

Getting Through the Real Estate Transaction Jungle: A Survival Guide

By Gregg A. Nathanson



Surviving the treacherous path to a successful real estate closing may be your client's biggest challenge. The type of property does not always matter. You can be dealing with a tiny home on a small city lot, a sprawling estate in an upscale suburb, a family farm or ranch, or commercial, industrial, or retail property. Many of the same issues come into play. Your client may fall into an economic trap for the unwary and, at the same time, miss out on hidden opportunities. Often clients make certain factual assumptions about the property and do not know the right questions to ask. At other times their emotions kick in. Their passion for owning the property overrides an objective analysis of potential hidden dangers. You, on the other hand, are the experienced survival guide, leading the client safely through the jungle. This article presents some of the most dangerous hazards and pitfalls to avoid, as well as some creative opportunities for tax avoidance and profit maximization for real estate purchasers.

Environmental Hazards

1. *Is the Property Contaminated?*

Nobody should buy real estate without first considering potential environmental liabilities. Lurking environmental liabilities can quickly transform a good deal into a bad one. Environmental liabilities may well exceed the purchase price and eventually kill the deal.

A prudent buyer should retain a competent environmental consultant to perform a Phase I environmental site assessment of the property. A Phase I report includes a visual observation of the property, inspection of public records regarding the environmental condition of the property and

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surrounding properties, and conversations with current owners and operators about past and present environmental practices. Common environmental problems include leaking or abandoned underground storage tanks, contaminated soil, contaminated groundwater, asbestos, lead paint, radon, polychlorinated biphenyls, and poor air quality. The Phase I report should conclude whether or not further environmental inquiry is required. If the consultant identifies potential environmental problems, the buyer can perform a Phase II subsurface investigation to better determine the nature and extent of existing contamination. This generally involves taking soil samples and testing groundwater for the presence of pollutants.

If the buyer encounters environmental problems and still wants to proceed, the parties have several traditional options. The parties can decide

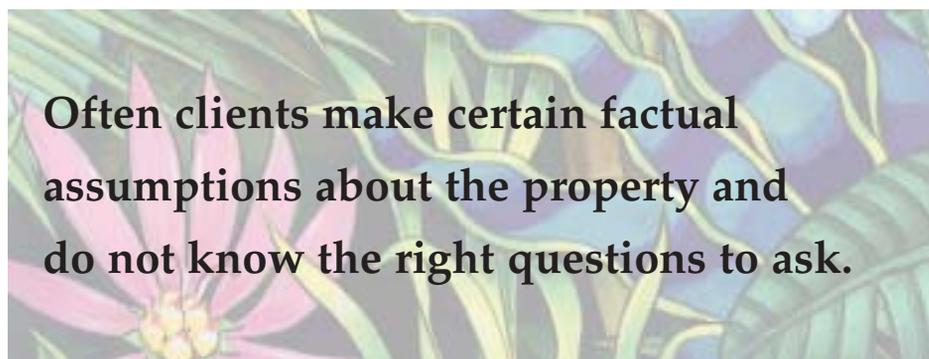
- who will perform the remediation (buyer or seller);
- when the remediation will take place (before or after closing);
- what activities will be required (options include recording a restrictive covenant, coating the floor with epoxy and leaving contaminants in place or removing contaminants and disposing of them offsite);
- who will bear the cost (buyer or seller);
- what will be the timing and manner of payment of environmental cleanup costs (decreasing the purchase price or paying with escrowed closing proceeds); and
- what will be the required standard of "clean" (site for day care facility where children may eat the dirt or for industrial facility where asphalt paving will cover contaminated area).

If the seller agrees to indemnify the purchaser against unknown environmental liabilities, the parties may decide to limit the extent of the seller's indemnity and collateralize that indemnity.

In transactions in which the buyer

and seller seek to limit their respective environmental liabilities further, the parties may obtain pollution insurance. Pollution insurance lets the parties shift the risk for some types of environmental liability to an independent (and presumably solvent) third-party insurance company.

Pollution insurance can protect the parties against claims for bodily injury and property damage, environmental cleanup costs, business interruption expenses, and legal fees. Policies can be tailored to meet the needs and requirements of the buyer and seller as well as the buyer's lender. Pollution insurance policies generally require a hefty initial lump-sum premium payment and exclude costs of remediation of known pre-existing environmental conditions. Although pollution insurance is not right for every transaction, under certain circumstances it can save the deal.



