

REAL ESTATE REPORT

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Four Traps For The Unwary Tenant

Over the past year, the news media have chronicled the emergence of a tenants' market for office space. High levels of construction over a series of years combined with a slowing economy have resulted in vacancy rates of 15% or more in a number of regional markets, including downtown Minneapolis and downtown St. Paul. It is a situation not existing since the early 1990's and is obviously good news for tenants. The media presentations have focused primarily on the effect the high vacancy rates are expected to have on rent levels. However, there is a further benefit from the tenant's perspective in such a market. The tenant and its representatives now have an opportunity to engage in meaningful negotiations on material lease terms, other than just rent.

The list and priority of issues to be negotiated will vary from lease to lease and depend significantly on each tenant's objectives. However, there are some key economic/business terms at the core of every commercial lease that merit particular attention in a market where the tenant has bargaining power and a variety of choices. As a starting point, the commercial tenant should consider the following questions:

What Are We Really Paying For Each Foot Of Space?

Tenants pay rent and operating costs for each "rentable" square foot of space. The space the tenant can actually occupy ("usable space") may be considerably less. You need to understand the "rentable/usable factor" or "loss factor" on each building you are considering to make a fair comparison of your costs. As an example, your rent cost per foot of usable space with a net rent rate of \$15 per square foot (and \$10 per square foot per

Continued on page 2

WHAT'S INSIDE

- Four Traps for The Unwary Tenant - continued **Page 2**
- New State Law Requires Seller Disclosures . . . **Page 3**
- Real Estate Section **Page 4**
- Construction Allowances - Income To Tenant? **Page 5**

A Note From The Editor

Welcome to the first edition of our Real Estate Report. We hope you find the articles contained in this issue helpful and informative. Felhaber, Larson, Fenlon & Vogt, P.A. was founded in 1943. We are a 50+ lawyer firm with offices in Minneapolis and St. Paul. The firm's primary practices are business, real estate, employment and labor law, tax, employee benefits, trusts and estate planning, and health law.

There are 19 lawyers in the firm's Real Estate Section. Four of them - David Cremons, Patrick Brinkman, Rebecca Kassekert and Stephen Yoch - have written articles for this first edition of the newsletter. In future issues, we will offer articles from other members of the Real Estate Section. We want to offer a newsletter to you which addresses topics which are both timely and effective of the concerns of the real estate market place. If you have an idea for an article or topic that we should address, please let me or any one of our section members know. The name, phone number and e-mail address for each of our members is listed on the back page of this newsletter.

If you find that the Real Estate Report is not of interest to you, please let us know that too. No sense cluttering up your in-basket with our newsletter. To remove your name from the mailing list, please contact Karen Dyck at 612.373.8478 or kdyck@felhaber.com.

Our firm also offers the following newsletters: Health Law Monitor, Business Report, Labor & Employment Report and The Estate Planner. If any of these newsletters might be of interest to you, please let Karen Dyck know and she will add you to the mailing list.

Finally, please check out our website at www.felhaber.com. The website provides background information on the law firm and we post articles and information on the website which may be of interest to you.



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year in operating costs) in a building with a rentable/usable factor of 1.08 will be less than the cost per usable foot on space with a net rental rate of \$13 per square foot (and \$10 per square foot operating costs), in a second building with an R/U factor of 1.18. Before you choose a building, understand what your costs will be on a usable, and not just rentable, basis.

How Much of Our Allowance Will Be Gone Before We Ever Start Construction Of Our Offices?

A typical allowance for office space is in the range of \$20 to \$30 per rentable foot; seemingly an ample amount to construct improvements if it can all be used for that purpose. However, does the lease require you to pay for demolition of existing improvements at \$2 to \$5 per foot? What about above-ceiling modifications, which may be \$2 to \$4 or more per foot? Are you paying for window blinds? Are you being charged for the supply of basic light fixtures and ceiling tile? Will there be a fee for the landlord's review of your plans, for "supervision" of your contractor, or for use of the freight elevators? Are there other hidden charges? Before you sign the lease, you should understand everything that will be charged against the improvement allowance or you will inevitably find yourself with less than you expected to finish the space.

What Will It Cost You To Leave When Your Lease Is Over?

