may find that certain concessions it wants to give are not permitted under the loan documents without the lender's consent. The parties might then tailor the lease modifications either to avoid the need for consent or make consent easier to obtain.

The lender will probably have the right to consent to "material changes," which include any lease modification that: 1) reduces the rent stream; 2) downsizes the tenant's premises; or 3) gives the tenant the right to terminate the lease. The landlord will have to convince the lender that it is in the best interest of the project to retain the tenant with these modifications.

The lender may be willing to agree to changes that do not require giving the landlord additional funds, but may not be willing to increase allowance payments or provide

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Tax-Exempt Issues

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the IRS will recharacterize the arrangement as a joint venture, or partnership (and tax the profits received by all "partners"), if it concludes that the reality is that the two parties are sharing profits, regardless of the terminology of the

funds for the landlord to perform the tenant's build out.

TAX CONSIDERATIONS

Many of the foregoing techniques can have significant tax consequences to both the landlord and the tenant. Landlords and tenants should consult with their tax advisors early in the workout process. Federal income tax issues that should be analyzed include, but are not limited to the following.

Income vs. Reimbursement

Each party will need to determine whether a particular payment between a landlord and tenant (*e.g.*, construction allowances and termination fees) is income to the recipient that must be recognized in the year of receipt, or whether such payment can be deferred or characterized as a reimbursement.

Deductible vs. Capitalized

Each party will also need to determine whether a particular payment between a landlord and tenant is deductible by the payor or whether such payment is required to be capitalized and depreciated or amortized (and the applicable depreciation or amortization period).

Participating Rents

The parties also need to consider whether certain "participating rents" (for example, percentage rent or relief based on gross sales) will: 1) create "unrelated business taxable income" for direct or indirect tax exempt investors; or 2) generate non-qualifying income for a real estate investment trust.

Section 467

Another concern is whether the prepayment or deferral of rents, or rents that fluctuate from year to year, will cause a lease to be subject to Section 467 of the Internal Revenue Code. Code Section 467 imposes on landlords and tenants a formula for

agreement. A provision permitting the parties to renegotiate the base rent at some point in the future based either on agreement or on a reappraisal of the property, can also be a hidden time bomb. Unless the lease carefully sets appropriate parameters to the process, there is nothing to prevent the parties from basing their new agreement on net

determining the income and deductions that must be accrued in connection with a lease, which income and deductions may not match the actual cash payments contemplated by the terms of the lease.

Local Tax Issues

The income tax rules in most states will generally follow federal principles. One purely local issue will be the possibility of transfer taxes or reassessments of property taxes in connection with an extension, termination or an assignment of the lease.

LITIGATION CONCERNS

A primary goal of negotiating a lease workout is to resolve the parties' disputes amicably and avoid litigation. However, much of these negotiations will take place in the context of one or more defaults under the lease by either the landlord or the tenant. It is a good idea for each party to understand the rights and remedies available under law arising from such defaults, to gauge the necessity and benefits of any proposed compromise. Having a litigator review the lease early on, to assess the available remedies and the likelihood of recovery, may be very cost effective.

CONCLUSION

When financial problems affect the ability of a retail landlord or tenant to perform its lease obligations, both parties can be mutually benefited by working out a solution that keeps the tenant operating and paying rent. By understanding the lease workout methods available and their corresponding consequences, retail landlords and tenants can tailor their agreements to alleviate the financial strain on the tenant and maximize the occupancy of the center.

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income, or the appraiser from using net income of any person as one of the bases of the appraisal.

The next article in this series will discuss the applicable Treasury Regulations and IRS rulings under the federal Tax Code, as well as other issues that arise if the property is developed and sold.

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