CHAPTER 17

Buying, Selling and Exchanging Hotel Properties

¶ 17.01 Purchase or Sale of Hotel Properties 17-2
[1] General Legal Requirements to a Real Estate Contract 17-2
[2] General Provisions of a Sales Contract.................. 17-4
[a] Real and Personal Property Being Sold 17-4
[b] Business Assets Being Sold.................... 17-5
[c] Closing.................. 17-5
[d] Purchase Price........... 17-5
[i] Adjustment of purchase price................ 17-5
[ii] Allocation of price among different assets 17-6
[iii] Allocation of price between land and buildings............. 17-6
[e] Earnest Money........... 17-6
[f] Due Diligence............ 17-7
[g] Terms of Purchase Financing............... 17-7
[i] Third-party financing 17-7
[ii] Purchase-money financing............. 17-8
[iii] Existing mortgage...... 17-8
[h] Title Commitment and Survey................. 17-9
[i] Seller's Representations and Warranties........... 17-10
[i] Building and zoning regulations 17-10
[ii] Franchise agreements... 17-11
[j] Closing Documents and Procedure 17-11
[i] Title deeds 17-11
[ii] Closings............. 17-12
[k] Brokerage Commissions.... 17-12
[l] Miscellaneous Provisions ... 17-13

¶ 17.02 Hotel Brokers.................. 17-13
[1] Creating a Story............. 17-13
[2] Negotiating From Strength 17-14
[3] Capital.................... 17-14
[4] Marketing a Hotel............ 17-15
[5] Preventing Disruptions 17-17

¶ 17.03 Like-Kind Exchanges 17-17
[1] Advantages 17-17
[2] General Requirements 17-18
[3] Real Estate Qualifications...... 17-18
[4] Utilizing Deferred Exchanges ... 17-19
[5] Related Party Transfers 17-21
[6] Determining Basis 17-21

¶ 17.04 Case Study: How Investor Raised Cash to Acquire a Profitable Hotel ... 17-24
[1] Methods Considered by Investor 17-24
[a] Why $22.5 Million Could Not Be Raised From Tax-Shelter Investors 17-24
[b] Why a Tax-Exempt Bond Issue Was Not Available to Investor 17-24
[c] Other Sources of Funds 17-25
[2] Investor Created a Ground Lease and a Leasehold Mortgage.................. 17-25
[3] How Investor Then Syndicated the Enterprise and Created a Subleasehold Operating Position 17-25

¶ 17.01 PURCHASE OR SALE OF HOTEL PROPERTIES

Because the purchase or sale of a hotel property is basically the opposite sides of the same coin, when discussing purchases or sales, investors should realize that the motivation for one party will usually be a factor for the other party as well. There are no easy answers when a hotel owner should sell a property. Many factors play into the decision to sell a property. What will the future hold? Is the market expanding or contracting? How much competition is coming on line in the next few years? Will supply be expanding or contracting? All these questions need to be guessed at as best as the seller can in making his determination to sell or not. Of course the buyer is doing the same type of analyzing and is hoping that he may be able to buy at an opportune time and thus increase his overall value.

The seller motivation is always on the mind of the buyer. Some of the more common reasons for selling a hotel property include:

1. *Change of corporate policy.* Many large conglomerates may feel a particular hotel chain or group of hotels no longer fit within their corporate strategy.
2. *Need the money.* Many property owners borrowed so much money on the hotel's value that the property has a difficult time servicing the debt load. Of course this puts the buyer who has this information in a very strong position. For example, the Asian crisis has forced many foreign-owned hotels to be put up for sale because the corporate owners are in need of capital.
3. *Changes in perceived future market values.* Many hotel owners wish to get out because they see a peak in values that they feel will not be duplicated again in the near future.
4. *Retirement of key personnel.* Many hotel owners simply wish to get out of the business because there is no one to take over the business.
5. *Declining depreciation and other tax shelter aspects of the property which results in more taxable income being attributable to the owner.* The owner may wish to capitalize on lower capital gains rates.
6. *Changing neighborhood.* The owner may realize that new competition is coming into town and may wish to sell out before the information is generally known or that a key reason for travelers to visit the location is in jeopardy of leaving.

These are just some of the more common methods that motivate an owner. The buyer needs to beware of any or all possible motives for the sale of the properties. This is why an indispensable part of any purchase is for the buyer to ascertain as realistic as possible the true value of the hotel that he is about to purchase.

[1] General Legal Requirements to a Real Estate Contract

When a hotel is purchased, the key instrument in the purchase is the sales contract or agreement of sale. This document spells out in great detail the rights and obligations of the parties during the contract period. It also will detail the manner in which the party will eventually be transferred.

Since real estate contracts need to be in writing in order to be enforceable, the sales contract is the essential agreement of exchange of promises which makes the sales transaction enforceable under law. Once the document has been signed, it is enforceable on both parties unless both parties assent to the changes. Throughout our legal history it has been well established that contracts must contain certain provisions in order to be enforceable.

☐ *Mutual agreement.* A basic requirement of any contract is that the parties have a "meeting of the minds." Mutual agreement is met when one party makes an offer and the other party accepts that offer.

- Any offer must meet certain well-accepted rules in order to be considered a valid offer. The offer must (1) be definite and certain; (2) define the precise subject matter of the proposed contract; and (3) be communicated by the one making the offer to the recipient of the offer.
- Once the recipient receives the offer it remains open and capable of being accepted until (1) it expires by its own terms; (2) the recipient rejects the offer; or (3) the person making the offer revokes it before the recipient accepts. The offer is also canceled by the destruction of the hotel property or by circumstances that make the contract illegal.
- The recipient accepts the offer only when his deed or words clearly indicate acceptance of the terms of the offer. An acceptance must (1) be positive and unequivocal; (2) conform precisely to the terms of the offer; and (3) be communicated to the person making the offer within the permissible time period.
- Any counteroffer is considered a new offer and the above-mentioned criteria then is applied as if the contract is being offered for the first time. The parties may go through several counteroffers until final acceptance or rejection has taken place.

☐ *Reality of assent.* The assent of a party is real when it is given freely and with full knowledge of the circumstance affecting the agreement. When assent is not freely given, the contract may not be valid depending on the cause. The four such causes are fraud, mistake, duress, and undue influence.

- Fraud is the intentional misrepresentation of a material fact in order to induce another to part with something of value. It clearly indicates there must be a misrepresentation of a fact, not merely an opinion. The misrepresentation also must be significant and substantial, and it must be made with the intention that the other party rely on it to his detriment.
- Mistake is a difficult concept to apply to invalidate a contract. Generally, only mistakes of fact can invalidate a contract, and only if the mistake is material and the other party should have realized a mistake was being made.
- Duress occurs when one of the parties uses threats or coercion to obtain consent.
- Undue influence is when a party in a confidential relationship uses improper or excessive persuasion to obtain a consent.

☐ *Legal capacity to contract.* Each party must have the legal capacity to enter into valid legal contract. Legal capacity means the ability to reason and understand the significance of an agreement.

- Minors (children under the age of 18 or 21, depending upon the particular state) lack legal capacity to enter into a contract for the purchase of real estate. Any contract that the minor should make on real estate can be disaffirmed on reaching the age of majority. This type of contract is called voidable because it is considered to be valid until the minor takes steps to disaffirm his obligations.

- Persons found to be insane, incompetent, and at times, intoxicated at the time the contract was entered into may be held to lack the legal capacity to contract.

☐ *Consideration.* Contracts cannot be enforced unless consideration has passed between the parties. This is a fundamental requirement of all contracts. Consideration includes promises and actions that can include anything that constitutes a benefit to the promisor (the one whom makes the promise) or detriment to the promisee (the one to whom the promise is made). The law does not look at the adequacy of the consideration but merely whether consideration was actually bargained for.

☐ *Legality of the transaction.* A contract will be enforceable only if the purpose of the contract is legal. A contract to buy or sell a hotel property for an illegal purpose (e.g., gambling in a state that bars this activity) would be void and unenforceable.

☐ *Contract in writing.* Finally, real estate contracts must be in writing in order to be enforceable. This requirement originally was imposed by an English statute, the Statute of Frauds, enacted in 1677. Its purpose was to prevent many fraudulent claims that were based on alleged oral promises or agreements. All states recognize the writing requirement and apply them to all transactions involving the sale and purchase of real estate and all leases of real property that exceed a specified time period (usually one year).

