

## **Chapter 15**

### **OWNING, ACQUIRING AND SELLING YOUR BUILDING**

#### **Options/Rights of First Refusal**

Often the seller of a practice or the seller's family member owns the premises in which the practice is located. The seller or family member may desire to sell the practice real estate as a condition of selling the practice. In this case, the seller should anticipate a waiting period until the purchaser is in a financial position to acquire it.

The purchasing dentist may desire to negotiate an option and/or a right of first refusal to acquire the real estate. Under an option to purchase, the purchaser has complete freedom to exercise or not exercise the option during the designated option period(s). Under a right of first refusal, the purchaser's right must be first triggered by an offer from a third party for the purchase of the real estate. With either the option or right of first refusal the purchaser is provided with the ability to acquire the practice real estate at a future date. Both the option and right of first refusal may be granted simultaneously.

#### **Appraisals**

##### **Appraiser Selection**

The purchase price for the practice real estate may be agreed upon or may be determined by way of appraisal. In appraisal situations, the seller and purchaser may select an appraiser and the two appraisals would be averaged and the purchase price determined. Another method of choosing an appraiser would be for the appraisers selected by the seller and purchaser to select a third appraiser, whose appraisal would be binding upon the parties. This method of selection utilizes one appraisal rather than two or three. The point to remember is that the appraisal method should be agreed to in writing at the time the option and/or right of first refusal is granted.

##### **Appraisal Method**

The seller and purchaser should agree, in advance, on the method of calculating the appraisal. For example, if market comparables are utilized, the purchase price should be lower in comparison with an appraisal based upon a cash flow approach. Under the cash flow approach, value is based upon the building and land cost, structural and maintenance costs and a return on investment, e.g., 10%, 12% or 15%. This value does not consider other comparable sales in a given geographical market, which is a common problem with comparable sales. To alleviate this situation, consider regional comparables if none or few sales have recently occurred in a particular geographic location.

## **Environmental Considerations**

### **Superfund Act**

The Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA"), commonly known as the Superfund Act, imposes strict, joint and several liability on various categories of responsible parties for the clean up of hazardous substance contamination. One category of a potentially responsible party includes a present owner of contaminated real property, as well as any individual or entity that was the owner at the time the hazardous substances were released (e.g., leaked or spilled) on the property.

#### Example

You acquire your practice and the practice real estate is in a high-traffic area, which is ideal. You practice successfully for five years. In the sixth year, you decide to repave the driveway and parking lot, which includes the removal of the existing layers of asphalt and installation of a sound base of concrete. During excavation, decomposed storage tanks containing gasoline and a variety of hazardous substances are found buried on the site dating back ten years to when the site was used as a service station. The Environmental Protection Agency finds out about the past practices and determines that there exists contamination and that you and previous owners are jointly and severally liable under CERCLA. The previous owners of the property are found to be insolvent and uncollectible and you are faced with having to pay substantial clean-up costs and fines attributable to the contaminated soil, even though you had nothing to do with the creation of the problem.

### **Environmental Assessments**

One way to minimize potential risks associated with such an environmental problem is to engage an engineering firm to conduct an environmental assessment or study and make the real estate acquisition contingent upon a satisfactory report. Environmental assessments are generally conducted in "phases." The initial phase should include an analysis of the previous owners and uses of the site and of the surface soil conditions and also a search of the records to determine the existence or removal of underground storage tanks, regulated electric transformers or other equipment which may contain PCB contaminated oil that may have leaked. If the environmental engineering firm finds sufficient cause after conducting an initial phase examination to conduct additional phases of investigation (such as soil samplings and lab work), the engineering firm would so advise.

While an environmental assessment is particularly desired by the purchaser of the real estate, the seller may be willing to share some portion of the cost by means of a closing cost reduction in the purchase price. The key regarding environmental problems, from a purchaser's standpoint, is their identification prior to the closing of the practice acquisition, even though the practice real estate may not be purchased until a future date.

## **Negotiating the Purchase of Real Estate**

The following considerations should be the subject of discussions for the purchase of the practice real estate.

### **Description of Premises**

The real estate contract should accurately describe the real property and any personal property to be included in such conveyance. If the purchaser has any doubt about the location of boundaries, the purchaser should request that a survey be performed at the expense of the seller prior to the closing in order to avoid later disputes when the property is ultimately sold. Banks usually demand that a location survey be performed as a condition to financing.