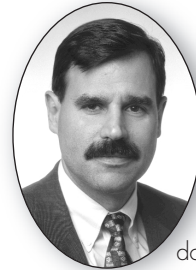
Clauses concerning surrender of space vary widely. Some require you to simply return the space "in clean and orderly condition, reasonable wear and tear excepted." Others mandate that you remove all improvements at your expense or grant the landlord discretion as to which improvements you have to remove. Consider this in the context of an interior staircase connecting multiple floors of a tenant's offices. The anticipated removal and floor restoration costs would almost certainly run into the tens of thousands of dollars. Protect yourself from unexpected costs at the end of your lease by negotiating for the right to return your space with all improvements in place.

Are Your Expansion and Renewal Rights Meaningful?

Business cycles are unpredictable and tenants have learned to place great value on flexibility. Therefore, among the most important elements of many commercial leases are expansion and renewal options. These often complex provisions may run on for pages, but do they truly give you the expected flexibility? For example, does another tenant have a priority claim to your option space or to your primary office space when you wish to renew? Is the

rent you will pay in an expansion or term extension scenario tied either to your rent schedule or a defined "market," or will it be determined by the landlord's (arguably self-interested) perception of the market? Is there an effective mechanism to resolve disputes with the landlord if you disagree over the proposed rent level or will you be left with a "take it or leave it" situation? Having an option to take expansion space at a landlord's stipulated figure of \$30 or \$35 net per square foot may be the practical equivalent of having no option at all.

In tight markets, the commercial tenant is often faced with the need to accept lease terms that are tilted significantly in the landlord's favor. That is not the case in a market like the current one. Tenants should negotiate aggressively on rents, but should also focus carefully on the other aspects of the transaction that can sometimes prove even more important in the long term than rent level.



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COMPLIMENTARY CLIENT SEMINARS

Consider attending one of our upcoming seminars, with timely discussions on a variety of legal topics. The seminar presenters include our firm attorneys who have expertise in the seminar subject matter.

Recent seminars we have hosted include the following topics: estate planning, labor and employment, real estate, and multiemployer benefits. Most seminars include a complimentary continental breakfast and luncheon.

Seminar Dates

Healthcare/HIPAA Seminar
September 26

Labor & Employment Law Seminar
October 25

Real Estate Seminar for Leasing
Brokers, Property Managers and Tenant
Representatives – November 6

Here is a listing of some of our upcoming seminars. Let us know if you are interested in receiving a seminar invitation by emailing kdyck@felhaber.com. State your name and address with the name of the seminar you wish to attend. You may also log on to www.felhaber.com, which will have online seminar registration available approximately three weeks ahead of the seminar date.

New State Law Requires Seller Disclosures in Residential Transactions

The general rule in Minnesota has long been that one party to a transaction does not have a duty to disclose material facts to another. However, over the years, many exceptions have been imposed by statute and case law. See the *Minnesota Common Interest Ownership Act* (Minn. Stat. 515B), *Sewer Management* (§ 115.55), *Storage Tanks* (§ 116.48), *Wells* (§ 103I.235), *Lead Paint* (24 C.F.R. § 35), *Real Estate Broker Disclosures* (Minnesota Rules 2805.1400, subpart 3), etc. Non-disclosure of facts by sellers in residential transactions has been a repeated source of disputes and litigation. Recently, the Minnesota Legislature enacted a statute which imposes responsibilities on sellers to disclose material information which might impact the purchaser's use or enjoyment of the property. Because of the impact of this statute, both sellers and buyers should be aware of the new requirement.

Statute Requires Seller's Disclosure After January 1, 2003

Beginning January 1, 2003, all residential transfers of real estate, whether by sale, exchange, contract for deed, traditional mortgage sale, option or otherwise will require a written disclosure by a seller to a prospective buyer of information that could adversely affect value. Residential homeowners (whether single family or in common interest communities) will be required to disclose "all material facts pertaining to adverse physical conditions in the property of which the seller is aware that could adversely and significantly affect the buyer's use or enjoyment of the property." (Minn. Stat. § 513.60-68). The written disclosure must be made to a prospective buyer before signing an agreement to sell or transfer the property. A seller will not be liable for any error, inaccuracy, or omission of information disclosed if the error, inaccuracy or omission was not within the seller's personal knowledge or was based entirely on information prepared by a qualified third party inspector.

