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ACCOUNTANTS & ADVISORS

MARKS PANETH REAL ESTATE ADVISOR, MARCH 2015: STRATEGIES AND SOLUTIONS FOR CONTINUING TO GROW YOUR REAL ESTATE BUSINESS

NEW ACCOUNTING RULES FOR REVENUE RECOGNITION: REAL ESTATE COMPANIES MUST EXERCISE MORE JUDGMENT

The Financial Accounting Standards Board (FASB) recently issued new guidance that standardizes when and how every type of company must recognize revenue. The guidance, found in Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, supersedes existing revenue recognition rules and makes significant changes to the rules for accounting for real estate sales. Because the new ASU focuses primarily on *when* the transfer of control of property occurs, revenue will likely be recognized sooner than it has been under the existing guidance.

5 steps … and their issues

The guidance lays out five steps that a business must follow to determine when to properly recognize revenue on its financial statements. Here's a look at each step and its associated issues particular to real estate companies:

***1. Identify the contract*.** The guidance applies to each contract that a company has with a customer. In some cases, two or more contracts might be combined for financial reporting purposes. A change order (a modification to the contract's scope, price or both) is an example of a contractual issue that could complicate matters. For example, should a change order be accounted for as a separate *new contract* or part of the *existing contract*? The ASU provides criteria for making this determination.

***2. Identify the company's performance obligations*.** Sellers often remain involved in property that they've sold. For example, a seller might have agreed to provide property management services, improve roads or erect a building on the property sold. If a contract contains obligations to transfer more than one good or service to a customer, the company can account for each good or service as a separate performance obligation *only* if it is: 1) distinct, or 2) a series of distinct goods or services that are substantially the same.

A good or service is "distinct" if: a) the customer can benefit from the good or service on either its own or together with other resources that are readily available to the customer, and b) the company's promise to transfer the good or service is separately identifiable from other promises in the contract.

***3. Determine the transaction price*.** The company must determine the amount that it expects to be entitled to in exchange for transferring promised goods or services to a customer. Under the new rules, some or all contingent consideration (such as incentive payments) may be included in the transaction price and, therefore, recognized earlier than previously done. The transaction price also may require adjustment if the arrangement includes a "significant financing component."

***4. Allocate the transaction price to performance obligations under the contract*.** The business will typically allocate the transaction price to each performance obligation based on the relative "standalone selling price" of each distinct good or service promised. A seller that will also provide management services, for example, generally must separately estimate the standalone selling prices of the property and the services and allocate the total transaction price proportionately.

***5. Recognize revenue as performance obligations are satisfied*.** A company must recognize revenue when it satisfies a performance obligation by transferring the promised good or service to a customer. The amount recognized is the amount allocated to the performance obligation. If the performance obligation is satisfied over time (rather than at a single point in time) the company must similarly recognize revenue over time. Ways to measure progress include output methods (such as surveys or appraisals) and input methods (such as cost-to-cost or labor hours). These methods are generally expected to yield results similar to those of the existing percentage-of-completion method.

Implementing changes

ASU 2014-09 will compel real estate companies to exercise more judgment than is required (or allowed) under the current, more prescriptive standards. It also requires enhanced financial statement disclosures regarding customer contracts.

Real estate businesses should start reviewing their accounting methods now to prepare for the changes. Fortunately, there is time. For nonpublic companies, compliance isn't required until annual reporting periods beginning after Dec. 15, 2017.

Sale-leaseback rules survive — for now

Sale-leaseback transactions are used for large capital assets — including real estate, office buildings and improvements — to free up cash for the seller. After the property is sold, the seller leases the property back from the buyer for a period of time (typically 10 to 25 years) and the seller retains control of the property.

Real estate entities will be relieved to hear that the current accounting rules for most sale-leaseback transactions involving real property were retained in the Financial Accounting Standards Board's (FASB's) new revenue recognition guidance.

