



Real Estate

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Carried Interest and Real Estate

Carried interest in alternative investments (i.e., private equity and hedge funds) is a share of the profits of an investment or investment fund that is paid to the investment manager in excess of the share of earnings that the manager is entitled to based on its contributed capital.

The taxation of carried interest has been an issue since the mid-2000s, as the amounts earned by promoters and sponsors of private equity, hedge and real estate funds increased substantially. The argument in favor of treating gains to these groups as capital gains rather than ordinary income, is that the risk of loss on one hand, and the long period of time before any gains are realized, justify treatment of the returns as capital gains. Critics of this tax treatment, on the other hand, argue that the favorable treatment cannot be justified.

The basic issue is whether those investors who provide limited, if any, funds but play an active role in the day-to-day management of the capital should be able to treat their returns as capital gains taxed at a lower level than ordinary income.

While the exact tax rate has changed over the years, long-term capital gains have been taxed at lower rates than

ordinary income since 1986. The capital gains rate was lowered in 1997 to 20 percent, then lowered again in 2003 to 15 percent and was recently increased to 20 percent in 2013.

The issue of favorable tax rates for carried interest became a hot issue during the 2012 Republican primary race for president because 31% of candidate Mitt Romney's 2010-2011 income was carried interest.

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Real Estate Easements: 14 Ways

One reason why real estate is such a popular investment is that a variety of legal interests can be created, thus permitting great flexibility in forms of ownership and extent of use.

This most often is in connection with equity and debt financing. However, the flexibility of legal interests also is important to users of real estate. The most common example is the creation of a lease instead of a fee interest.

However, a lesser-known type of interest is the easement. An easement is an interest in real estate that gives the holder the right to use or occupy land in a particular limited way. Easements on an adjacent property often can increase the usefulness and value of property at a very small cost. The cost can either be a one-time payment made for the easement or a periodic fee. Alternatively, an owner can subject property to an easement for the benefit of another as a means of increasing cash flow. Sometimes, easements can be exchanged (cross-easements) so that no out-of-pocket outlay is necessary.

The following paragraphs describe 14 types of easements that are used in connection with different types of real estate.

Rights of Way

One of the most common easements is the right to cross over the land of another. A right of way may be limited to a walking path or may extend to automobile traffic or the right to lay tracks for a railway spur (often necessary for industrial property). The holder of the easement, in addition to paying for the benefit, may be required to maintain the right of way. Use may be restricted to certain days or hours or may be unrestricted.

Driveway Easements

A variation of the right of way is the driveway-in-common that may separate two one-family houses, with half the driveway within the boundaries of each parcel. Almost always, this is a mutual easement, giving each homeowner a right of use.

Utility Easements

Also very common are utility easements, which permit telephone and electricity poles and lines, as well as natural gas pipelines, to be built on or under the land. Such an easement normally includes the right to enter the land to repair or operate the utility lines as well as the right to clear the right of way of all natural growth that may interfere with the utility service.

Real Estate Easements: 14 Ways

Light and Air Easements

This easement protects the right of an occupant of real estate to have access to light and air unencumbered by adjoining structures. The general rule in the United States is that there is no implied easement of light and air, so that absent an agreement, an adjoining owner may construct an improvement to any height and to the property line assuming this is not barred by local zoning or setback requirements. Consequently, a light and air easement must be created by express agreement.

Solar Easements

Just as with light and air, a property owner has no implied right to receive the direct rays of the sun in order to utilize a solar heating system. Consequently, the adjacent owner must agree either to remove trees or natural growth to permit the passage of sunlight or to refrain from putting structures above a certain height on his property.

Fence Easements

A property owner desiring to construct a fence may find it impossible to site it exactly along the boundary line. To the extent that the fence intrudes upon adjacent property, it constitutes an encroachment and the adjacent owner's permission must be obtained.

This can be done through grant of an easement that is permanent or for a specified period of time.

Aviation (Avigation) Easements

This easement permits aircraft to fly low over property (normally in the course of landing at an adjacent airport). In addition to barring any legal action for damages because of the noise created by low-flying aircraft, the easement may bar the landowner from building above a fixed height or may require him to trim trees already on the property.

Water Easements

Ownership of property adjoining a pond, lake or river does not necessarily carry with it riparian rights (the right to use such waters). Depending upon local law, such waters may be owned by the public or may be subject to private or another type of ownership. In either case, the property owner's right to use the water may depend upon the existence of an easement.