The Statute of Frauds will be satisfied so long as the person against whom the contract is sought to be enforced has signed it. It is not necessary that the person seeking to enforce the contract has signed it. Generally, the writing must contain the following information:

1. The identity of the parties
2. The identification of the property of the contract
3. The consideration

The writing need not be designated a contract. Any written memorandum will suffice to satisfy the statute, provided it contains the requisite information.

Appendix 2, Sample Clauses for Hotel Purchase and Sale Agreement, contains an excellent checklist of what is included in most hotel sale agreements. Below is a summary of that checklist and some considerations that the buyer and seller may want to ensure are included in the contract.

[2] General Provisions of a Sales Contract

[a] Real and Personal Property Being Sold

A contract for the purchase and sale of a hotel should accurately describe the property to be conveyed and also the personal property to be included in the conveyance. The description may be by street address, full legal description, or reference to a public map; by plat attached to documents or schedules; or by some combination of these. Regardless of the method used, however, unless the description burnishes

the means of determining with reasonable certainty the property intended to be conveyed, the contract is unenforceable.

Sources for the description of the hotel would include current surveys, copies of the seller's warranty deed or title policy, and current title reports or binders. If a current, accurate description is not available or if the parties contemplate that a survey will be made before the closing, it is advisable to provide that the description that will be used at the closing be based on the survey.

All descriptions of property should be independently verified by the purchaser. Also, if rights of access or other rights affecting adjoining property are important to the use and enjoyment of the property being purchased, those rights should be specifically included. Where appropriate, clauses may be included to cover such items as air rights, rights in adjoining streets, easements, and leaseholds.

[b] Business Assets Being Sold

Some of the most important assets of the hotel will be the right to operate the property through various government permits. If a government license or permit has already been issued for the property, the seller will want assurances that the seller will transfer these valuable rights. Success in obtaining a license (e.g., gaming license) or in obtaining the transfer of an existing license may be essential to the right of the purchaser to conduct or continue the conduct of the hospitality business located thereon. For this reason, contracts for the sale of hotel properties frequently contain provisions concerning the seller's duty to keep necessary licenses or permits (e.g., liquor license) in force and cooperate with the purchaser in obtaining the transfer of a license or permit to him.

[c] Closing

The closing is the final meeting of the parties at which the instruments necessary for conveying title to the premises and to the personal property from the seller to the purchaser occur. It is also when the consideration from the purchaser to the seller takes place. Also at the closing, the final documents are signed and delivered, expenses are apportioned, income from the property is prorated, and all closing adjustments are made.

[d] Purchase Price

The purchase price for the hotel must be readily ascertained from the sales contract or be calculated with a degree of certainty. Often, the contract will provide certain clauses that make the final purchase price unknown, but the price will be able to be ascertained by closing, thus meeting the requirement of certainty.

The contract should specify how payment of the purchase price shall be made; any down payments or earnest money payments that are required; and the method, medium, and time of payment.

[i] **Adjustment of purchase price.** Often the total purchase price will only be determined after a final audit of the property. The contract should specifically spell out what items will be used in adjusting the purchase price. For instance, liquor inventory at the time of closing would be an adjustment to the final purchase price.

[ii] **Allocation of price among different assets.** Although not required by law, the parties should consider allocating the purchase price of the hotel among the various assets. The reasonable allocation of purchase price among assets is an excellent method of avoiding trouble with the IRS over the value placed on personal property vs. real property. Of course, the seller would like as much as is reasonable, allocation of purchase price to real property for capital gain treatment and less to personal property, which would be taxed as ordinary income. The buyer has the opposite needs and wants, and therefore a goodfaith allocation is usually acceptable to the IRS.

[iii] **Allocation of price between land and buildings.** In order to maximize depreciation deductions, purchase price needs to be allocated to the building as opposed to land which is not a depreciable asset.

The Treasury regulations require that when nondepreciable and depreciable properties, such as land and building or improvements, are acquired together for lump sum, the acquisition cost must be allocated on the basis of the respective values of the land and the building or other improvements on the land. The Treasury regulations do not state how the respective values are to be ascertained. One way is to use a professional appraisal; other ways are to base the allocation on the relative values placed on the land and building by the local tax assessor or on the buyer's own information resulting from his personal familiarity with the area in which the property is located. Still another method is for the buyer to evaluate the buildings situated on the land from the investment point of view by capitalizing its cash flow. This may produce a particularly favorable allocation in the case of a hotel which is old is a very profitable one.

[e] Earnest Money

Almost all major hotel sales require that the buyer put a substantial down payment or earnest deposit to show good faith in the purchase of the property. This goodfaith deposit will be held in escrow during the period between the signing of the sales contract and the closing on the property (transfer or title). Also, in complex hotel sales there may be substantial performance clauses in which the buyer or seller may place funds in an escrow, in which case the escrow deposit is used as a security for the performance under the agreement.

An escrow deposit may be in cash, securities, promissory notes, letter of credit, or such other device that the parties agree will suffice as to proper value. Cash deposit is the most common method for securing a down payment. The cash deposit will be credited against the purchase price of the hotel and paid over to the seller at the closing, unless the purchaser has committed a breach of contract. Often the deposit is returned to the buyer if the sale is not consummated due to some other reason than a breach of contract.

Most escrow agents in the sale of hotel properties are brokers, attorneys, title companies, financial institutions, or escrow companies. The escrow agent by law must follow the specific instructions agreed to by the parties concerning his custody and disposition of the funds entrusted to his care. The law puts an escrow agent in a fiduciary bound duty to act according to the dictates of the escrow agreement. His duties should be strictly ministered, limited to the safekeeping of the funds in a separate, properly identified, interest-bearing account, and paying over the funds at the proper time and place to the proper person when required to do so under the terms of the escrow arrangement.

Often when the contract for sale requires the purchaser to make the deposit as security for his performance, the seller may insist on a provision declaring that the sum placed in escrow shall constitute liquidated damages if the purchaser subsequently defaults or breaches the contract. The purchaser, on the other hand, may in-

sist on placing provisions in the sales contract that if certain contingencies are not met or that if the seller defaults in his performance, the escrow deposit is to be returned to him.

[f] Due Diligence

Usually in the purchase of a hotel property a prudent purchaser will insist that the seller expressly warrant the condition of the property, but also insist in the sales contract to the right to physically inspect the hotel and its record prior to closing. The purchaser should place in the sales contract a provision that if the condition of the hotel proves to be unsatisfactory or not as warranted or represented by the seller, the purchaser has the right to rescind or cancel the contract.

The purchaser will also want to insist that all existing leases and tenancies be disclosed in the contract. The purchaser will also want to put in the contract that the seller continue to perform any service and repair arrangements with the tenants until title passes to the purchaser.

Anytime that the purchaser is given the right to enter upon the premises and inspect the property before title is transferred to him, the seller should insist on the right to be indemnified or held harmless by the purchaser against any and all losses, damages, or claims arising out the purchaser's entry and activities on the premises. The seller should also require that the tests the purchaser conducts in the course of the inspection are at the purchaser's sole cost and expense.

If there are major physical problems with the hotel, the seller could be held liable to third parties after the sale of the property unless the purchaser hides and/or fails to disclose the dangerous or defective condition to the seller. Therefore, the purchaser should require provisions in the contract offering him protection against defective conditions existing at the hotel.

The purchaser's protective provisions may take several different forms. For instance, he may require the seller to fix the problems before closing will take place. The buyer could insist that the seller place in escrow sufficient funds as security against his performance of the necessary work within a specified time after closing.

The seller may want the contract to afford him the option to cancel the contract and return the purchaser's earnest money if the cost of remedying the offending conditions or securing the violations exceeds a specified amount.

[g] Terms of Purchase Financing

[i] **Third-party financing.** Most hotels usually involve some type of mortgage financing in order for the purchaser to buy the hotel. Because the loan authorization process is often a very lengthy affair, the sales contract is made contingent on, or subject to the purchaser's procurement of a mortgage loan commitment meeting specified requirements. Some of the more common requirements for a loan include interest rate, amount, and duration.

Another important clause in the sales contract is the amount of time that the purchaser will have in order apply for and to procure a loan commitment. The parties may agree that the purchaser's procurement of the loan commitment within the required time and containing the required terms shall be a condition precedent to the obligation of either party to perform, or that the purchaser's failure to obtain the required mortgage loan commitment within the allotted time may be grounds for rescission or cancellation of the contract.