Although the new revenue recognition standard generally supersedes all other industry-specific guidance, FASB decided that, if the sale of real property is part of a normal, arm's-length sale-leaseback transaction, the transaction would continue to be evaluated under the existing guidance until FASB and the International Accounting Standards Board complete their joint project on leasing. Your financial advisors are monitoring the joint leasing project. They'll let you know whether anything changes and can help you comply with the accounting rules for sale-leaseback transactions.

REAL FIXER-UPPERS: ETFS DRIVE INFRASTRUCTURE IMPROVEMENTS

Many of us have read or watched news reports about the poor conditions of our nation's roads, electrical grids, airports, water supply plants and buildings. Whether it's a bridge crumbling from neglect or a highway so riddled with potholes that it blows out your tires, government entities need funds to help rebuild America's infrastructure.

Fortunately, there's a good option for financing such endeavors: exchange-traded funds (ETFs). These funds have continued to grow in popularity and have gathered assets at a rapid pace. They trade like stocks and have the diversity of mutual funds.

ETFs can help you not only diversify your portfolio, but also finance much-needed construction and repair of infrastructure in the United States. Of course, as with any investment, ETFs bring both potential reward and risk.

An open door

Both developed countries — such as the United States and Great Britain — and developing countries will need to extend or revamp their infrastructures in the coming years. And, with many governments still strapped for cash, the door is wide open for private investors to get involved in financing infrastructure construction and repair.

Whether it's for bridges and dams, railways and roads, waste disposal, telecommunications, power stations, pipelines, or ports, these worthy projects warrant backing. ETFs can help investors do just that.

These funds may offer a safer, more dependable income stream than some other types of real estate investment options. While the real estate market continues to lag behind other industries, many governments are ready to spend trillions of dollars on infrastructure projects.

In addition, many infrastructure assets have a virtual monopoly on the markets. And the large monetary investment required to develop most infrastructure assets makes it highly unlikely that competing assets will ever be built.

Unfortunately, the distinct opportunities presented by infrastructure investing are accompanied by unique challenges. Industry growth and consolidation, new investment products, government intervention and regulatory changes could all affect infrastructure investors in years to come. Asset-specific risks relating to the design, construction and operation of infrastructure assets pose additional challenges.

Uncommon asset class

In light of the related risk and high capital requirements for infrastructure investing, investors may want to consider accessing this uncommon asset class through index-based ETFs, which trade like stocks on an exchange and offer diversity similar to that of mutual funds.

But unlike mutual funds — which try to outperform the market — index ETFs sync with a major market index and can be traded intraday or in aftermarket sessions. Because they are passively managed, ETFs also offer lower administrative expenses and fees than do mutual funds.

Infrastructure ETFs mimic the performance of certain indexes, such as the S&P Global Infrastructure Index and the Macquarie Global Infrastructure 100 Index. These indexes are designed to help investors track infrastructure companies, monitor fund performance and allow easier investment in ETFs.

Because of their particular attributes, infrastructure ETFs may warrant attention from investors interested in defensive, high-yielding securities. Infrastructure investing isn't without risk, however. Rates of return vary vastly from project to project and, even though infrastructure is somewhat insulated, it isn't immune to the ebb and flow of economic tides.

Necessary due diligence

If you're interested in ETFs, make sure you do your due diligence. Work with a qualified financial advisor and stockbroker.

IRS TACKLES INTERACTION OF GAIN EXCLUSION AND PAL TREATMENT

It's not unusual for someone to convert a personal home into a rental property. But such conversions can raise some thorny tax questions when the home is subsequently sold.

Proper tax treatment

Under Internal Revenue Code Section 469, passive losses are generally deductible only to the extent of passive income. Rental real estate activities typically are deemed passive activities.

A passive activity loss (PAL) is the excess of your passive activity deductions over your passive activity gross income. Such "disallowed losses" are carried forward to the succeeding tax year and can be used to offset passive activity in the next tax year — what's commonly known as a "suspended PAL."

But Sec. 469 also provides that suspended PALs are fully deductible against nonpassive income if there's a "qualifying disposition." Such a disposition occurs when the taxpayer sells his or her entire interest in a passive activity to an unrelated party, and all gain or loss realized is recognized. In these circumstances, the excess of any loss from the activity over any net income from all other passive activities is treated as a loss that's *not* from a passive activity.