Statute does not Apply to Selected Property Transfers

While as a general rule, the "run of the mill" real estate transactions will be subject to the real estate disclosure requirement, the legislature carved out specific exceptions where no disclosure is required:

1. Transfer of non-residential real property;
2. Gratuitous transfer;
3. Transfer pursuant to a Court order;
4. Transfer to a government or governmental agency;
5. Transfer by foreclosure or deed in lieu of foreclosure;
6. Transfer to heirs or devisees of a decedent;

7. Transfer among cotenants;
8. Transfer to a spouse, parent, grandparent, child or grandchild of the seller;
9. Transfer between spouses as a result of a marriage dissolution;
10. Transfer of newly constructed residential property which has not been inhabited;
11. An option to purchase a unit in a common interest community until exercised;
12. Transfer to a person who is controlled by a grantor under the Common Interest Ownership Act;
13. Transfer to a tenant who is in possession of residential real property; or
14. Transfer of a special declarant under the Common Interest Ownership statute.

Disclosures Which Are NOT Required

While a seller must generally disclose information regarding the condition of a home which might materially affect value, the legislature has found specific issues that a seller does not need to disclose:

1. That the property was occupied by an owner who is or was suspected to be infected by HIV;
2. The site was the result of suicide, accidental death, natural death, or perceived paranormal activity;
3. Is located in a neighborhood containing adult group homes, community-based residential family or nursing homes; or
4. An obligation to make disclosures regarding individuals who are required to register as predatory offenders, as this information is available from local law enforcement.

Inspections

A seller may also provide a report disclosing the physical condition of the real property, if the report was prepared by a qualified third party with expertise necessary to meet the industry standards of inspection. This report may be provided to the buyer in lieu of a written disclosure. However, this report does not remove the duty of the seller to disclose to the prospective buyer material facts known to the seller that could contradict any information included in the report.

Statute of Limitations and Waiver

A buyer who believes the disclosure requirements in this statute have been violated must bring a civil action to recover damages, or other equitable relief, within two years after the date on which the prospective

buyer closed on the purchase of the transfer of real estate. A violation of the statute alone does not constitute grounds for invalidating a sale, but this does not prevent a court from ordering rescission of the transfer.

Finally, the parties are free to enter into an agreement where a buyer waives his/her right to the disclosure required under the statute. An agreement waiving the right to disclosure must be in writing.

Conclusion

Beginning in January 2003, sellers will need to carefully consider what they are disclosing to buyers to make sure they do not violate the statute. In the alternative, sellers should retain reputable third parties to generate inspection reports or seek an explicit waiver from the prospective buyer of the statutory disclosure requirement. Buyers should understand that sellers now have an affirmative obligation to provide information, and should understand the rights they are giving up if a seller wants the statutory disclosure waived by

agreement. In any event, the legislature has created a new statutory framework which will likely result in substantial additional litigation between buyers and sellers concerning what was, or was not, disclosed in the sale of residential real estate.



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Construction Allowances - Income To Tenant?

A fundamental issue in real property lease negotiations is tenant improvements. The cost of tenant improvements often represents a significant percentage of the total value of a retail or office lease. The importance of who pays the cost of tenant improvements, how the cost is paid and how the cost is recovered is obvious and always given major consideration in negotiations. Less obvious, and seldom considered, are the significant tax benefits or burdens available or imposed by the outcome of the landlord and tenant negotiations.

Construction allowances in leases are common but can create different and conflicting tax objectives for landlords and tenants. Construction allowances paid to a tenant may be characterized as income, and if so must be recognized by the tenant as income in the year received. A tenant can avoid income recognition if the landlord is deemed to own the leasehold improvement so that the tenant receives the construction allowance merely as a conduit for payment of the landlord-owned improvements. However, even though the construction allowance is paid at or before the start of the lease term, the landlord as owner of the non-residential leasehold improvements paid by the construction allowance cannot deduct the cost when paid or even over the term of the lease but can generally only depreciate the cost of improvements ratably over 39 years. On the other hand, a landlord can avoid a 39-year depreciation period and write off the construction allowance over the shorter lease term if the tenant owns the improvements, but then the construction allowance must be recognized as income by the tenant when received and the tenant must depreciate the cost of the improvements constructed with the allowance over a 39-year depreciation period.

