Best Practices for Construction and Real Estate Firms

As the economy continues to improve, the commercial real estate market and the building trades stand to regain the financial footing they once enjoyed in better times.

By Miles Z. Epstein
Editor, COMMERCE

THE CONSTRUCTION AND REAL estate industries are connected to the economy in significant ways, and are subject to the ups and downs of the market. But there can be up to a three-year lag between the economy rebounding and construction and real estate regaining their momentum. From financing requirements to delayed payments to ever-changing zoning and regulatory hurdles, profiting from these complicated enterprises requires top-notch accounting, banking and legal expertise. In fact, here are some key best practices for construction and real estate firms in New Jersey.

ACCOUNTING

Citrin Cooperman
By Scott Derco, CPA, Director, Construction Industry Practice Group

One of the most common frustrations I hear from my construction clients is the inability to get paid timely (or at all) from their customers. Collections issues, coupled with increased competition, lower margins, claims and litigation, can put a significant strain on a company's cash flow. I routinely advise my clients to protect themselves by having a good screening process in place, which can identify problem customers before a project even begins. One of the best ways to obtain information about a potential customer is to contact people who have worked with this company. Some great sources can include your banker, sureties, peers in the industry, as well as local trade associations. Your attorney can also be used to research the litigation history of a company. If a customer has a poor credit history, you should ask for additional protection. This can include a bond, letter of credit, retainer or escrow deposit, or a personal or corporate guarantee. Requesting a financial statement can also provide more insight into the customer's financial stability and their ability to pay. Lastly, maintaining good documentation of all communications with a customer can be the difference in recovering payment in a litigation or claim situation.

CohnReznick LLP
By James Kiernan, CPA, Senior Manager

A longstanding client was in the process of building a new location for their business. The client was looking for tax savings options in order to offset some of the significant cash outlay related to constructing the building. Working closely with the owner, accounting staff, and construction/engineering personnel, we were able to identify an opportunity to implement a cost segregation study in an effort to accelerate the depreciation on the building and reduce their current tax liability. Cost segregation studies can save real estate owners significant tax dollars by reallocating certain building costs into separate identifiable components that can be depreciated over shorter lives, thereby accelerating depreciation deductions. While the tax savings from every cost segregation study is different, our experience indicates the tax savings will range from 2.5 percent to 5 percent of the property cost. In addition, in the initial conversation, we discovered that the building qualified for energy tax credits, which would further assist them with their tax liability. Through our tax credit advisory practice, we were able to assist the client in navigating the complex process of applying for the tax credits—resulting in a favorable return.

EisnerAmper LLP
By Jordan D. Amin, CPA, MST, Partner

Our client owns and manages industrial rental real estate. One of their tenants contaminated the land and was the subject of a New Jersey Department of Environmental Protection investigation. An environmental remediation was required. Unfortunately, the tenant declared bankruptcy, leaving the landlord on the hook for the cleanup. As part of the bankruptcy settlement, $3 million was to be paid to the landlord for the cleanup. The landlord would be responsible for any excess costs. If our client had to pay tax on the $3 million in the year received, they would have to use their own funds for the remediation, and wait for the completion of the project to recoup the tax paid through tax deductions. We advised the client to establish a Qualified Settlement Fund under Internal Revenue Code §468B. By meeting the requirements of §468B (established fund via a court or governmental order, in order to resolve a claim, and the funds were to be segregated or maintained in trust), the $3 million received wasn't subject to income tax upon receipt by the fund, and the expenses incurred for the remediation were likewise not deductible. The land was cleaned up and the client avoided an unnecessary tax burden.

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Friedman LLP
By Glenn M. Josephs, CPA, Partner

In 2010, a nursing home owner and operator client entered into a lease for a building that housed a former nursing home, and set out to completely remodel it into a state-of-the-art facility. They spent almost $3.5 million on leasehold improvements, equipment and furniture. We segregated almost 50 general ledger pages of invoices into the most beneficial categories, and were able to record bonus depreciation on all capitalized assets. This allowed a depreciation deduction of more than $1.5 million for 2010. The two entity owners were in

the highest tax bracket and saved more than $625,000 total for the year. The funding for these expenditures was obtained by loans from the company and was guaranteed by the members. The IRS decided to audit the entity due to the size of the deductions. They wanted details of the expenditures, along with proof that the members had the correct guarantees on the loans so that they had the basis to take the loans. We provided the invoices with descriptions, documentation on the loans and the members' guarantees to the IRS. Over the next 12 months, the IRS reviewed each invoice and loan document, and determined that all the invoices were valid, all categorizing was correct and that they had the basis to take the losses. As a result, the IRS delivered a "no change" determination and all deductions were allowed.