The sales contract should provide for a refund to the purchaser of the sums paid by him to the seller where the contract is canceled for failure to obtain the necessary

financing within the required time; if the seller is entitled to his costs, the contract should clearly state exactly what he is entitled to.

[ii] **Purchase-money financing.** Often the seller will be willing to help finance in whole, or in part, the purchase price of the hotel property by extending a purchase-money loan to the buyer secured by a mortgage, land contract, or deed in trust on the property sold. The most frequent use of the purchase-money loan will be as a second mortgage on the hotel property. Under these conditions, the purchase-money loan will be used to fill the gap between the purchase price of the property and the aggregate of the purchaser's cash investment and the proceeds of the existing outside-mortgage loan.

Sellers frequently enter purchase-money financing arrangements with their buyers on smaller hotel properties where financing of any kind is difficult to obtain or in times of high interest rates, which make the purchase of a hotel prohibitively expensive. Many sellers may prefer to enter into purchase-money financing because it will generate interest income for the seller.

It is important that any purchase-money mortgage loan arrangement be reflected in the sales contract and the material details of the mortgage, land contract, or deed of trust including the property that secures the obligation. Some of the more important details include the amount of the loan, the loan term, the debt service payments, and the interest rate.

If the purchase-money mortgage is to be junior to an existing mortgage on the property, the contract should so state; and if it is to be subordinate to a new mortgage on the hotel property in favor of an outside lender, the contract should clearly state that fact. Finally, the sales contract should state whether the purchase-money loan is to be a recourse or a nonrecourse obligation; that is, whether the purchaser is to be personally liable for the loan or whether the seller's sole remedy in case of default is to proceed against the property.

[iii] **Existing mortgage.** Often there is an existing mortgage that is in existence at the sale of hotel property. The contract should spell out whether the hotel is to be purchased subject to an existing mortgage. If the buyer takes the property subject to an existing mortgage, the parties understand that the mortgage will not be satisfied by the seller by the time the title is transferred to the seller (closing). Instead, the purchaser will be responsible after the closing to make the mortgage payments under the original terms of the mortgage document.

Of course, any purchaser who takes subject to an existing mortgage should realize that the financial institution still maintains a lien on the hotel property and can foreclose and sell the property if the purchaser defaults on future mortgage payments. However, because he is not personally liable for the mortgage obligation, he cannot be held personally liable for the deficiency if the proceeds of the foreclosure sale are not sufficient to satisfy the balance due under the mortgage obligation plus intuits and costs. Instead, the mortgage holder (mortgagee) must look to the original seller (mortgagor) to recoup the deficiency, assuming that the mortgage obligation is a recourse obligation.

Another type of existing mortgage arrangement is when the purchaser assumes an existing mortgage. Rather than merely taking the title subject to the mortgage where the purchaser assumes a mortgage on the property, he undertakes personal liability for payment of the existing mortgage indebtedness. If the seller was personally liable to the mortgagee or the mortgage obligation before the sale, he remains personally liable after the sale even though the purchaser assumes the mortgage, unless the assumption of the mortgage obligations by purchaser is accompanied by a novation (new contract). Thus, if the holder of the mortgage agrees to substitute the personal liability of the purchaser for that of the seller (in other words, if the mortgage holder agrees to a novation), the seller remains personally liable and, in most juris-

dictions, the purchaser is also personally liable to the mortgage holder. If the seller becomes liable to pay any part of the mortgage debt, he is entitled to reimbursement from the purchaser since, as between them, the purchaser is primarily liable.

Today, however, many mortgage agreements carry a due-on-sale clause under which the mortgagee may accelerate the mortgage debt so that it becomes immediately payable in the event that the property is sold by the mortgagor. If such payment is forthcoming and the sale takes place, the mortgagee may proceed to its remedies under the mortgage. That is to force the payoff of the mortgage and force the purchaser to secure a second mortgage at supposedly a higher interest rate.

Finally, if there is a mortgage on the property, the purchaser should request before purchasing the hotel a duly executed estoppel certificate, statement, or letter from the mortgagee that states all the current particulars with respect to the mortgage, including the interest rate, balance due, and that there has been no default under the mortgage. The party executing the estoppel certificate cannot later claim that the facts stated are different, since the statement was issued with intention that it be relied on by the purchaser, and the purchaser bought the property with reliance on it.

[h] Title Commitment and Survey

It is very important that the seller be able to convey title to the purchaser. If the seller can not convey good title, he will want provisions in their agreement so as not to be liable to the purchaser or to cure the defects of title regardless of the cost to him. The purchaser, for his part, will want assurance that the seller will be obligated to convey a good title when the closing date arrives. Within this framework, the parties may agree that the purchaser shall either accept, without abatement of the purchase price, such title as the seller can convey, or terminate the agreement and receive a refund of his earnest money deposit. Another option is to require the seller to remove, at his own expense, any and all defects of title that are subject to removal regardless of cost.

A contract that specifies that a marketable title is required refers to a title that (1) is free from liens or encumbrances except those specifically set forth in the contract; (2) discloses no serious defects; (3) does not depend for its validity on doubtful questions of law or fact; and (4) will not expose the purchaser to the hazard of litigation. In addition, the title should be such that a reasonable, well-informed, and prudent person acting on business principles with full knowledge of the facts and their legal significance would be willing to accept with the assurance that he, in turn, will be able to sell or mortgage the property at fair value.

The following examples have been ruled to render title unmarketable:

- A reasonable hazard of litigation
- Title acquired by adverse possession
- An outstanding right in a third person that interferes with the use or transfer of the property or subjects the property to an obligation, leases, liens of any tax assessment, or water charge
- Debts of decedents or a reasonable possibility of their existence
- Easements
- Outstanding mineral and oil rights

Regardless of the agreement reached by the parties, with respect to defects of title, the purchaser will want to include a provision that if the sellers inability to convey good title results from his own acts or omissions, he will be considered to be in default under the contract and will continue to be liable to the purchaser for any damages resulting therefrom.

One way to avoid many problems with title questions is for the purchaser to acquire a title insurance policy. The purchaser will still insist that the seller fix defects of title where the condition of the title is unsatisfactory, and that if title defects are not rectified, the purchaser should have the right or option to terminate the contract.

Although the title insurance does not cure a defective title, it does, however, protect the buyer against loss as a result of defects and encumbrances that are not specifically expected from the insurance coverage. In this regard, it is important for the purchaser to understand the legal implications of the endorsements to the title insurance policy and the exception contained therein.

A title insurance policy ensures against loss or damage to the insured by reason or defects, liens, or other encumbrances on his title that are not specifically excepted from, or excluded by, the policy. The policy does not cure a defective title; if the defect is such as to render the title unmarketable, title insurance will not render the title marketable.

In most jurisdictions, all title policies cover losses or costs arising from defects disclosed by the pubic records; defects not disclosed by the public records; the costs of defending title, whether justified or not; and mistakes of the title examiner, whether errors, omissions, or mistakes or judgment.

The purchaser will also insist that within a given number of days after the signing of the sales contract, a current survey of the property be prepared by a licensed surveyor.

Surveys, on the other hand, give the purchaser a description of the property by describing the property by metes and bounds and show the gross number of acres as well as the number of "net acres." The survey will also show all existing easements, rights-of-way, alleys, streets, and roads, and any encroachments upon the property.

[i] Seller's Representations and Warranties

A warranty may be distinguished from a representation in that a warranty is a promise that is given contemporaneously with, and as part of, the contract, while a representation is of an existing fact and usually precedes and induces the contract. All hotel sales unless prearranged sales between related parties should have warranties as part of the sales contract. In the case of a breach of warranty, the contract remains binding, but the opposite party may sue for damages by reason of the breach. On a false material representation, however, the opposite party may elect to avoid the contract and recover the entire price paid or he may affirm the contract and sue for damages.

Representations and warranties may be expressed or implied. For this reason, the contract may include provisions that the seller makes no representations or warranties, whether express or implied, and that the purchaser is not relying on any representation or warranties made by the seller. Alternatively, the contract may state that no representations or warranties should be made or relied on other than those expressly stated in the contract as being made.

The specific representations and warranties that the parties will want to insist on depend on the situation of the parties and the nature of the transaction and the property. However, basic representations and warranties such as marketability of title or that no condemnation proceeding is pending, should be considered to be fundamental in any contract for the sale of the real estate.