### **Purchase Price**

One method of determining whether the asking price is reasonable is to analyze the cost to rent a comparable practice facility within the same geographic area. The analysis should make the assumption that fair rental value would be charged to the practice. If this provides a dentist enough rent to pay the mortgage on the structure, plus a fair rate of return, e.g., 10%, on the investment, then the practice owner would not be overpaying for the real property. This calculation makes the assumption that the practice pays all costs associated with the property except mortgage payments and excludes inflation as a consideration. A second method of determining whether the asking price is fair is to ascertain the cost of building a facility yourself, as opposed to purchasing an existing facility. The repairs over time should be considered, as well as other issues such as whether the building is a multi-tenant structure and the eventual return on investment, given the estimated selling price of each unit (if a multi-tenant structure).

### **Depreciation Deductions**

An important technique for maximizing depreciation deductions for real estate purchases consists of allocating as much of the costs of acquiring the real estate as possible to the depreciable buildings and improvements on the property and as little as possible to nondepreciable land. The Regulations under the Internal Revenue Code require that where nondepreciable and depreciable properties, such as land and buildings or improvements, are acquired together for a lump sum, the acquisition costs must be allocated on the basis of the respective values of the land and buildings or other improvements to the land. While the Regulations do not prescribe the manner in which the respective values are to be determined, the IRS has generally recognized professional appraisals conducted by independent third parties as reliable.

### **Down payment and Escrow**

Under most real estate purchases, the purchaser will generally be required to deposit a sum of money or other property as a good faith gesture and as security for performance of the contract. This sum is negotiable and generally, the deposit is held in escrow for the period between the signing of the contract and the closing of title. If the purchaser fails to satisfy the terms of the contract, purchase agreements generally provide that the purchaser forfeits the

earnest money to the seller. Alternatively, when the transaction closes, the earnest money is applied against the purchase price.

Often a seller and purchaser appoint an escrow agent to accept and hold funds and closing documents prior to transfer of title. The escrow agent is instructed to close the transfer after all items have been deposited. It is advisable that an escrow agent be an independent entity such as an attorney, a title company or a bank. The escrow agent should be given explicit and detailed instructions agreed to by the parties concerning the custody and disposition of the funds, documents or other things of value entrusted to such agent's care. An escrow agreement is advisable, either as separate document or as part of the purchase contract for the real estate.

Escrow agreements typically provide for the proration of real estate taxes, payment and release of mortgages, transfer of deeds and disposition of other closing costs between the seller and buyer for the protection of both. Since a poorly drafted escrow agreement may lead to disputes between the seller and buyer, which may ultimately result in litigation, it is advisable for both parties to carefully review and understand the escrow instructions.

### **Title and Title Insurance**

The purchaser in a real estate contract desires assurance that the seller will be obligated to convey good and marketable title when the closing date arrives. A purchaser can request that the insurance cover the location survey performed with respect to the property, as well as insure against liens such as mechanic's liens. Within this framework, the parties can negotiate that the purchaser will either accept, without abatement of the purchase price, title as the seller can convey, or terminate the agreement and receive a refund of the earnest money deposit if the seller cannot convey good title at closing.

The purchaser may wish to require that: (i) the seller obtain a title commitment from a reputable title insurance company; (ii) the seller rectify any defects of title where the condition of the title is unsatisfactory to the purchaser; (iii) and, if title defects are not rectified, the purchaser would have the option to terminate the contract. While a title insurance policy does not cure a defective title, it does protect the purchaser against loss as a result of defects and encumbrances which are not specifically excepted from the insurance coverage. In this regard, it is important for the purchaser to understand the legal implications of the exceptions contained in a title insurance policy. The basic title insurance policy forms now used by the vast majority of companies throughout the United States are the American Land Title Association (ALTA) standard forms. In addition to title insurance policies, other types of title indemnification are available in various states. It should be noted that title insurance policies generally do not indemnify or hold harmless a purchaser for environmental problems, encroachments, unless location coverage is obtained, or structural defects discovered after the closing.

### **Building and Zoning Regulations**

A purchaser acquiring real estate should be aware of the zoning ordinances and requirements that apply to the specific property and of potential time delays and difficulty in changing those ordinances and requirements. If the property is not zoned for the purchaser's intended use, the purchaser should condition his or her purchase upon successful rezoning.