Hunter Group CPA LLC
By Kevin J. Hansen, CPA, Co-Managing Director

My advice to clients who own and manage rental real estate, especially multi-tenant properties, is not to relinquish responsibility for the management of the property to others without plenty of oversight. Unfortunately, over the years we have had a few clients hire outside management and let them completely take over all operations. Later, they discovered too late that their profits and security had been compromised because they were too trusting to ask tough questions or get involved. Hiring outside services does not mean you can relax. There must be oversight. There must be accountability. That includes surprise visits and sometimes asking uncomfortable questions. There absolutely must be good recordkeeping and routine inspections to ensure your wishes are being executed to your satisfaction. Don't give others fiduciary or legal powers without your direct involvement. And, I know this sounds basic, please read important documents before you sign for covenants, promises or liabilities that you are not comfortable providing. Above all, use both your CPA and your attorney as part of your management team. These professionals not only provide guidance, they can act on your behalf when complex matters arise, and help you keep your hard-earned assets working for you.

O'Connor Davies, LLP
By Christopher Casini, CPA, Partner

In the world of accounting for construction contractors, there are unique issues and complexities. From reporting on the percentage of completion to completed contract method, over- and under-billing to backlog and retainage, it's critical for management, finance and project personnel to understand the intricacies of numerous accounting issues. Recently, we worked with a client who was experiencing cash flow issues due to a number of factors, including slow receipts from general contractors, under-billing on numerous contracts, and an inability to identify unprofitable jobs. We assisted management in reviewing the status of contracts and identified jobs that were not being billed and collected on time. We stressed the important role the project manager plays overall, and in the collection process. Tasked with monitoring and communicating the status of projects and challenges to management, the project manager is in the ideal position to employ the needed action when collection issues arise. Additionally, we identified instances where retainage was owed to the company but was not released. The key to success was that we helped our client better understand the terms of the contracts for each of their projects, resulting in more timely billing and ultimately the collection of funds due to them.

SaxBST
By Ermal Luzaj, CPA, MBA, Partner, Construction and Financial Service Industry Groups

Our client, a contractor in the tri-state area, was not able to increase his line of credit and his bonding capacity. SaxBST's construction group got involved in the process and helped the client provide the necessary information to prepare a financial statement which included a Percentage of Completion Schedule. In addition, the team was involved in reviewing and streamlining the existing processes within the client's accounting department, such as performing account reconciliations; managing and tracking job costs; and allocating equipment costs, etc. We recommended an insurance broker from a local brokerage firm who was able to obtain a bonding line for the client in a relatively short term. In addition, we recommended a bank that was able to provide the financing needed within two weeks.

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Sobel & Co., LLC
By Ken Bagner, CPA, MST, Member of the Firm

Our firm recently enjoyed a significant success story while working with one of our clients who had just completed a major electrical rewiring project at their facility. Based on the new IRS regulations regarding repair and maintenance costs, we were first able to identify the prior (old) wiring by conducting a cost segregation study and secondly, write off the remaining tax basis of the prior wiring through a partial disposition. The result was a savings of hundreds of thousands of dollars on this multi-million dollar improvement project. This can even be done for prior year improvements by filing Tax Form 3115. It is important to note, though, that for prior year improvements the IRS is allowing a one-time cleanup to appropriately write off assets that are essentially recorded twice in the company's tax depreciation records—but this opportunity expires at the end of 2014. Once it expires, the business can only take advantage of writing off the cost of prior assets when they have new improvements.

