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By Laura Gregoriadis - Using a development analysis to save money and make better decisions

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A true development analysis is more than just gathering costs and market research. It involves projecting budgets and cash flows. It analyzes potential uses for a property so that owners can make informed decisions about what to build. It identifies the tax implications of a project and includes consulting to determine the most advantageous way to structure the deal.

It begins with a feasibility study based on information gathered from various sources: planning and design costs from architects, construction costs from contractors, financing assumptions from lenders, capital market information from investors, and market research. As accountants, our role is to compile this information to analyze the financial viability of the project and to consult on the tax attributes of the development. A thorough feasibility study should include the following:

* Projected budgets and cash flows for various development scenarios
* A skeptical review of the underlying assumptions and market data
* The tax implications of the project during the construction period, holding period and eventual sale

The next step in the analysis is structuring the deal. When structuring a new development, three phases are examined: funding, operations and exit strategy:

* Whether the funding comes from private investors, bank debt or a combination thereof has significant impacts on the structure of the venture. For instance, if funded by investors, will they require preferred returns or priority distributions? If so, how will those impact the cash distributions and income allocations from the venture? If bank debt is obtained, what are the financial reporting requirements? Can the bank or investors determine the basis of accounting?
* The operations and management of the venture should be determined early on in the development analysis. The agreement will outline who has control of the property, who will manage the day to day operations and who will make the major decisions. For instance, does the agreement allow investors to force a sale of the property? Does the agreement give the owner the first option to buy out the investors?
* The exit strategy should also be determined during the development process. The projected cash flows and tax implications need to be considered based on whether the plan is to hold the property long term or sell in the near future. Some questions to consider are: Has the holding period been defined? When the property is sold, will it be a straight sale or a tax deferred sale? What part of the gain will be taxed at capital gains rates and what will be taxed as ordinary income?

To demonstrate the importance of a thorough development analysis, the following are cases in which our firm consulted with clients on feasibility studies and advised on how best to structure a deal:

* A multi-use complex was planned for condominiums, apartments, retail space and a hotel. After we projected cash flows for the property based on a variety of combined uses, it was clear that a hotel

was not the best use for the property. The owners recognized that it would be more profitable to build additional condominiums.

* A client was exploring an option to redevelop a property using capital from outside investors. In the proposed agreements, the investors were to receive a preferred return and priority return of their capital. We determined that our client would have been allocated income without the cash distributions to pay the taxes on that income and worked with them to add tax distribution clauses to their agreements.

* On a property that was subject to a ground lease, we worked with the building owner to identify the tax consequences if they chose 1) to sell, 2) do a like-kind exchange or 3) hold the property. We helped them determine that it would not be profitable to sell because of the ordinary and capital gains taxes they would owe. Instead, they chose to negotiate a joint venture in which the building owners would contribute the building, the land owner would contribute the land and the lease would be eliminated. This gave both parties a better tax position by deferring gain and eliminating the liabilities created by the ground lease.

Consulting on a development analysis is one way in which an accountant that specializes in real estate can actually contribute to the bottom line. No one would begin a construction project without seeking advice from attorneys, architects, engineers and contractors. Given the investment at stake, it makes sense to include an accountant in the process as well.

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