A purchaser should also be concerned with violations of regulations adopted by local governmental entities concerning the construction, design, quality, use, occupancy and maintenance of the building. Some municipalities have specialized codes for plumbing, electrical systems and other structural requirements. Consider obtaining a building inspection prior to and as a condition of closing for the property.

### **Licenses, Permits and Certificates of Occupancy**

Certificates of occupancy are issued by local government authorities to indicate that the building complies with building code requirements. Additionally, depending upon the jurisdiction, the doctor may be required to obtain a license or permit, or where such license or permit has already been issued, that it be transferred to the purchaser. The real estate contract should contain provisions concerning the seller's duty to keep necessary licenses or permits in full force and effect and cooperate with the purchaser in obtaining any necessary transfers, particularly where the sale of the real estate includes the purchase of an existing practice.

### **Condition of Premises/Violations**

Absent any express representations or warranties, some jurisdictions hold that a purchaser of real property is deemed to purchase the property "as is." Most jurisdictions also maintain the legal principle of caveat emptor, which means "let the buyer beware." This principle means that a purchaser of real property must examine, judge and test the nature and quality of the real property. Except for fraud, most jurisdictions strictly adhere to this principle in ruling against disgruntled buyers who later find problems with purchased property. For this reason, the purchaser should inspect the property and make suitable tests with the advise of experts to obtain a clear picture of the physical conditions which exist on the particular property. Further, the purchaser should negotiate certain representations and warranties on the part of the seller as to the condition of the property, that such conditions be true and accurate as of the date of closing, and be a condition precedent to closing.

Where there are existing leases and tenancies, the purchaser should require that the seller disclose the nature of such leases and invoices and specifically describe all problems in this regard.

### **Fixtures and Personal Property**

If fixtures or personal property are to be transferred to the purchaser with the real property, such property should be specifically defined in the purchase agreement. A schedule itemizing personal property, fixtures and equipment should be attached to the purchase contract and incorporated by reference. Additionally, where the sale includes real property and an established practice located thereon, the sale may include such items as goodwill, a registered fictitious name, licenses or permits and trade fixtures and furnishings.

### **Possession of Premises**

The contract should clearly define the date upon which possession of the property will be delivered to the purchaser. Usually, the purchaser has no right to possession before title closes

and the deed is delivered, unless the contract provides otherwise. Where the contract requires the seller to deliver possession of the property to the purchaser on or before a specified date, the buyer should negotiate a provision for liquidated damages if possession is not delivered. In this regard, the contract should specifically refer that "time is of the essence."

### **Representations and Warranties**

Contracts for the purchase of real estate usually contain provisions concerning warranties and representations by the seller as to material elements of the transaction. A purchaser may also be called upon to make representations or warranties to the seller. 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.

### **Brokerage Commissions**

If a broker is involved in the transaction, the contract should identify the broker and indicate the extent to which the seller and purchaser will be responsible for any brokerage commissions. Where no broker participates in the transaction, the contract should include a representation by each of the parties to the other that no broker was involved and that if any claim for broker's commissions or fees is ever made as a result of any contract made by such party with respect to the property, such party will indemnify the other party against any loss or expense suffered as a result of the claim. Brokerage fees are typically paid from escrow upon closing of the transaction.

### **Recording the Contract**

In the case of land installment contracts, where the seller retains legal title to real property until the purchaser pays the full purchase price, a purchaser should record the purchase contract in order to claim priority over the rights of third parties intervening between the date the agreement is entered into and the date upon which the deed is recorded. Many states require land installment contracts to be recorded in a manner similar to mortgages in order to provide a purchaser priority over rights of third parties.

### **Real Estate Closing**

The closing of a contract for the purchase of real estate sometimes takes the form of a final meeting of the parties where the instruments necessary for conveying title to the premises and the personal property are executed and delivered by the seller to the purchaser, as well as the consideration for the transaction passing from the buyer to the seller. It is at this meeting that the final documents are signed and delivered, expenses are apportioned, income from the property is prorated and all closing adjustments are made.