The Mironov Group, LLC
By Stuart J. Raskin, CPA, Partner-in-Charge, Real Estate Industry Practice

One of our clients, a central New Jersey auto dealer, was experiencing a significant increase in sales volume for his Hyundai franchise. In order to meet this demand, his dealership underwent an $8.3 million construction project—a major renovation that included a more modern facility with a second-floor addition, expanded showroom, new customer lounge and corporate offices, as well as additional lot space for sales vehicles and customer parking. When the renovation was completed, we advised our client to undergo a cost segregation study to take advantage of potential tax benefits and increased cash flow. The engineering firm that completed the cost segregation analysis was able to reclassify $3.6 million of the personal property and land improvements into shorter depreciation lives of 5, 7 and 15 years instead of the standard 39-year life for federal tax purposes. Without a cost segregation study, our client would have had a $200,000 tax deduction in the first year. With the reclassifications from the cost segregation study and taking advantage of bonus depreciation eligible at that time, we were able to write off $1.8 million instead of $200,000. This resulted in a significant tax savings of $640,000 for our client.

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WeiserMazars LLP
By Joseph Stickland, Jr., RA, Director, Cost Segregation

WeiserMazars was retained by a New Jersey-based real estate owner after their purchase of a three-story, 53,000 square foot building for $6.1 million. We recommended a purchase price allocation, a disposal analysis and a cost segregation analysis of the final improvements. Our cost segregation professionals started by reviewing the preliminary project drawings, gaining a clear understanding of the planned use of the property in order to prevent assigning any purchase cost basis to assets that would be abandoned immediately. As a result, we captured the remaining asset bases and assigned them depreciable lives, allowing the client to accelerate their tax depreciation. Next, we analyzed the final building improvement drawings to determine which property would be disposed of as a result of the construction. We then determined a cost basis for the disposed assets and advised the client of the available write-off basis of the disposed property. Last, we provided a cost segregation analysis of the final improvement costs ($6.9 million), providing a cash flow benefit resulting from the accelerated depreciation of certain qualified assets, resulting in approximately $1.4 million in benefits. Becoming part of the project team early in the project life cycle resulted in this excellent result.

Wiss & Company, LLP
By Alex Narcise, CPA, Partner-in-Charge, Real Estate Services

Cost segregation studies provide real estate owners with valuable tax benefits by reclassifying asset lives on real estate purchases. Typically, when a building is purchased, it is assigned a 39/27.5 (commercial/residential) year life for depreciation purposes disregarding land improvements, tenant improvements, etc. These are many assets that can be reclassified in smaller incremental year lives, which would accelerate depreciation deductions and reduce taxable income for owners. The Wiss Real Estate Services Group conducted a cost segregation study for a client which granted the owner substantial savings in federal and state income tax. We sent the properties' details to our engineering colleague to analyze how much of the 39-year property could be reclassified. In a cost segregation study, the IRS allows a one-time catch up adjustment in the year the study is performed. The adjustment to income is made pursuant to IRC 481(a). In one instance, we were able to reclassify $2 million and $500,000 to five year and 15 year, respectively. The catch-up adjustment to the client's 2012 depreciation on this property was approximately $1.7 million. For the client's federal and New Jersey income tax rates, this yielded a cash savings of approximately $680,000.

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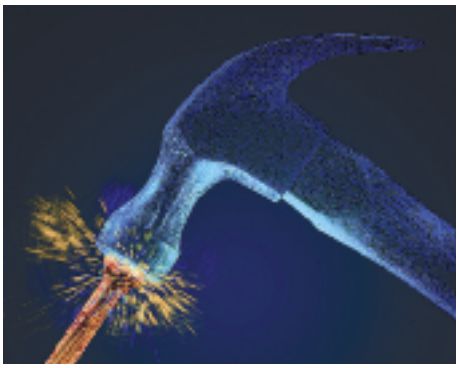
BANKING

Bank of America Merrill Lynch
By Todd Gomez, Northeast Region Executive, Commercial Development Banking Group

The lack of handicap-accessible housing, combined with the lingering impact of Hurricane Sandy, rendered a shore community in desperate need of safe, affordable housing for disabled individuals. To address the issue, Lawrenceville, New Jersey-based nonprofit Project Freedom began developing Freedom Village, a 72-unit affordable and supportive housing project in Toms River, New Jersey, this summer. The organization specializes in developing and operating housing for individuals with disabilities, helping them live independently while also receiving on-site social service support. Bank of America's Northeast Community Development Banking team helped Project Freedom manage the complex layers of financing the development. Due to the myriad capital sources involved, we needed to coordinate with all parties to ensure everyone was aligned and working together seamlessly. For example, the project received funding from the New Jersey Housing Finance Mortgage Agency (NJHMFA), the Federal Home Loan Bank, the Toms River Affordable Housing Trust Fund and the National Equity Fund, which provided Low Income Housing Tax Credits. With Bank of America Merrill Lynch as the lead lender providing the construction and equity financing, it was critical that we worked together to ensure consistent, open communication throughout the entirety of the process. As a result, Project Freedom was able to close the transaction in only two months, enabling construction to quickly begin.