[i] **Building and zoning regulations.** Of critical importance to the purchaser is that any use of the hotel property comply with proper building and zoning ordinances. It is important for the purchaser to make sure that he puts in the right protective language in the contract even if he is accepting the hotel "as is." The purchaser's worse nightmare is to purchase a hotel property that he cannot use or develop for the purposes or in the manner contemplated.

In order to protect himself, the purchaser should place a clause which makes the sale conditional on obtaining the required zoning change or accommodation. A contract so conditioned should clearly state who will be responsible for the approval and expenses of any zoning changes or accommodations required. As a general rule, the purchaser will want the option to rescind the contract and have the down payment or earnest deposit returned to him if the zoning change or accommodation cannot be obtained.

The purchaser should also be concerned about building violations such as violations of regulations adopted by local or state governmental entities concerning the construction, design, quality, use, occupancy, and maintenance of the hotel.

The purchaser should be assured that an existing hotel structure meets all the current government building codes and regulations. Depending on the severity of the violations, the parties can most likely negotiate any compliance measures needed to bring the hotel up to code.

[ii] **Franchise agreements.** Any franchise agreements need to be examined; generally, approval is needed to transfer to a new owner. See Chapter 18, Hotel Franchises, for a complete discussion of the hotel franchise process.

[j] Closing Documents and Procedure

[i] **Title deeds.** A deed to real property is a written instrument by which title to the property is conveyed by the owner (grantor) to the buyer (the grantee). A deed is not valid as between the grantor and the grantee unless it is delivered to and accepted by or on behalf of the grantee and it also meets the following requirements.

- ☐ Each grantor must be identified and he must be a competent adult. While there must be a valid consideration that is set forth in the deed, the actual consideration need not be set forth and nominal consideration may be stated.
- ☐ A deed must contain language (e.g., "grant and convey") that shows that the property is being conveyed and the property conveyed must be sufficiently described to identify it.
- ☐ A deed must be signed by the grantor, and under the statutes of some states, the signature must be witnessed and/or notarized. Generally, a deed must be delivered by the grantor to the grantee and, unless delivered, it is invalid and ineffective to transfer title. The grantee must be in existence at the time the deed is delivered.

Deeds are of several different types; the key distinction among them is related to the precise responsibilities that the grantor assumes in connection with the conveyance. These responsibilities are called warranties. A warranty combines a representation that a certain state of facts is true and the responsibility to make good any damages if the facts turn out to be otherwise.

- ☐ *General warranty deed.* This deed includes the broadest warranties by the grantor and so would be most preferred by the grantee. In fact, it is the most common method of transferring title in this country. A warranty deed usually contains four basic covenants:

1. The covenant of seisen, by which the grantor represents that he in fact owns the property
2. The covenant of the right to convey

3. The covenant against encumbrances, that is, a representation that no claims exist against the property other than those specified in the deed or contract
4. The covenant of quiet enjoyment, by which the grantor represent that no person with superior right to the property can interfere with the grantee's use or possession of the property

☐ *Special warranty deed.* This is exactly the same as a general warranty deed with one important distinction. The grantor will be liable for the breach of his warranty only if the cause arose through the grantor's own act or during his period of ownership. The grantor thus disclaims any responsibility for defects that arose before he became the owner.

☐ *Bargin or sale deed.* This type of deed conveys title to property just as effectively as either kind of warranty deed but contains no covenants. Thus, it is also known as a deed without convenants.

☐ *Quitclaim deed.* While this deed, too, can effectively convey title, it is normally used as a means of surrendering a claim to property that may or may not be valid. In effect, the grantor under a quitclaim deed says "I don't know if I own this property, but if I do, I convey to you whatever rights I may have." This type of deed often is used to correct an error made in an earlier conveyance.

[ii] **Closings.** At the time of the closing, the seller will bring all the necessary documents necessary for the title to pass. This should include the deed to the property, and any documentary stamps that may be required will be attached to the deed at that time or immediately before recordation. The seller will also have with him any leases that pertain to the property. He will also bring the insurance policies covering the property (e.g., fire and extended coverage), certificates of occupancy, and all required government inspection documents.

The seller will also bring with him receipted bills for real estate taxes, water and sewer charges, and any other items as to which adjustments will be made at the closing. He may also bring a contract with the labor union representing the hotel workers.

In addition, the seller will have a bill of sale covering personalty ready for delivery to the buyer.

At the closing, the buyer will be ready to deliver a certified check for the approximate amount that will be due from him. While the adjustments are often approximated in advance of closing, they are computed accurately and finally, and often paid by check executed at the closing. The seller will want to obtain an owner's estoppel certificate from the purchaser if a purchase-money mortgage or deed of trust is to be assigned at the time title closes.

As already indicated, the adjustments are made at the closing, and the deed, any mortgages, release of mortgages, or other liens, the check or checks for the purchase price and the adjustments, and other documents are turned over to the attorneys for the parties or the title insurance company to be held until the deed and other documents are recorded. Recordation normally takes place as soon as possible after the closing.

[k] Brokerage Commissions

Most hotel sales will involve a broker who brought the parties together. The sales contract should identify the broker; the party who is responsible for the payment of the brokerage commission; and the amount, time, and manner in which payment is to be made.

Generally, the seller will be responsible for payment of the brokerage commissions although the parties can agree otherwise. Assuming the seller is responsible for the brokerage commission, he will want to provide that the commission will not be payable unless and until the contract is closed and that it will not be payable if certain circumstances prevent the contract from being closed (e.g., purchaser unable to obtain financing). The brokerage contract is an important document in a hotel transaction and should be analyzed carefully before signing.

[l] Miscellaneous Provisions

Although the discussion of the sales contract has been extensive, there are still many areas that the parties need to be aware exist although their discussion in detail is beyond the scope of this text.

1. Eminent domain and risk of loss
2. Assignment, successors, and heirs
3. Binding arbitration and other legal means of settling disputes
4. Controlling law

¶ 17.02 HOTEL BROKERS

This section discusses the importance of of hiring a professional broker when selling a hotel.

[1] Creating a Story

Two of the most important factors in achieving the optimum price for a hotel are creating a competitive environment for that hotel and creating a "story." Every hotel has a story that describes its upside potential and opportunities for improvement. The better the hotel's upside potential, the greater the price the market will be willing to pay. Determining and understanding a hotel's highest and best use is the foundation of that hotel's story.

A hotel achieving only an 80 percent RevPAR penetration for its market may or may not be performing at its optimum potential; a hotel achieving a 130 percent RevPAR penetration, however, may or may not be achieving its RevPAR potential. No two hotels are the same physically or financially; none have identical market-demand generators or barriers to entry. Being able to reconcile all of the foregoing variables and accurately determine the weight that should be given to each is the difference between selling a hotel below market or selling a hotel above market. A professional hotel broker with an extensive transaction track record should provide great insight in sorting out the variables.

The story must be credible and intellectually defensible. If it consists of only "pie in the sky" projections, it will do more damage than good. A credible story, by contrast, places the foregoing variables in their proper perspective and can mean the difference of several million dollars in value. For example, consider a 300-room commercial hotel that recently sold at an enhanced price because of a competitive market. This hotel was in a city that had experienced the shutdown of a large military base, which had been the largest single provider of room nights to the city. The ini-

tial response of many to this loss of a major room-night generator was that it would hurt the hotel's future performance. However, it did not work out that way.

The military is lower-rated business than other commercial or leisure segments. This particular city ran a high annual city-wide occupancy. There were many days throughout the year in which tourist or commercial travelers who wanted to visit the city were unable to because of the lack of available rooms. With the absence of the military business, this city now can accommodate this latent or unaccommodated demand. As a result, occupancies remain the same as before the base closing, but average rates have grown significantly. Because the creators of the story of this hotel understood that the loss of the military base would ultimately be to the hotel's benefit, the price was enhanced.

[2] Negotiating From Strength

A strong negotiating position is critical if a seller is to achieve the optimum proceeds from a hotel sale. The seller can lose proceeds from a sale in two ways if he attempts to market the hotel himself. First, purchasers discount the valid strong points made by a seller. If the seller describes the demand generators for a hotel as growing significantly over the next several years, a buyer will not only disregard this potential, but will argue, convincing himself, that the hotel's price should be based solely on the hotel's historic performance.