Often clients make certain factual assumptions about the property and do not know the right questions to ask.

In some states, like Michigan, buyers of contaminated property have yet another alternative. In 1995, Michigan enacted sweeping environmental legislation intended to permit buyers to avoid liability for existing contamination. This law permits buyers who want to limit their environmental liability for contaminated property to perform a baseline environmental assessment (BEA). The BEA establishes a baseline for existing contamination. The buyer may petition the Department of Environmental Quality (DEQ) to review the BEA and request a written determination of the buyer's exemption from liability. In other words, the DEQ will tell the buyer in

writing that it will not have environmental liability for existing contamination identified in the BEA. Certain time limits apply for preparing and submitting a BEA. Also, under certain circumstances, BEA protection may be difficult to obtain, depending on the nature of the contamination and the buyer's proposed use of the property.

In Michigan, even if the DEQ determines that the buyer is generally exempt from environmental liability, the buyer will still have certain statutory "due care" obligations for existing contamination. For example, the buyer may not do anything to exacerbate existing contamination. In petitioning the DEQ, Michigan law permits the buyer to set forth its proposed due care activities and ask the DEQ to approve those activities.

Each state's environmental laws treat contaminated property differently. If you are dealing with contaminat-

ed property, take care to determine both the requirements of and opportunities available under applicable state and local law.

Construction or Physical Defects

2. Will the Buyer Have an Opportunity for Thorough Inspection Before Deciding Whether to Complete the Sale?

The purchase agreement should grant the buyer broad rights to inspect the property for structural defects, heating, cooling, electrical, plumbing and mechanical problems, environmental matters, soils, and anything else that may be of concern to the buyer.

Buyers often hire independent, competent professional inspectors to examine the premises. If, for example, the inspector discovers a potential roof problem, an engineering roof specialist can be retained. In each instance, the buyer should accompany the inspector during the inspection and obtain a written inspection report. The buyer should also consider whether a municipal inspection is permitted or required.

If the property includes an apartment building, strip mall, or other business, the buyer should inspect leases, financial records, and similar information. For commercial properties, the buyer may wish to obtain estoppel certificates from tenants that confirm the status of each lease. The buyer should attempt to discover any bad news regarding the physical and financial condition of the property before committing to buy it. Many problems can be addressed in an

take soil samples to determine if special footings or foundations may be required? Are all necessary utilities available to the site at a cost reasonably acceptable to the buyer? Does the property abut a main street, or is there a satisfactory road easement granting access to and from a main street? Has the buyer identified an experienced and reputable architect, engineer, builder, and other qualified professionals to help design the project, shepherd it through the local site plan approval process, obtain building permits, and construct the proposed improvements on time and within budget?

Title Defects

4. Can the Seller Deliver Good and Marketable Title to the Property, Free and Clear of All Unwanted Liens, Claims, and Encumbrances?

A buyer should never purchase real estate without obtaining a title insur-

ed documents may limit the buyer's intended use of the property.

Consider, for example, vacant land encumbered with a recorded utility easement. If you look at the property, you will not see the easement. But the easement may permit a utility company to build a 75-foot-tall electric tower that could have a negative effect upon the future value and use of the property. Unnoticed recorded building and use restrictions can turn the buyer's plan to construct a dream home into a nightmare. In one situation, a 1920s use restriction prohibiting the sale of alcoholic beverages prevented a 1990s shopping center owner from renting space to a liquor store. Likewise, by looking at vacant land you cannot tell whether an undesirable recorded oil and gas lease encumbers the property.

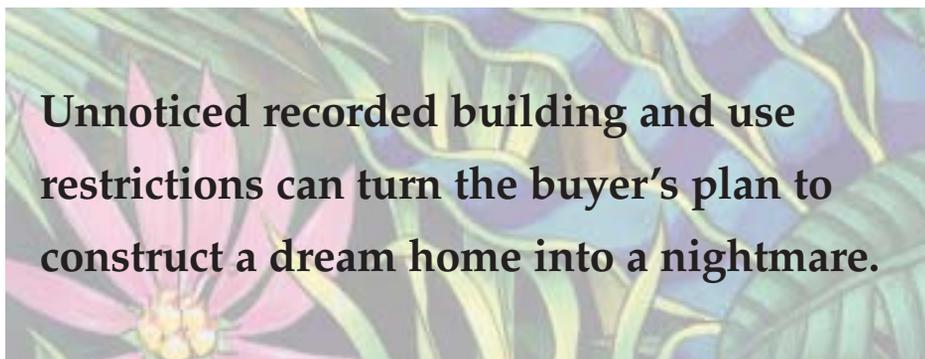
Obtain current title work and carefully review all documents recorded against the property to avoid unpleasant surprises. Bear in mind that sometimes the title company will "insure over" undesirable title matters. The problem may still exist, but the title company will assume some or all of the risk that the buyer will suffer an actual loss relating to title.