Valley National Bank
By Russell C. Murawski, First Senior Vice President, Manager, Commercial Real Estate Department

Valley National Bank exceeded a customer's expectation with the timely delivery of a $12 million construction loan for the development of a grocery-anchored retail center. The proposed retail center was an integrated part of a much larger urban redevelopment that was at least 10 years in development with the town. Besides the normal complexity of any construction financing, the subject loan came with the added complexity of having to incorporate

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agreements with and between a variety of other developers, governmental agencies and the local redevelopment authority. Valley National Bank committed to the loan quickly, seamlessly executed the transaction and remained flexible through a number of key issues and negotiations. Some of those issues included working with another developer which was building at the same time on the same parcel of land. The ability to work as a team internally and establishing a strong customer relationship with the client was essential in making this loan happen in a timely and efficient manner.

LAW

Connell Foley LLP
By Mark L. Fleder, Esq., Senior Partner, Co-Chair, Construction Law Group

Connell Foley acted as special legal counsel to the public owner of a $400 million county jail being built in New Jersey. At the time Connell Foley was retained, the project was more than 900 days behind schedule and projected to run more than $100 million over budget. There were at least 15 major contractors, as well as subcontractors and suppliers, who had filed numerous claims related to the project, and many who claimed they were out of money and threatened to abandon the project. Connell Foley's role as legal counsel was to establish an immediate claims resolution process and promise each contractor decisions and payments for every settled claim. As a result, some $66 million in claims from more than 20 contractors and subcontractors were settled for approximately $20 million and no contractor left the project before completion. Legal counsel and claims consultants remained onsite to assist in both claims resolution and decisions on urgent construction issues. Following this experience, Connell Foley has been retained as special legal counsel for every major construction project undertaken by this public owner, including a $100 million hospital. The firm has also served in a similar role for private projects.

Day Pitney LLP
By Craig M. Gianetti, Esq., Partner, Real Estate, Environment and Land Use Practice

Commercial developers and corporations that are doing expansions or renovations to existing offices or facilities should be aware of the statewide non-residential development fee (NRDF).

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From 2009 to 2013, there was a moratorium on the NRDF, but it expired on July 1, 2013, and the governor has vetoed all legislation extending it. Any project that received site plan approval after the moratorium expired is subject to the fee. We represented a large corporation that did a substantial renovation of its facility, converting it from warehouse to office space and expanding the parking area. The resolution of approval, as is typical, had general language about the project being subject to all affordable housing requirements, including payment of development fees. When the client applied for the building permit, the construction official had them fill out the NRDF form. The client calculated the fee based on a 2.5 percent increase in the equalized assessed value and was concerned by the amount. We discussed the issue, analyzed the statute and were able to successfully make the argument to the town that the project was not subject to the NRDF. First, it was not "construction" under the definition in the statute, because there were no additions, but rather renovations. Secondly, parking lots were excluded from the fee in the statute. In the end, our client saved tens of thousands of dollars. Developers and businesses should know that the NRDF is in effect and about the exemptions that may apply to their project.

Gibbons P.C.
By Peter J. Torcicollo, Esq., Team Leader, Construction Litigation Practice

Our client was seeking compensation for construction defects at a facility it owned. Initially, the matter seemed to be a straightforward construction defects case against the developer. Around the time we filed the initial complaint, however, the developer's owner passed away, and the developer (a corporate entity) was unable to economically withstand a judgment. As a result, what otherwise would have been

a fairly run-of-the-mill construction case became anything but, with the client pursuing not only a construction defect claim, but also claims of personal liability in several jurisdictions. The client's Board of Directors was faced with the need to maximize recovery so it could make as many of the necessary repairs as possible, while simultaneously managing costs. Thus, we needed to provide realistic advice and develop an approach that would enable us to vigorously represent the client's interests in the most efficient and cost-effective manner possible. Ultimately, through a combination of our efforts, the client's patience, the prudent exercise of the Board's fiduciary duties, and the assistance of a seasoned and tenacious mediator, the client was able to achieve a multimillion-dollar settlement that will enable it to repair its facility.