The second risk the seller runs by marketing a hotel himself is that the buyer wil detect any weakness in the seller's position. When a seller pushes a buyer for a decision, the purchaser often perceives this as anxiety and may negotiate a lower price than the purchaser was willing to pay. On the contrary, if a professional hotel broker pushes a purchaser for a decision, the purchaser may perceive the time being of the essence in order to beat the market. This perception and concern on the part of the purchaser may yield a price higher than the purchaser wanted to pay.

[3] Capital

Another method a professional hotel broker uses to achieve the highest possible price is to be a steady source of capital. An intermediary should be in constant contact with the lowest-cost capital sources and the most creative financing techniques. Consider the following example, wherein the capital helps achieve a higher price.

A buyer perceives that a hotel will produce a $5,300,000 net operating income during its first year of ownership. This purchaser has a source of financing for 70 percent of the acquisition price at an interest rate of 9 percent and an amortization schedule of twenty years, and the purchaser is seeking a 12 percent first-year return on equity. The buyer determines that it can pay a purchase price of $47,500,000 for this hotel. A 70 percent loan is equal to $33,250,000 and the equity required is $14,215,000. Using the foregoing interest rate and amortization schedule, the annual debt service is $3,589,907. The resulting cash flow after debt service is $1,710,093. If the $1,710,093 is divided into the equity investment of $14,215,000, the resulting cash-on-cash return is 12 percent.

If the professional hotel broker is able to source a 70 percent first mortgage at an 8 percent interest rate for 70 percent of the purchase price, the purchaser can then pay $50,000,000 for the same hotel, producing the same income stream and still yielding a 12 percent return on capital.

Mezzanine financing is another case in which the capital can create value, giving the seller a higher price and the purchaser a higher return. This form of debt is

subordinate to first-mortgage financing. It may or may not be secured by a second mortgage on the real estate. The cost of mezzanine financing is significantly higher than first-mortgage financing because of its higher-risk position; however, the cost is lower than market equity returns and occupies a priority position ahead of the purchaser's equity.

Assume that a purchaser is acquiring a hotel that is a turnaround opportunity. Although the hotel is currently producing a $500,000 net operating income, the purchaser believes that if the hotel had $5,000,000 invested in renovation and the franchise were changed, the stabilized cash flow of the hotel would be $2,000,000. The purchaser wants a 20 percent cash-on-cash return on his equity. Assume that the first mortgage is 70 percent of loan-to-cost at a debt constant of 10 percent. On the basis of a $2,000,000 stabilized net operating income, the purchaser could pay a purchase price of $10,384,615. That price plus the $5,000,000 renovation makes the total investment $15,384,615. The first mortgage is 70 percent of the total investment—$10,769,231. With a 10 percent debt constant, the annual interest payments on the first mortgage are $1,076,923. The equity, 30 percent of the total investment, is $4,615,385. Subtracting the annual debt service of $1,076,923 from the $2,000,000 net operating income yields a total of $923,077, which is a 20 percent return on the purchaser's equity.

If, instead of the purchaser making a 30-percent equity investment, a mezzanine lender invests half of the equity capital, a higher price can be paid for the hotel. Again, assuming that the purchaser's goal is a 20 percent cash-on-cash return on the stabilized year in which this hotel produces a $2,000,000 net operating income, the use of mezzanine financing can allow the purchaser to be more aggressive against the market and pay $11,326,531 for the hotel—a 9.1 percent increase. In this structure, the first-mortgage lender again makes a 70 percent loan to the total development cost. The purchase price is $11,326,531 plus the $5,000,000 renovation, making the total investment $16,326,531. The 70-percent first mortgage is now $11,428,571, and the annual debt service is $1,142,857. The mezzanine lender in this scenario has a 10 percent interest-only rate and participates in 20 percent of the resulting cash flow. The total debt service of the first-mortgage mezzanine lender is $244,898, resulting in a cash flow after debt of $612,245. Twenty percent of this cash flow is paid to the mezzanine investor and 80 percent is paid to the purchaser. Because the mezzanine lender put up half of the equity, the purchaser has invested only $2,448,980. After the debt service has been paid and 20 percent of cash flow is paid to the mezzanine investor, the cash flow available to the purchaser is $489,796, which is a 20 percent cash-on-cash return to the purchaser.

Obviously, if the purchaser were able to acquire this hotel at the original price of $10,384,615 and use the mezzanine structure, the purchaser's cash-on-cash returns would increase dramatically. In this example, the returns would be $553,846, which is a cash-on-cash return of 24 percent.

[4] Marketing a Hotel

A professionally assembled marketing package requires 150 to 200 work-hours. Because the marketing package should be designed to convince a purchaser to part with millions of dollars to own a hotel, it must be more than an accumulation of facts. Some packages contain volumes of information but are uninteresting and unpersuasive. A marketing package should succinctly describe a hotel's potential for future cash flow and capital gain increases. An accurate and effective description of this potential can justify a higher price than a review of a hotel's historical performance.

Consider two properties—Property *A*, a hotel at a 12 percent capitalization rate

with a cash flow that will remain steady for the next five years, and Property *B*, a hotel at a 9 percent capitalization rate, the cash flow of which will grow at 15 percent per year. Assuming that both hotels originally produce $1,000,000 in cash flow, their purchase prices would be $8,333,333 or $11,111,111, respectively. Property *A*'s cash flow five years from now is still $1,000,000. Assuming that this hotel sells at a capitalization rate of 12 percent, the unleveraged internal rate of return is 12 percent. With Property *B*'s cash flow increasing at a compounding annual rate of 15 percent, at the end of five years, its cash flow is $1,749,006. Assuming it sells at the same 12 percent capitalization rate, its unleveraged internal rate of return is 18.6 percent.

Realistically, Property *B*'s historic rate of growth will allow it to sell at a lower capitalization rate than Property *A*, increasing the already-higher return. An effective marketing package should effectively explain the hotel's growth potential to justify a greater than a "back of the napkin" value calculation.

To market a hotel, significant work-hours are required to make successful sales presentations to purchasers. All information in a presentation should be provided to a prospective purchaser in the context of what that purchaser wants. In other words, each presentation must be custom-made for each prospective purchaser. This can be done only in a one-on-one, give-and-take presentation, and a substantial number of work-hours per presentation is required.

First, a prospective purchaser's existing business and its wants and desires must be understood. This requires an interview. An in-person, face-to-face interview is more effective than one conducted by telephone. To arrange a face-to-face meeting, one to two hours are required. If the prospect is in a different city, an entire day is required to accomplish the interview. Because other work can be done during travel, five hours is a fair estimate of the amount of time needed to accomplish the interview. One hour is required either by telephone or in person to present a hotel's full potential and two hours of follow-up per prospect are required, on average, to determine its interest. To generate ten interested prospective purchasers, at least 100 presentations must be made. This means that, at an average work-hour requirement of 10 hours per presentation, 1,000 work-hours are required to effectively market a hotel. This does not include negotiating the transaction, purchaser's due diligence, purchase and sale agreement negotiation, or the closing process. If performed by one person on a fifty-hour work week who exclusively markets that hotel, forty weeks would be required to perform the marketing function alone. This length in chronological sequence required would prevent a competitive market from being achieved. A prospect whose interest was generated during the first month would most likely not be be willing to wait for the marketer to complete the comprehensive process through the tenth month. Negotiations in a vacuum—with only one prospective purchaser at a time—are likely to result. This takes the competitive environment out of the process and, most likely, will result in a lower transaction price.

Only a professional hotel brokerage organization can provide the required work-hours in a rapid and efficient manner. First, a professional brokerage firm with a long history in the industry has already performed the interview step before even taking the assignment to market a hotel, cutting the required work-hours in half. Second, if the brokerage firm has a multi-person sales force, multiple presentations can be made simultaneously. This can reduce a nine- to ten-month marketing process to a matter of weeks. Additionally, showings can occur back-to-back when a firm has a multi-person sales force.

It is an often-stated truism that "time kills all deals." The professional hotel brokerage firm should greatly increase an owner's closing percentage.

[5] Preventing Disruptions

All sellers must take measures to prevent disruptions at their hotels. If, for example, the direct management and leadership of a hotel becomes disgruntled or discouraged, the hotel's performance could decline. A negative trend in business could affect the price or derail a closing process.

The hotel brokerage professional can assist in minimizing disruption to the hotel's operations, and the owner can take several steps as well. First, the general manager of the hotel should be informed of the owner's intention to sell and should be made a part of the process. Obviously, the general manager can be quite apprehensive. An owner should structure a bonus for the general manager if the hotel is sold. This bonus should be significant and should be paid regardless of whether the general manager remains at the hotel to work for the new owner.