There are added tax considerations for certain leasehold improvements made after September 10, 2001, and before September 11, 2004. The economic stimulus package, known officially as the Job Creation and Worker Assistance Act of 2002, passed in March of this year, gives landlords and tenants of commercial property the option to depreciate for federal tax purposes 30 percent of the cost of "qualified tenant improvements" in the first year that the improvements are placed in service. The other 70 percent is depreciated over the standard 39-year schedule. This accelerated depreciation option can be a significant benefit to landlords or tenants, but it is subject to

conditions and is available for a limited time only. To qualify, the improvements:

- must be made after September 10, 2001, and before September 11, 2004,
- must be placed in service at least three years after completion of the building (improvements to new buildings will not qualify), and
- must be interior improvements in commercial, including retail, qualified lease space placed in service no later than January 1, 2005 (excludes building expansions, structural repairs or common area improvements and improvements to owner occupied space).

Currently, Minnesota law does not allow the 30% bonus depreciation expense for state tax purposes.

To help avoid controversies between taxpayers and the Internal Revenue Service (IRS) as to who owns the leasehold improvements, Congress passed the Taxpayer Relief Act of 1997 which included a safe harbor for retail tenants that receive "qualified lessee construction allowances." The section provides that a retail tenant with a short-term lease that receives a construction allowance from a landlord of retail space is not required to treat the allowance as income if it is used to construct improvements of qualified long-term real property. A short-term lease is a lease that has a term of 15 years or less, including option periods. Qualified long-term real property means non-residential real property that is part of, or otherwise present at, the retail space and which reverts to the landlord when the lease terminates. The definition of retail space is broad enough to generally extend to office and warehouse leases of retail tenants. The effect of the safe harbor is the construction allowance is not income to the tenant but the landlord, as the owner of the improvements, must depreciate the cost of the improvements over a depreciable life of 39 years, subject to the 30% first year depreciation option if qualified and acceleration if the improvements are sooner disposed of or abandoned.

In an expansion of the construction allowance concept, anchor stores often command significant inducements such as cash, land, and buildings to locate in a shopping center. The IRS has attacked these inducements and characterized them as income to the anchor store. However, under favorable case law, if the developer/owner making the contribution receives in return only an intangible and indirect benefit, such as an attraction of other tenants for the center, the inducements

Continued on page 6

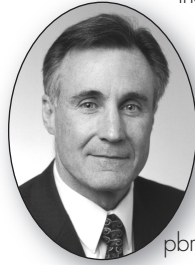
Construction Allowances - Income To Tenant? ■ Continued from page 5

may be excludible from income under IRS Code Section 118 as a capital contribution made by a non-shareholder. But it is the IRS's position that if rent is received by the developer/owner from the anchor tenant, there is a direct benefit to the developer/owner and consequently the inducement received by the tenant is not excludible by Section 118. The inducement may, however, qualify for exclusion under the Section 110 safe harbor.

Even though non-residential leasehold improvements owned by the landlord must be depreciated over a 39-year life, the depreciation may be accelerated if the improvements are then "irrevocably disposed of" or "abandoned." This may happen at the end of the lease term. However, to accelerate the write-off the landlord must be able to separately account for the adjusted basis of the disposed or abandoned leasehold improvements. Likewise, a tenant that owns the leasehold improvements and has been depreciating the cost of the leasehold

improvements over 39 years, may at the end of the lease term deduct the remaining depreciable balance of the leasehold improvements abandoned by the tenant. The landlord is not required to recognize offsetting income (nor will the landlord receive the benefit of a basis adjustment) provided the turnover of leasehold improvements by the tenant is not in lieu of or considered a rent payment.

To control the tax consequences of construction allowances, tenants and landlords should designate in the lease the owner of the improvements and specify that at lease-end all the improvements made with the construction allowance are the property of the owner.



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Real Estate Report is an update on legal developments. It is not intended to be legal advice and should not be relied on without consulting counsel.

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