In some parts of the country, however, the closing of a real estate transaction does not take place at a meeting held between the purchaser and the seller. Instead, the purchaser deposits with an escrow agent the agreed purchase price and such other documents as may be required, while the seller deposits with the escrow agent the executed deed to the property and related

documents. Additionally, if financing by a lender is to be provided, the mortgage deed or deed of trust and its related instruments are also deposited with the escrow agent. When the agent has received all of the necessary documents and cash, it will consummate the transaction and title will pass to the purchaser.

Normally, contract provisions include the date and place of closing, the documents to be transferred, and whether or not time shall be construed as of the essence of the contract. The contract should further provide for execution and delivery of a deed in recordable form and the nature of the quitclaim deed or general warranty deed.

### **Tax-Free Exchanges of Real Estate**

An owner of real estate generally pays a capital gain tax calculated on the difference between the sales price and the adjusted tax basis of the property. Among various tax postponement devices available to avoid such capital gain is IRC Section 1031, which permits the tax-free exchange of like-kind investment and trade or business property. The key advantage of a tax-free exchange pursuant to Section 1031 is that gain realized by one or both of the exchanges need not be recognized, tax need not be paid on the gain, at the time of sale. Instead, the tax is postponed until a future taxable disposition occurs of the newly received property. Thus, a series of exchanges can defer tax indefinitely, and if the property ultimately ends up in the estate of the exchanger upon death and a "stepped-up basis" is achieved, tax may be avoided permanently. One example of a taxable disposition which will trigger gain recognition and immediate tax liability is selling property received in the exchange for cash. It should be noted, however, that if the estate tax is repealed, there may no longer be a step up in basis at death.

### **Miscellaneous Ownership Issues**

For smaller properties, the management function of maintaining property and collecting rents is usually performed by the owners. For larger properties or where owners live at a distance or have other commitments, the function normally is performed by a property manager, either an individual or a management firm. Property management often can make a significant difference in the determination of whether to lease or own real estate, and moreover, is an important variable when analyzing a property for purchase.

A doctor(s) owning a multi-tenant building may find rent collection and tenant relations to be burdensome when added to the daily pressures of operating a successful practice. For this reason, a doctor-owner may choose to hire a management firm to deal with this. Alternatively, if only two or three tenants are involved, it may be more cost effective and of little additional inconvenience for the doctor-owner to manage the property. The word "manage" is intended, for example, to encompass the task of contacting a competent plumber, electrician or custodian to deal with the needs of tenants. However, depending upon the age and condition of the structure, management may involve considerable time, expense and aggravation on the part of the doctor-owner.

Adequately insuring a property at a minimum cost is an important consideration for a doctor-owner of a property. If the doctor-owner is the only occupant of the building, an analysis

of appropriate levels of insurance is a relatively straightforward determination. However, this analysis is complicated by owning a building with multiple tenants. While a doctor-owner should require all tenants to maintain appropriate levels of insurance, depending upon the businesses conducted, tenant insurance does not obviate the necessity for the doctor-owner to obtain and maintain adequate and separate property and liability insurance on the property.

Another consideration in owning real estate is the necessity of adequate security. Crimes connected with real estate take many forms, ranging from mischief to theft or destruction of tenant property. Since the total damages suffered by property owners may be significant, and the costs for insuring against such problems may also be high, it may be cost effective to consider an alarm systems and/or security services for the protection of the practice, as well as the businesses of other tenants.

Another consideration of owning real estate is the real property tax liability to the owner. Before purchasing real estate, the doctor-owner should determine the annual real estate taxes on the premises and this factor should be part of the cost analysis prior to making an offer on such real estate.

### **Financing the Acquisition of Real Estate**

Subject to negotiations, sellers of real estate are often willing to finance a portion of the acquisition, particularly if the seller is a retiring doctor. On the side of the seller, to the extent bank financing is obtained for the purchase, the bank would require a first mortgage or deed of trust on the real estate, unless the purchaser was able to obtain other collateral, e.g., a personal guaranty. However, it is generally because a purchaser whom the seller favors cannot obtain conventional financing, even with guaranties of family and friends, that the seller would agree to provide some financing. Not surprisingly, bank's tend to favor the financing of real estate more than financing for the purchase of a practice due to the collateral associated with real estate.

All in all, if you are planning to practice in the same geographical area over your professional career, owning the practice real estate offers advantages over renting. Ultimately, the real estate may become a valuable investment asset for achieving economic independence.