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McCarter & English, LLP
By Martin F. Dowd, Esq., Partner, Real Estate Practice Group

A business client that was considering leasing office space in a building that was subject to a tax abatement recently retained us to advise them on the transaction. Abatements, such as PILOT programs, benefit the owner, but can cause significant, unanticipated costs for the tenants. Office rent is usually on a gross basis, making the tenant responsible only for increases in taxes and operating expenses over an initial base year. When a building is not subject to an abatement, the annual increase is normally only a small percentage. But when, as here, abatements are involved, taxes, as defined in the lease, may increase substantially over the base-year amount. We examined the agreements affecting the property and found that the financial agreement would expire in six years, and that the PILOT would increase by 25 percent in the year following the base year. We helped our client assess the economic impact of the impending increase in the second year of the proposed 10-year lease and the projected increase upon expiration of the PILOT. The landlord resisted subsidizing anticipated increases, but we were able to define the true cost of occupancy, which allowed our client to assess the economics of the proposed lease.

Norris McLaughlin & Marcus, P.A.
By Timothy P. McKeown, Esq., Partner, Real Estate & Land Use Department

I have always counseled commercial landlords to pay special attention to mitigation when a tenant breaches a lease. Mitigation is fact-sensitive. Thus, it is critical for the landlord's realtor to document not only the efforts undertaken to re-lease the vacated space generally, but to be able to paint a detailed picture of the nature of the market where the property is located, including a fair market price. Without this information, some courts will find it impossible to assess whether the landlord's efforts to mitigate were reasonable. It is a mistake for a landlord to think that unreasonable or unsuccessful efforts by a realtor constitute reasonable mitigation efforts. The longer the premises remain vacant, the more attuned a court will be to knowing whether the landlord and/or realtor persisted in the same asking price and whether doing so rendered the landlord's marketing efforts unreasonable. An honest assessment of the fair market price of the premises is a critical part of that evaluation. This advice has served my commercial real estate clients—landlords and tenants—well over the years, including most recently a commercial tenant who avoided almost $300,000 in damages sought by a landlord who did not take mitigaion seriously.

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NPZ Law Group
By David H. Nachman, Esq., Managing Attorney

U.S. immigration laws allow foreign national investors to enter the United States on E-2 visas if they are coming as an investor and where their country of origin has an "Investment Treaty" with the United States. This is a common method used to transfer an investor to the United States who is seeking to be employed in real estate investment. We were enlisted by a real estate investment organization to assist with the transfer of Canadian staff to become their new U.S. management team. After due consideration for the NAFTA TN, H-1B Professional and E-2 Investor Visas, it was determined that the L-1A Intracompany Transfer Visa would be best. The L-1A was chosen because it rapidly leads to a green card for the transferees. There were many nuances in the project, but the most challenging was that the Canadian and the U.S. real estate development organizations were owned through a very complex set of offshore affiliates and subsidiaries. Working closely with Canadian staff, we secured internal corporate, financial and public documentation to prove that the U.S. organization was appropriately related to the Canadian affiliate to permit the transfer of the Canadians.

Riker Danzig Scherer Hyland & Perretti LLP
By Nicholas Racioppi, Jr., Esq., Partner and Head of the Real Estate Practice Group

Riker Danzig represents the major developer of a large mixed-use project, which includes nearly 1 million square feet of office space, a hotel and a large residential development. A threshold issue that needed to be addressed was how to satisfy the large COAH obligation that would result from the development without significantly impacting the financial viability of the project. The developer, working collaboratively with occupants of the project, the municipality and the local chapter of a national charity that focuses on identifying and addressing local community issues, has developed a plan to construct supportive housing for mentally and physically disabled individuals as part of the project. The charitable organization will construct a group home, which will be harmonious with and located adjacent to the residential development. As a result of the plan, the developer will be able to take advantage of the "bonus" credits available for supportive housing and significantly reduce the financial impact on the development, while satisfying the development's COAH obligation. While the details of the supportive housing development are still being finalized, it is off to a great start and will be a creative, mutually-beneficial and philanthropic solution to a typical problem faced by all developers. ■