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Real Estate Deals Pile Up As 'Fiscal Cliff' Looms Near

By **Kaitlin Ugolik**

Law360, New York (December 06, 2012, 8:38 PM ET) -- Property developers and owners around the country are rushing to complete sales by the end of the year in anticipation of the "fiscal cliff," making December a busy month for real estate attorneys, who say the unique circumstances also introduce the possibility of lawsuits in the new year if deals fall through.

While December is often a busy month for deals in many asset classes, this year is shaping up to be particularly packed for real estate attorneys as clients who may have been holding on to properties for the right time to sell seek to beat the potential spike in capital gains and other taxes.

Some have been planning deals with a closing date of Dec. 31 since it became clear earlier this year that congressional negotiations could stall and the economy could fall over the "cliff," but many real estate lawyers say the number of new deals with year-end expiration dates has shot up in recent weeks.

"It's amazing the pressure that people are under" Ron Kremnitzer, co-chair of Pryor Cashman LLP's real estate group, told Law360.

If a compromise can't be made in Congress, the Bush tax cuts will expire and other taxes may be raised and deductions reduced or eliminated, directly affecting the economic viability of many deals and casting a wider pall over the economy that could cause longer-term issues for the real estate market, attorneys say.

For the real estate industry, experts say the most pressing concerns are a potential hike of 5 percent or more in the capital gains tax and the possibility that carried interest, which allows certain types of investors to convert personal service income into investment gain, could be taxed at the ordinary income tax rate.

These changes will raise the bar for what a new deal would have to yield in order to justify the risk, said Mark Fawer of Brown Rudnick LLP. Real estate fund managers and development sponsors will have to consider the effect of a higher tax rate and the loss of carried interest on their ultimate gain in a sale, which could have a chilling effect, he said.

"People generally think of [capital gains] only applying to hedge funds, yet it is something that would probably include those who syndicate real estate deals and those that have real estate opportunity funds," Fawer said.

With the stakes so high, some real estate attorneys say they expect to see at least a few specific-performance lawsuits in the new year as deals go awry and some don't make it to closing by New Year's Eve. These aren't deals that can be postponed, and the seller faces a potential 5 to 10 percent increase in cost if proceeds aren't received by year's end, said

Eric Landau of Paul Hastings LLP.

"We may see a couple of court cases deciding issues resulting from a buyer's failure to close on a time-of-the-essence specific-performance transition on Dec. 31," he said.

And though it's not set in stone that Congress will miss its deadline to avoid the fiscal cliff, in order to get out ahead of the changes that could take place if the worst happens, some property owners are taking unique strategies to be sure they're protected.

One attorney noted that at least one of his clients had opted to write so-called seller take-back financing options into its deal. This obligates the buyer to accept financing from the seller if the buyer isn't ready to close in time so that the seller can lock in the profit for the deal immediately, having the buyer pay back the financing down the road.

And Kremnitzer predicts that sellers may be forced to do more 1031 exchanges, which allow property owners to defer the income tax gain on a sale, if they purchase a new property with the proceeds, until that second property is sold.

For some clients, it makes the most sense to simply pay the tax on the sale now, since deferring will almost certainly mean a higher tax rate in the end. But after the fiscal cliff, should Congress fall off it, the economics of selling at all will not be as beneficial to property owners and the market could see more 1031s and refinancings in lieu of sales, Kremnitzer said.

A failure by Congress to reach a deal to avoid major tax hikes would also have a broader macroeconomic impact that would trickle down into the real estate market, experts say.

If, as some predict, the tax increases and spending cuts associated with the fiscal cliff take about 4 percent out of the country's gross domestic product, attorneys say the growth we have seen in recent months that has allowed renters to rent, homebuyers to buy and developers to develop could be reversed.

In one example, a weaker economy could mean high unemployment, which translates to companies not looking to lease office space, a real concern for a sector of the market that has struggled to regain some stability over the last year.

Attorneys say that as long as interest rates stay low, real estate deals are likely to continue piling up in the new year, if a bit more slowly. But while the market is poised for a major recovery, with a lot of cash waiting in the wings for good investments, the fiscal cliff would be a major setback, according to Grosser.

"There is a lot of pent-up demand and not a lot of supply," he said. "If something happens to make the train go off the rails, all of that money is going to do exactly what it's done for the last four years: a lot of nothing."

--Editing by Elizabeth Bowen and Jeremy Barker.