In a recent Chief Counsel Advice memo, the IRS weighed in on the proper tax treatment of suspended PALs from passive rental activity involving a taxpayer's former principal residence when the property is sold for a gain. In addition to addressing Sec. 469, the IRS considered Sec. 121 of the Internal Revenue Code.

Under Sec. 121, a taxpayer can exclude from taxable income any gain from a sale or exchange of property that has been owned and used as the taxpayer's principal residence for two or more years during the five-year period preceding the sale. The allowable exclusion is up to $250,000 in gain per taxpayer; married taxpayers filing jointly may exclude up to $500,000.

Scenario in question

The Chief Counsel Advice described a scenario in which a taxpayer bought a principal residence for $700,000 and owned and used it as his principal residence for two years before converting it into a rental property. The related rental activity was the taxpayer's only passive activity for purposes of Sec. 469.

During each year the property was rented, it produced $10,000 in suspended PALs. Within three years of renting the property, the taxpayer sold the property to an unrelated third party for $800,000, realizing a net gain of $100,000.

The gain was excluded under Sec. 121, but what about the suspended PALs? Did the use of the exclusion block the release of PALs upon the qualifying disposition? No, according to the IRS.

The agency held that, to the extent the suspended PALs exceeded any net income or gain from all other passive activities in the tax year of the sale, the losses should not be treated as a passive activity.

Because the $100,000 gain was excluded under Sec. 121, it wasn't part of passive activity income for purposes of Sec. 469, so the taxpayer had zero passive income or gain. Thus, the $30,000 was treated as a nonpassive loss that could be fully deducted.

Some clarity from the IRS

The Memo makes it clear that the gain excluded under Sec. 121 isn't treated as passive gain. It also confirms that the suspended PALs are "freed up" in the year of disposition.

Although this eliminates some of the uncertainty surrounding the interplay between Sec. 121 and Sec. 469, each situation is a little different. If you're considering a sale of a former primary residence that has been converted to a rental property, be sure to consult your tax advisor to discuss exactly how the rules apply to you.

ASK THE ADVISOR. IS A CREDIT TENANT LEASE RIGHT FOR ME?

Credit tenant lease (CTL) financing is gaining popularity as a way for owners and developers to leverage the rental stream from a single-tenant property. But, like most forms of financing, these arrangements have their risks as well as some potential advantages.

How it works

With CTL financing, rather than rely on the property's value, the lender looks to the tenant's creditworthiness and the cash flow from what's typically a long-term lease of 15 to 30 years. The lease is guaranteed by the tenant, with no obligations for the landlord. The property owner assigns the rent payments to the lender, with the property pledged as collateral, and forms a special purpose entity (SPE) to hold the property and pass the rent to the lender.

CTL transactions are being used for a variety of properties — including retail, grocery and drug stores; health care facilities; office buildings; warehouses; data centers; and bank branches. They're also becoming more common for government facilities and nonprofits.

These arrangements work well with triple net leases. In addition, double net and gross leases also might qualify with some expense and reserve deductions included for underwriting.

Appealing features

CTL financing offers many appealing features, including:

- Loan-to-value ratios as high as 100%,
- No limits on loan dollars per square foot,
- No maximum loan-to-cost,
- Nonrecourse financing to the borrower,

- Fixed interest rates, and
- Amortization that can be linked to the lease term or structured for a longer duration or with a balloon payment.

Possible downside

One possible downside for the borrower with CTL financing is the lender's ability to preempt the right to restructure the loan in a Chapter 11 reorganization. Lenders generally require the involvement of an SPE in the arrangement to prevent it from being affected by a bankruptcy filing by or against the borrower.

In theory, a borrower won't be allowed to include the SPE's assets and liabilities in a reorganization plan. But a savvy borrower may be able to take certain steps to circumvent a lender's antibankruptcy provisions.

Optimal terms

CTL arrangements can pay off for owners and developers that have the right type of property and lease. But consult with your financial advisor to ensure that you're getting the optimal terms to protect your interests.

FOR FURTHER INFORMATION

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