One potential cause of disruption is the presence of propspective purchasers at the hotel prior to the sale. Understandably, the purchasers will want to spend time at the hotel before buying it to learn as much as possible about it. Unfortunately, their presence could serve to disrupt or otherwise affect the direct management of the hotel. The hotel broker can alleviate this potential problem by providing comprehensive information to a prospective purchaser prior to the purchaser's ever inspecting the hotel. If the broker has diligently provided this information, inspection time at the hotel can be minimized.

¶ 17.03 LIKE-KIND EXCHANGES

Today's competitive business environment has forced many changes within the hospitality industry as well as the constant restructuring of hotel properties. In many cases, financing new hotel properties has also become increasingly difficult. Thus, it is more important than ever that hospitality business owners be creative wherever possible in developing cost-saving strategies to achieve their goals.

One strategy often overlooked by hospitality owners is the use of like-kind exchanges to acquire property. The following discussion reviews some alternative methods of like-kind exchanges, which may provide new business opportunities for the hospitality owner as well as lucrative tax benefits.

[1] Advantages

An exchange of hotels, or an exchange of business property for a desired hotel property, represents one creative means of acquiring a new property. This method can offer unique planning opportunities for the hospitality or business owner who wishes to relocate to another market. It can also provide significant tax savings for a new owner, because appreciated property can be exchanged without incurring any tax on the appreciated gain. The deferral of the gain is what makes like-kind exchanges such a valuable tool for hotel owners.

Consider the following example: a hotel owner in New York wishes to retire to Florida but remain active in the business. The individual might be able to find a property suitable to his needs in Florida, one that has an ambitious young owner anxious to relocate to a potentially faster growing market in New York. The two get together, simply exchange properties, and completely avoid tax liability on the appreciated gains of the two hotels. Other valid reasons for engaging in a like-kind exchange might be to reposition one's property into a different market, obtain property that will allow for expansion, allow investors into the hotel business with the exchange of dif-

ferent property; or to allow a hotel owner to leave the hospitality business and obtain other business property without paying any capital gains tax.

Business owners may also have non-business reasons for exchanging property under IRS like-kind exchange rules. It is a commonly used strategy in estate planning to defer taxes on appreciated property. For example, an owner would be required to pay substantial capital gains tax in an out-and-out sale of property that had significantly appreciated in value over the years. If the owner exchanges the property for property at another desirable location, however, all capital gains taxes are deferred until the property is eventually sold. In some cases, in fact, the gain on the property may never be taxed if the owner dies before it is sold and the property is passed on to the heirs.

IRS stepped-up basis rules essentially allow heirs to inherit property at the fair market value of the property at the time of the owner's death. This applies even if the deceased owner had very little basis left in the property. Thus, if the heirs sell the property at fair market value shortly after the owner's death, there is no gain to report. In this case, the basis equals the value of the property. This is known as receiving property that has been "stepped-up" to its fair market value at the time of death. Of course, estate taxation is a difficult, complex area of the law. A business owner getting on in years would be wise to talk to his tax adviser on whether the use of like-kind exchange as an estate planning tool would be advantageous or not in his or her specific circumstance.

There are several important reasons why the hotel industry is ideal for using business options such as like-kind exchanges. For one, the hotel industry is considered a specialized component of real estate and it is treated very favorably under like-kind rules. Second, the hotel industry is subject to market saturation. Therefore, there are a great many excellent hospitality properties operating in the market, providing a multitude of possibilities for an owner wishing to exchange properties to enter a desired market or better fit his or her strategic goals.

[2] General Requirements

A like-kind exchange is a reciprocal transfer of property, as distinguished from a transfer of property for money only. But an exchange can occur even where cash (boot) is part of the consideration, if the transaction otherwise qualifies as a like-kind exchange. Like-kind property must be both given up and received in the exchange in order to satisfy the "exchange" requirements.

There are several requirements that must be met for a taxpayer to take advantage of a like-kind exchange. The exchanged property must be:

1. Held for the productive use in a trade or business, or for investment; and
2. Exchanged solely for property of a like kind, which is to be held for either productive use in a trade or business, or for investment.

If a taxpayer has a qualified like-kind exchange transaction in any given year, he or she is required to file the transaction on IRS Form 8824 along with his or her regular tax return.

[3] Real Estate Qualifications

Whenever making business decisions in accordance with the Internal Revenue Code it is imperative to look closely at the language to determine the exact meaning of the

statutes. For example, "like-kind" as used in this chapter means "alike in terms of nature or character of the property." It does not refer to its grade or quality. Thus, one class of property cannot be exchanged for another class.

This means that real estate can not be exchanged for personal property. However, when real property is exchanged for real property, it does not matter whether the property is similar, or even whether one of the properties is unimproved. Thus, the exchange of vacant land for a hotel would qualify under the like-kind exchange rules. The existence or lack of improvements merely affects its grade or quality, not its class.

The following examples of exchanges have been held to qualify as like-kind transactions:

- Rental housing for farm property.
- A commercial building for a condominium interest in a newly constructed commercial building.
- Real property subject to a lease for real property not subject to a lease. The existence of the lease affects the grade and quality of the property, rather than its nature and character.

Consequently, a hotel could be exchanged for a different type of business real estate and be within the like-kind exchange guidelines. For example, a hotel owner could exchange his property for a bowling establishment. The transaction would still qualify under the like-kind exchange rules, because both the properties are classified as real estate.

There are certain properties that do not qualify for tax-free exchange (e.g., inventory stocks, bonds, and partnership interests). The property for exchange must be similar in nature or character to the transferred property, notwithstanding differences in grade or quality as shown in the preceding examples.

However, there are cases in which real estate exchanges are not considered as like-kind exchanges. Listed below are some circumstances under which a real estate transaction will fail to qualify under the like-kind exchange rules:

1. *Foreign property.* This is never considered like-kind property under the like-kind exchange rules.
2. *Sale of an apartment building in which the taxpayer used the proceeds from the sale and other property to acquire a like-kind property.* The fact that the taxpayer first sold the property invalidated any exchange opportunities.

It is important to keep in mind, however, that the IRS rules regarding property exchange transactions are mandatory, not optional. In a transaction structured as an exchange, all gain must be deferred on the property. Although this is generally good strategy, there are times when this should not be done. These occasions are discussed subsequently in this chapter.

[4] Utilizing Deferred Exchanges

One of the biggest controversies involving like-kind exchanges occurs when exchanges are deferred, or do not take place at the same time. Because the Supreme Court stated in the now famous *Starker* case that exchanges do not have to occur at the same time to qualify as like-kind, Congress acted in 1984 to stipulate exchange time limits. It was not until 1991, however, that the IRS finally got around to issuing regulations that provided rules for complying with the deferred like-kind exchange requirements.

A deferred exchange is defined as an exchange in which, under the terms of the agreement, the taxpayer transfers qualified property (relinquished) and after the transfer, receives qualified property (replacement property).

Strict requirements have been established concerning when exchanged property must be identified and accepted in the exchange for the "like-kind" aspect to qualify the exchange as tax free. The property will not qualify as like-kind property if:

1. The replacement property is not identified as property to be received in the exchange within forty-five days after the date on which the transferor transfers the old property (the identification period requirement); or
2. The replacement property is not received by the earlier of 180 days after the date on which the transferor relinquishes the old property, or by the due date (including extensions) for the transferor's tax return for the taxable year in which the old property is transferred (the exchange period requirement).

An example how of the deferred exchange rule might work is as follows: On May 17, pursuant to a deferred exchange agreement, hotel owner Astor transfers his 100 room hotel property with a fair market value of $200,000 to Baker for a hotel property to be identified later. On or before July 1, (the end of the 45-day identification period), Astor is required to identify the like-kind replacement property to be received from Baker. Astor must then receive from Baker on or before November 13 (180-day receipt requirement) the property identified as the like-kind replacement property.

Neither party can extend the foregoing limitation periods for any reason. Therefore, if a hotel owner fails to identify replacement property or take possession of the replacement within the required time limit, the transaction will not be treated as a like-kind exchange. The gain on the transaction would thus be taxable.

For a hotel owner to properly identify any replacement property, he or she must send a description of the property in writing to the qualified parties before the end of the forty-fifth day. If the replacement property is transferred to the hotel owner before the forty-fifth day, the identification requirement is satisfied.