Survey Problems

5. Is There a Current Quality Survey of the Property?

One picture is worth a thousand words. This is particularly true when the thousand words make up the property's legal description and the picture is a survey drawing of the property. The title commitment contains the legal description for the property; the survey draws a picture of that legal description.

Common types of surveys include a mortgage report, which may omit important information; a staked survey, which shows exact property lines and possibly encroachments; and an ALTA survey, which is extremely detailed and more costly. In each case the survey helps confirm that the title commitment contains the property's correct legal description. The survey, the title commitment, and the deed to be delivered at closing all should contain the same legal description, word



amendment to the purchase agreement that lowers the purchase price or requires the seller to perform certain repairs before closing.

Improving Vacant Land

3. Is the Property Physically and Legally Suitable for the Buyer's Proposed Development?

With new construction, inspections generally take the form of due diligence investigations to determine whether the property can be used for the buyer's intended purposes in a time and manner expected by the buyer. The buyer should consider matters such as: Should an engineer

take soil samples to determine if special footings or foundations may be required? Does the property abut a main street, or is there a satisfactory road easement granting access to and from a main street? Has the buyer identified an experienced and reputable architect, engineer, builder, and other qualified professionals to help design the project, shepherd it through the local site plan approval process, obtain building permits, and construct the proposed improvements on time and within budget?

The purchase agreement should provide for the buyer to receive a commitment for an owner's policy of title insurance and for copies of all recorded documents. The commitment provides a snapshot of the condition of title. It not only confirms property ownership, but also lists mortgages, liens, and judgments against the property. It describes recorded easements that benefit and burden the property, building and use restrictions, and other important matters affecting title. Undesirable record-

for word. Any discrepancy among these three legal descriptions should be spotted, understood, and resolved before closing.

A good survey will do more than show the buyer the perimeter and legal description of the property. A survey can highlight problems the buyer may encounter. For example, a good survey will show the location of all buildings and improvements; identify recorded and observable utilities, easements, and rights-of-way; flag actual or potential setback violations of local zoning ordinances; and include any necessary offsite easements, such as an access road. The survey can ferret out existing encroachments and potential boundary disputes. The survey may reveal that the buyer's planned future expansion will encroach upon an existing easement or violate an existing setback requirement. All of this information could prove crucial. In short, a quality survey provides a great deal of valuable information about the property.

Governmental Impediments

6. Will the Buyer Have Problems Obtaining Necessary Governmental Permits and Approvals?

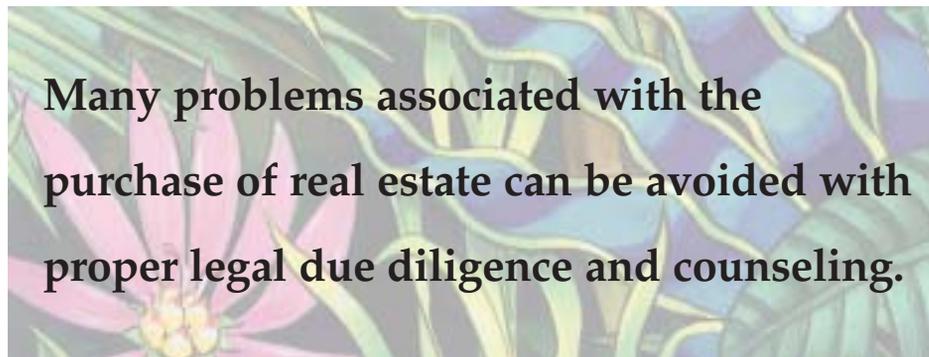
It is all too common that a buyer purchases a piece of vacant land, expecting to build a certain project, only to discover that it cannot be done, it cannot be done quickly, or it cannot be done without incurring substantial expense battling the local government. If the property is not zoned for the buyer's intended use, the buyer should determine how difficult it would be to change the zoning or obtain a variance. If the buyer plans to refurbish an existing building, consider building code and permit issues. The buyer may wish to obtain preliminary or final site plan approval or, better still, grading or building permits, as a condition to closing. By obtaining all necessary governmental approvals before paying for the property, the buyer can narrow the risk of acquiring property that cannot be developed for the buyer's intended use in a timely manner and at the anticipated cost.