Sport or Recreational Easements

The owner of property may grant to another (usually for a fee) the right to use the property for fishing, hunting, boating or other recreational purposes. These easements are sometimes known as "novelty easements."

Real Estate Easements: 14 Ways

Pasture Easements

Common easement in the western United States is the right to use land for pasture. This permits a rancher to utilize large areas of land for raising livestock without owning the land.

Support Easements

There are two types of support easements. The subjacent support easement is the right of a landowner to have the surface of his land supported by the adjoining land (i.e., the adjacent owner may not excavate his land to the point where his neighbor's land will collapse). The other form of support easement is used in connection with air rights. An owner seeking to construct an improvement in his or her land may need the right to place the improvement on columns driven into the ground owned by another. Normally, such support easements will be included in the lease or deed creating separate rights in the air space.

Drainage Easements

If land is subject to flooding due to excessive rainfall or the overflow of a lake or river, the owner may seek the right to construct a drainage ditch across the property of another. This problem also may arise where a large area is paved over (as in the case of a shopping

center) so that the land is no longer capable of absorbing rainfall.

Flowage Easements

In the same situation as just described, the owner of flooded land may seek the right to have the water flow over the land of another, perhaps temporarily flooding it. The adjacent owner may be willing to grant such a flowage easement if the land is unimproved or will otherwise not suffer from the overflow.

Overhang (Encroachment Easements)

If property is improved by a building that reaches to the property line, overhangs from the building (e.g., window air conditioners) may encroach upon the adjacent property. It may be necessary in such cases to obtain an easement so that title to the adjacent land will not be made unmarketable.

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Using and Option as An Investment Tool

An investment technique often overlooked by investors is the option. Its great virtue is that it can bestow on the holder control over large parcels of property for a very small cash outlay. Thus, it creates leverage and conserves cash – two objectives sought by every investor and speculator in property.

Purposes of an Option

An option gives its holder the privilege to buy (or to sell) specific real estate at a specified price within a designated period. An option to buy is known as a call; an option to sell is a put. Options usually serve one of two purposes. The first and, by far the most common, is to permit the option holder to tie up land while the holder decides to buy or not. For example, an investor receives information on a proposed new highway or a new shopping center development and obtains options on surrounding land for a period of time until a date when the information is expected to be confirmed. If the holder is wrong, he or she suffers only the loss of the option price; If the holder is right, the holder is in a position to make a bargain purchase. An investor also may take a long-term option, running several years, in expectation of a change in economic conditions or the like.

Options are important in the assemblage process, too. A developer who is buying up contiguous parcels is interested in an “all or nothing” acquisition. To reduce the risk, in the event all the land cannot be acquired, he will proceed via options rather than straight purchases.

A second purpose of the option is to permit the holder to speculate in property on a very small cash outlay by buying and selling the option itself. For example, the speculator pays \$1,000 for an option to buy real estate worth \$50,000. Within the option period, the value of the real estate rises to \$60,000. The optionee can sell the option to a third party for \$10,000, realizing a gain of \$50,000.

Checklist of Option Techniques

Fixed option: This is the simplest form of option, entitling the optionee to buy the property at a fixed price during the option period.

Step-up option: The purchase price of the real estate goes up in steps periodically throughout the option period. This is used in long-term options, or in rolling options. If an option is renewable, frequently the step-up will occur at the time of renewal.

Using an Option as An Investment Tool

Rolling option: This is most commonly used by sub-dividers of raw land. The option covers a number of contiguous tracts. The developer buys and subdivides one tract and, if it proves profitable, he can acquire the next tract. Thus, the option rolls from one tract to another. Usually the price steps up as each tract is acquired, thus permitting the landowner to share in the increased value of the property as it is built up.

Full-credit option: The price paid for the option is credited fully against the purchase price of the real estate, if the option is exercised.

Declining-credit option: As an inducement to the optionee to act promptly, the percentage of the option price that may be credited against the purchase price of the property declines as time goes by.

Hidden Options

An option can exist even though called by another name. Suppose the developer buys a tract of land for a small cash payment, and a large-purchase money mortgage. The mortgage contains an exculpatory clause, limiting the seller's remedy, in the event of a default by the buyer, to repossession of the land securing the mortgage. At the

same time, the mortgage contains release clauses whereby the developer, as he sells individual lots, can release the lots from the lien of the mortgage upon payment of a portion of the mortgage debt. In effect, the developer holds an option, since at any time he can walk away without further liability except loss of the land not yet released.