The hotel owner can identify more than one property when using the deferred exchange method. A hotel owner can, subject to the "three-property" and "200%" rules (explanation to follow), identify more than one replacement property regardless of the number of properties he has relinquished in the same exchange. Under the three-property rule, a hotel owner can select up to three properties without regard to their aggregate fair market value. Alternatively, a hotel owner, under the 200% rule, can select any number of properties as long as their aggregate fair market value does not exceed 200% of the aggregate fair market value of all the relinquished properties.

Using the preceding example, Astor on May 17 transfers his 100-room hotel valued at $200,000 to Baker. On or before July 1, Astor is required to formally recognize the like-kind replacement property. Astor identifies three potential hotel replacement properties (Properties 1, 2, and 3) in a written document that he signs and personally delivers to Baker on June 28. The written designation also provides that Astor will orally inform Baker by Aug. 1 which of the three identified hotel properties he wants to receive. Since Astor did not choose more than three properties, all three have been properly identified before the end of the identification period. It does not matter whether the aggregate fair market value (i.e. $500,000) exceeds 200% of the fair market value of the relinquished property ($400,000).

[5] Related Party Transfers

There are specific rules covering transfers among family members. There is a special two-year holding period requirement for exchanges between related parties. This rule requires the hotel owner to report to the IRS on the property in the sale year of the like-kind transaction and again at the end of the two-year holding period. The related party rule does not bar like-kind exchanges between related partners; it merely imposes a two-year holding period.

Related parties for purposes of this rule include most family members and corporations in which the party holds more than 50 percent ownership. Special rules also govern transactions between partnerships and their partners.

There are three exceptions to the two-year waiting rule, permitting a holder to claim a nonrecognition provision for the like-kind exchange:

1. Any disposition of the property after the death of either the taxpayer or the related person.
2. Any disposition that is caused outside the control of the taxpayer, such as an involuntary conversion.
3. Any disposition to the satisfaction of the IRS that the main purpose was not to avoid income tax on the transaction.

Any taxpayer who feels that he or she may qualify for an exception to the general rule must attach an explanation to his or her tax return explaining the qualifying exception.

[6] Determining Basis

Generally, the basis of property acquired in a like-kind exchange is the same as the basis of the property transferred. There is an exception, however, if money (called "boot" by accountants) or certain debt is involved.

Many times in a like-kind exchange, the properties will not be equal. The taxpayer may receive or give money, or other property, to equalize the transaction. As previously stated, the basis of property received in a like-kind exchange is the same as that of the property given up.

If money or other property not of a like-kind (boot) is received in the exchange, gain is recognized, but only to the extent of the money or boot received. If a party to the exchange assumes debt on the property, or acquires property from the taxpayer subject to a liability, then the debt assumption will be treated as boot.

It is important to remember that even if the taxpayer receives boot and shows a loss, the loss is not recognized under like-kind exchanges. Therefore, the taxpayer needs to be careful to analyze the transaction in terms of the possibility of realizing a loss. If a loss is probable, the trade must be structured so that the transaction does not qualify as a like-kind exchange. The same rules apply to recipients who receive money or property not qualifying as like-kind exchange property in a deferred exchange.

When a person gives boot instead of receiving boot, the non-recognition rules still apply to the person giving the boot. However, a taxpayer could recognize gain if certain nonqualified property is given as boot in the exchange.

A common practice is to give and receive property subject to a mortgage. The assumption of a liability or a transfer subject to a liability is treated as boot. The taxpayer who assumes a liability or accepts property subject to a liability receives boot.

If each party to an exchange assumes the liability of the other party, the liabili-

ties assumed by one party are offset against those assumed by the other. Only the excess is treated as part of the boot given or received. The following example will help explain how debt exchanges work.

Example: Hotel owner *A* in New England owns a property that has an adjusted basis of $80,000. It is subject to a $70,000 mortgage. He makes an exchange with hotel owner *B* for realty on another hotel in Florida worth $120,000, which is subject to a $50,000 mortgage. In addition, owner *A* receives $10,000 in cash. The gain *A* recognizes on the exchange is $30,000, computed as follows:

TABLE 17-1

Hotel owner *A* received:		
Property worth	$120,000	
Cash	10,000	
Mortgage on hotel given in exchange (treated as cash received):	70,000	
Total consideration:		$200,000
Hotel owner *A* gave in exchange:		
Hotel at its adjusted basis	$80,000	
Mortgage on Property received (treated as cash paid):	50,000	
Total given:		$130,000
Maximum recognizable gain to *A*:		$ 70,000

In this scenario, however, the amount of gain recognized is limited to the net cash received by hotel owner *A*. If the mortgage on the property given is counted as cash received and the mortgage on the property received as cash paid, or $30,000, it computes as follows:

TABLE 17-2

Mortgage on property given up by hotel owner *A* [$70,000] –
Mortgage on property received by hotel owner *B* {50,000) =
Net reduction of hotel [$20,000]

Owner *A*'s indebtedness [$20,000] +
Cash paid to hotel owner *A* [10,000] =
Gain recognized by hotel owner *A* [$30,000]

The final calculation a hotel owner needs to make in analyzing a like-kind exchange is to determine the tax basis for the properties. The tax basis is the value that the IRS recognizes when and if a property is sold. Generally speaking, the basis of the new property is the same as the property exchanged. However, if boot was given or received in the exchange, the basis on the new property could be affected.

If any gain is recognized because of receipt of money or other boot, the basis of all the property received is adjusted to include the old property, increased by the gain recognized and decreased by the money received.

If a loss is realized, but not recognized in an exchange in which a taxpayer receives money or other boot, the basis of all the property received is the adjusted basis of the old property, decreased by the money received.

The following is a simple formula for determining basis of property acquired in a like-kind exchange:

TABLE 17-3

Adjusted basis of old property	$ ......
Add:	
Cash or value of non–like-kind property given	$ ......
Gain recognized	$ ......
Subtract from this total:	
Cash or non–like-kind property received	$ ......
Loss recognized on non–like-kind property given (excess of adjusted basis over trade-in allowance)	$ ......
The resulting total is the basis of the new property.	

Finally, a hotel owner must carefully examine his basis to determine whether property transferred will actually result in the deferral of a gain, and not a loss. This is an important concept to remember, because there are situations when it might be more beneficial for a business owner to structure such a transaction so that it is taxable. In this case the hotel owner will want to intentionally avoid meeting the like-kind exchange requirements, because the rules are not optional.

For example, a hotel owner may want to recognize gain, because he or she has just recently experienced a loss, which could be offset by a gain on the trade. This results in the hotel owner's getting a higher basis for the property received, which in turn, results in larger depreciation deductions.

The like-kind exchange rules are a valuable planning tool often overlooked by hospitality owners. Like-kind exchanges allow property relocation without recognizing any taxable gain on appreciated real estate. Like-kind exchanges can also be used as a strategy for family members wishing to exchange properties to better position family holdings. Finally, the like-kind exchange can be a valuable estate planning tool. Since step-up rules regarding estates value inherited property at fair market value at the time of an owner's death, taxes on his or her deferred gain may never be realized. Although like-kind tax rules appear complicated, the opposite can be true. The rules actually allow considerable flexibility in choosing properties to exchange. In addition, since any recognizable gains are usually very minor, compared with deferred gain on appreciated property, the tax benefits could be substantial.

CASE STUDY: ¶ 17.04 How Investor Raised Cash To Acquire A Profitable Hotel

Mr. Comer Mann, an experienced hotel investor, wanted to acquire a going hotel that produces an annual operating profit of $1.68 million. The hotel has been doing well for several years, and its profits show an upward trend, as can be seen from the following table:

Year	Gross Income From Operations	Net Profit From Operations
1992	$ 8,200,000	$1,300,000
1993	9,000,000	1,425,000
1994	10,100,000	1,680,000

The owner, recognizing the earnings trend, insisted on a total price of $22 million for the hotel. This price covered the land, building, and the supplies, furnishings, and equipment. In addition, he wanted it all in cash.

The hotel was owned free and clear of any mortgages or other liens or encumbrances. It is 40 years old; it has 635 guest rooms and meeting rooms, and has a small ballroom that can accommodate 200 people. The hotel also has a food and beverage operation that accounts for almost 30 percent of its gross revenues.