Alternatives to Purchase

7. Should the Buyer Consider Alternatives to Buying the Property?

Possible alternatives to property ownership include obtaining an option to purchase the property. The option should provide that the buyer has the right, but not the obligation, to purchase the property during a defined period of time. The buyer may also enter into a short-term or long-term

ing current and future investor capital, debt financing, flexibility in decision making and structure, liquidation, and transfer issues, and asset protection and estate planning concerns. For example, a buyer may want to own property in a living trust for estate planning purposes. A possible solution would be for an LLC to own the property and the buyer's living trust to own all membership interests of the LLC. This combines estate, tax, and liability



lease with an option to purchase. This permits the buyer to "try out" the property before assuming substantial financial or other obligations associated with ownership. The buyer could also obtain a right of first refusal to purchase the property. If the seller receives a written offer to purchase, the seller must permit the person holding the right of first refusal an opportunity to buy the property upon the same terms and conditions contained in that written offer, before the seller is free to accept the offer. This permits the holder of the right of first refusal a chance to buy the property before it is sold to someone else.

Choice of Entity

8. Will the Buyer Take Title to the Property Personally or Through a Legal Entity?

Today many buyers set up a limited liability company (LLC) to purchase property. This provides the buyer with the flow-through tax benefits of a partnership, combined with the limited liability aspects of a corporation. Other considerations in selecting the appropriate entity include the need for rais-

protection planning. Selecting the appropriate entity may also depend upon the type of real estate involved and how that real estate will be used. For example, ownership of vacant land will require few, if any, management decisions. On the other hand, ownership of a shopping center or an apartment complex will require more intense management and attention. In any event, the buyer could be making a huge mistake by taking title to the property personally and therefore needlessly risking personal liability.

Tax Deferred Exchanges and Other Tax Considerations

9. Should the Transaction Be Part of a Code § 1031 Tax Deferred "Like Kind" Exchange or Use Other Possible Tax Benefits?

A Code § 1031 tax deferred exchange is an extremely valuable, yet vastly underused, planning tool. A Code § 1031 exchange is a transaction in which the buyer or seller (the taxpayer) exchanges one property for another without recognizing any gain (or loss) on the transaction. The main benefit of a Code § 1031 exchange is

that, instead of paying taxes, the taxpayer uses tax deferred dollars to acquire another property. In essence, the taxpayer receives an "interest free loan" from the IRS. Historically, taxpayers were required to dispose of the current (relinquished) property before acquiring the new (replacement) property. Recently, the "kinder, gentler" IRS decided that taxpayers could engage in a "reverse" exchange. This permits the taxpayer to acquire the new (replacement) property before disposing of the old (relinquished) property. To engage in a successful Code § 1031 exchange, the taxpayer must hold both like-kind properties for productive use in a trade or business or for investment, complete the transactions within certain time frames, and comply with other technical IRS requirements.

Many other tax benefits are associated with the purchase, ownership, and sale of real estate. Opportunities vary from state to state. In Michigan,

for example, some of the lesser known benefits include

- state (and federal) historic tax credits for rehabilitation of historically significant property;
- property tax abatements for certain industrial property primarily involved in manufacturing;
- single business tax credits and other financial incentives for redevelopment of contaminated brownfields, including blighted and functionally obsolete structures;
- income tax credits for entering into an agreement promising to maintain a current farm as farmland for at least 10 years;
- lower real property taxes for entering into an open space easement agreement that restricts future land development rights;
- income tax deductions for entering into a conservation easement that also prevents future land development; and

- tax savings associated with charitable land donations.

Obtaining each of these tax benefits requires planning, time, and energy. Yet often the tax benefits are well worth the hassle.

Conclusion

Real estate investment presents enormous opportunities for making money and saving taxes. Although not all investments are winners, many problems associated with the purchase of real estate can be avoided with proper legal due diligence and counseling. A lawyer can guide a client through the real estate jungle, in part, by raising the issues described in this article and others. The client should understand the importance of addressing each of these issues and the ramifications of failing to do so. A little education and quality legal representation can go a long way toward making the purchase of real estate a smooth and successful event. ■