Another example of the hidden option is a contract of sale with a small down payment and a clause limiting the seller's remedy to the down payment in the event of the buyer's default. Here again, the buyer may walk away without liability, if he decides not to complete the purchase, or he may sell his contract rights to a third party, and thus realize a large percentage return on his small investment.

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Residential Wind Turbine Enjoined As Nuisance

Wind and solar are increasingly important sources of energy and several states have adopted programs to promote their construction and use. At the same time, wind turbines or solar installations can bother neighbors and affect property values, concerns traditionally addressed by the law of nuisance. In a recent case, a Nevada appellate court upheld a permanent injunction barring a homeowner from installing a wind turbine, as a nuisance, despite the state's aggressive policy favoring renewable energy sources.

(Sowers v. Forest Hills Subdivision, 294 P.3d 427, 129 Nev. (Nev.2013).

Background

Rick Sowers proposed to erect a wind turbine on his residential property, leading his neighbors to bring an action to enjoin the project as a nuisance. The trial court took testimony regarding the project and its effects in terms of noise, obstructed views, shadow flicker and property values. It visited a comparable site to see a wind turbine in action, and Sowers demonstrated that the noise from that turbine was under five decibels at 100 feet. The judge then visited Sowers' property to understand the setting for the proposed turbine. Evaluating all of this, the court held that the turbine would be a nuisance in fact and entered a permanent

injunction against its construction. Sowers appealed.

Nuisance

The appellate court began by reviewing nuisance law. A nuisance is "anything which is injurious to health, or indecent and offensive to the senses, or an obstruction to the free use of property, so as to interfere with the comfortable enjoyment of life or property." An activity that might not be a nuisance in some settings can be a nuisance in fact (rather than a nuisance per se) by reason of its circumstances and surroundings. That is, an otherwise lawful use may be held to be a nuisance "where it is done or conducted in a place where it necessarily tends to the damage of another's property."

In considering whether a use constitutes a nuisance, the court must consider the reasonableness or unreasonableness of that use in relation to the particular locality and under all the existing circumstances.

The determination of whether a particular use is a nuisance is a question of fact, so the appellate court reviewed the district court's findings to determine whether they were "clearly erroneous and not supported by substantial evidence." In examining the facts, the court began by

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noting that aesthetics alone cannot support a finding of nuisance in fact, because aesthetic considerations are “fraught with subjectivity.” However, aesthetics can be considered as one factor, along with others, in establishing a nuisance. Thus, the size (75 feet tall) by itself would not be a basis for finding the turbine a nuisance.

However, taking into consideration that this was a quiet neighborhood and testimony that the turbine would generate noise equivalent to a highway, obstruct views and reduce property values, the court affirmed the trial court’s determination that the turbine would constitute a nuisance.

Observation: One of the plaintiffs’ claims was that the turbine would violate a subdivision covenant, but this claim was rejected on the basis of a statute providing that covenants that impose an unreasonable restriction on wind turbines or solar installations is unenforceable. While noting the statute, the court made no connection between the policy considerations under the statute and the standards for common law nuisance.

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Non-Traded REITs: Regulatory Concerns

Non-traded REITs do not trade on exchanges and limit the opportunities of investors to redeem shares. As a result, they have come under some criticism in the past. According to the Financial Industry Regulatory Authority (FINRA), brokers often stress the income but fail to make clear that the payments actually tap the investor's principal.

REITs give investors an equity interest in a pool of assets such as land, shopping centers or hotels, or in mortgages secured by real estate. REITs pay no income taxes if they distribute at least 90 percent of their earnings to investors. Thus, investors are attracted to the higher payout as compared to other investments. While most REITs trade on stock exchanges, many brokerages also offer non-traded REITs or "direct participation programs" not listed on an exchange. There are about \$62 billion in total equity invested in these types of publicly registered products.

FINRA

Non-traded REITs have been on FINRA's annual list of products that can be too risky for many investors for several years, amid concerns that low interest rates are leading investors to seek yield from investments they do not fully understand. FINRA said

descriptions of distributions must make it clear where returns are coming from. Rules on redeeming investments must be spelled out. At the same time, brokers should be careful in describing performance by past programs, FINRA said, and avoid cherry picking from programs or periods with higher returns. Finally, FINRA said that programs should not feature pictures of properties that only resemble those that may be purchased. Investors must be told clearly that the property seen may not be the one in which they are investing.

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