Mr. Mann believed that if he acquired the property he could increase its operating profits within three years to as much as $2.3 million annually, because the hotel business is booming and the present owner has become less attentive to controlling operating expenses. However, he could not acquire the property unless he found some way that made its acquisition feasible for him. Whatever financing plan he came up with would, or course, have to take into account his front-end fees, expenses, and some immediate profit. He expected these "add-ons" would amount to some $500,000 as follows:

Legal fees	$ 75,000
Accounting fees	25,000
Commissions and finder's fees	150,000
Promoter's profit	250,000

The total required was $22.5 million.

[1] METHODS CONSIDERED BY INVESTOR

Mr. Mann's task was to figure how approximately $1,680,000 of annual cash flow could service $22.5 million of financing. He began to think of the prices he would have to pay to attract various sources of investment funds.

[a] Why $22.5 Million Could Not Be Raised From Tax-Shelter Investors

The lowest price would be demanded by individual investors seeking a tax shelter in the form of large passive losses. If the reportable annual tax losses from the investment could be sufficiently high, these investors would be willing to invest with either no cash return or a cash return ranging up to 7 percent a year. But, there were two problems.

First, even though this was an older hotel with a lot of personal property which had short depreciable lives, not enough annual depreciation deductions could be generated during each of the first five years to satisfy an investor.

Second, a 100 percent equity investment can never be an attractive tax-shelter investment. The reportable annual losses can never be stretched to amount to a significant percentage of the capital contribution. For those investors who want to obtain reportable losses in the first five to eight years in an amount that is greater than their capital investment, their capital investment cannot represent a large proportion of the total cost of acquiring the depreciable assets.

[b] Why a Tax-Exempt Bond Issue Was Not Available to Investor

Mr. Mann knew that the next cheapest money would be municipal bond money, i.e., the proceeds from the sale of tax-exempt bonds issued by states, cities, and certain governmental authorities. Such investors require a return of 7 to 7.5 percent a year if the bond is issued by a creditworthy issuer and the annual interest payments are tax-exempt. Such financing may be available for the construction of new housing or industrial properties or for the rehabilitation of existing housing, but it is not available for the simple acquisition of an existing commercial hotel whose function will not be changed.

[c] Other Sources of Funds

Among the other possibilities that occurred to Mr. Mann were:

1. Selling off the land to an investor who wanted a very safe investment and did not need any reportable losses. If the land was not worth more than about 25 percent of the total value of the land and building, the safety of the investment would be so great as to warrant paying a price as low as 7.5 percent per year for the money.
2. Finding equity investors who wanted an annual cash return but did not seek large amounts of tax shelter. Mr. Mann knew that if there was no significant amount of tax shelter to offer, equity investors could be found but would require at least a 9 percent cash return. They would have to be convinced that, in the long run, they could do better investing in this property than in making long-term savings bank deposits, which would pay them 6 percent or so, and would be much less illiquid than a real estate investment. Mr. Mann believed that investors could be found who would put up part of the money he needed, but he did not believe he could raise the full $22.5 million solely from this source.
3. Conventional first mortgage lenders. This source used to be the obvious first choice for financing an acquisition. However, Mr. Mann realized that if he sought even a 70 percent mortgage, that is, a first mortgage of $15.75 million, he would probably have to pay a constant of about 11 percent, or $1,732,500, which would leave him no cash flow available to service the remaining $6.75 million which had to be raised.
4. Financing with first and second mortgages was obviously impossible in this transaction, because second mortgage money, even if it was available, would cost Mr. Mann between 3 percent and 8 percent per year more than first mortgage money. The property simply did not earn enough to carry such a debt structure.

Mr. Mann knew that he would have to break up the investment into a number of different positions that would offer different attractions for investors pursuing a range of different objectives. This is what he did.

[2] Investor Created a Ground Lease and a Leasehold Mortgage

Mr. Mann was able to arrange for the sale of the land, without the building or improvements, to a pension trust for the sum of $5 million; simultaneously, he leased the land back from the trust under a long-term net ground lease calling for a basic annual rent of $375,000. The ground lease was to run for an initial term of 25 years and figured to provide an annual return of 7.5 percent to the trust. The lease gave the lessee several options to renew for additional terms totaling 80 years. It also called for reappraisals of the land at the end of the first 15 years and thereafter at intervals of 10 years. The rent, on each reappraisal, will be fixed for the next 10 years at the higher of (1) the ground rent during the lease period then ending or (2) 7.5 percent of the fair market value of the land alone if the land was devoted solely to hotel uses.

Mr. Mann, having created the long-term ground lease, then obtained a leasehold and building mortgage loan of $9 million which was to run for a term of 15 years and bear interest at 9.5 percent. The annual debt service came to $945,000, or a 10.5 percent constant. When it matured at the end of 15 years, there would be a balloon of about $6 million.

The leasehold mortgage lender was a large savings bank. The mortgage covered both the lessee' interest in the ground lease and the fee title to the building. The mortgage was subordinate to the fee interest. Because of this, it was not necessary to obtain the consent of the pension trust, as owner of the land, to the terms of the leasehold mortgage. The lender agreed to this because it had appraised the entire property at $23 million, and regarded the land rent as representing only about 22 percent of the value or earnings. If the mortgagor defaulted under the mortgage, the lender could not foreclose the pension trust's fee interest, but could only become the lessee under the ground lease and the owner of the improvements.

[3] How Investor Then Syndicated the Enterprise and Created a Subleasehold Operating Position

Mr. Mann then decided he could raise the remaining $8.5 million by organizing a limited partnership to own the leasehold estate and the building, and selling (syndicating) $8.5 million of limited partnership shares to passive investors. Because the leasehold mortgage was a nonrecourse mortgage,

Mr. Mann was able to offer his investors tax deductions and no risk of personal liability.

At the same time, he chose to create an operating position in a Hotel Operating Company (HOCO), a separate partnership composed of himself and five of his business associates. HOCO sublet the entire property from the partnership under a long-term net sublease which ran from the partnership, as sublessor, to HOCO, as sublessee. This net lease was also for an initial term of 25 years and gave HOCO options to renew for additional terms aggregating 80 years. The basic annual rent HOCO would pay under the sublease came to $1,745,000. This sum was arrived at as follows:

1. $375,000 (annual ground rent to the fee owner) plus
2. $945,000 (annual debt service under leasehold mortgage), plus
3. $425,000 (representing a 5 percent annual cash return before taxes to the syndicate investors), plus a participation in future profits.

This basic rent was somewhat higher than the earnings produced by the hotel at that time. However, the pattern of increasing earnings made it reasonable for Mr. Mann to undertake the risk. What's more, the sublease gave the sublessee the option to walk away from the deal at any time after the first three years without the landlord's consent, and upon an assignment HOCO would have no further liability.

The sublease also contained a profit-sharing formula. HOCO, the sublessee, could retain the first $155,000 of profits after paying $1,745,000 of basic rent annually. If profits exceeded $155,000, HOCO could keep one-half of the excess and pay the other half as coverage rent to the sublessor.

Mr. Mann could have used a general partnership as the legal vehicle for the syndication group. By creating an independent operating sublessee, he removed the risk of any of the investors being liable for the operation expenses of the property. However, he chose to use a limited partnership as the legal form because many investors have become accustomed to it. (They have some hesitancy about entering a general partnership even if they know they have been legally and totally separated from the conduct of the activities that could result in liability.)

Mr. Mann had considered taking a limited partnership interest along with the investors, instead of creating the net sublease. The cash investors would have been entitled to the first available distributions up to $425,000 in each year. Then Mr. Mann's limited partnership interest would have received the next $155,000 of each year's distributable operating profits. If the annual operations produced more than $580,000 of distributable cash (after payment of ground rent and leasehold mortgage debt service), the excess would be divided half to Mr. Mann and half to the other investors. He decided against this course because he preferred to have the sublease, which was a separate, salable asset.

In addition to their 5 percent cash return, Mr. Mann could offer his syndicate investors the benefit of annual depreciation deductions of approximately $959,000 in the first five years of their investment as follows:

Asset	Basis	Recovery Period	Annual Depreciation
Building	$14,000,000	39 years	$359,000
Equipment, furnishings, & supplies	$ 3,000,000	5 years (average)	$600,000

After the fifth year of their investment, the syndicate investors would no longer receive depreciation deductions for the furnishings and equipment because their replacements would be paid for by the sublessee. At that point, however, they had the expectation of an increased cash flow, most or all of which would be tax-sheltered.