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Development analysis can lead to better economic results and tax savings

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A development analysis is a key tool to assess the potential economic results of a real estate project. It involves projecting budgets and cash flows for potential uses of a property so owners can make informed decisions. It also identifies the tax implications of a project and includes determining the best way to structure the deal.

It begins with a feasibility analysis based on: 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 analysis should include the following:

* Projected budgets and cash flows for various development scenarios;
* A skeptical review of the underlying assumptions and market data; and
* 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 in which three phases are examined: funding, operations and exit strategy:

* Whether the funding comes from private investors, bank debt or a combination thereof has significant impact 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 be determined during the development process. The projected cash flows and tax implications depend 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?

Feasibility Analysis in Action

The following are cases in which our firm consulted with clients on feasibility analyses and advised on how best to structure a deal:

* A multi-use property 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 but 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 property 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 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 consult an accountant as well.

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