Navigating Through EMINENT DOMAIN

PROPOSED NEW RETAIL DISTRICT

Can You Arrive At A Profitable End?

By R. O'Neal Gray

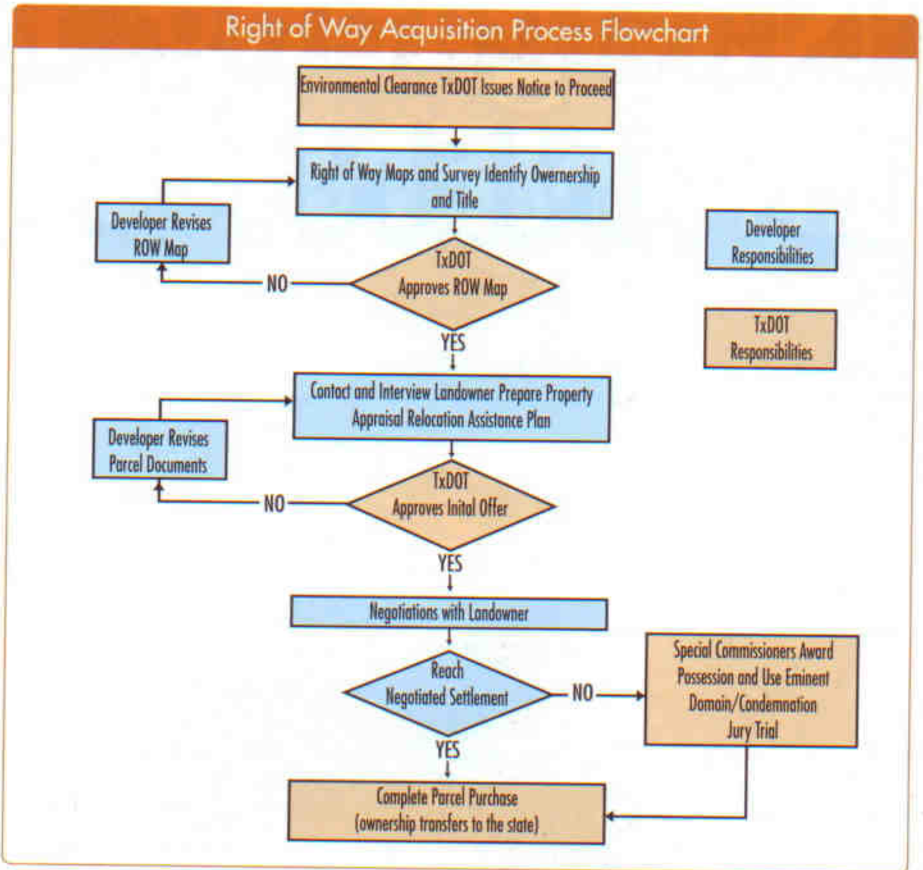
Don't be shocked if you read an article in your local newspaper, or worse, find out after the fact about a public hearing where it was announced that your self-storage property is among multiple properties subject to condemnation.

Self-storage properties are frequently subject to condemnations (also known as an "eminent domain taking") due to their locations in growing metropolitan areas. The condemnation may be triggered by a widening of a highway or street, the need to expand a neighboring school, or other public uses.

The Fourth and Fifth Amendments to the Constitution assure that no person shall be "deprived of ... property, without due process of law; nor shall private property be taken for public use, without just compensation." There are many legal interpretations of the allowed use of condemnations, which is the subject of lawsuits across the country, but we will concentrate on how the condemnation or taking of property will affect you, the property owner, and what you should do to minimize the negative impact on your self-storage investment.

The taking of property may be one of two primary forms: a partial or a complete taking. A complete taking is fairly straightforward in that the governmental entity that is doing the taking will have your property surveyed, appraised, and then make you a purchase offer. In this case, you may choose to accept the offer or to appeal the valuation.

The condemnation process flows as detailed below in a typical flow chart from the Texas Department of Transportation's Web site. Although this flow chart is specific to Texas, its overall process is controlled by the Federal Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, which applies only to federally-aided projects. Condemnations covered by this Act are required to "… make every reasonable effort to acquire expeditiously real property by negotiation."



Source: TTC-35 High Priority Trans-Texas Corridor

Valuation In A Partial Taking

A partial taking follows the same process, but a twist is added in that the property has to be appraised "as is" before the taking and "as will be" after the taking. With a self-storage property, the difference in value may be much more than a mere per-square-foot calculation would indicate.

Example: You own a 70,000-net-leasable-square-foot, "A" class self-storage facility that is 85 percent occupied, generating $1.05 per foot rents or $62,475.00 per month in revenues. Your expenses are running $3.60 per foot per year, or $21,000 per month, thus netting you, before debt service and capital items, $41,475 per month. Class A properties are changing hands in the 6.75 to 7.25 percent cap range, so your property is valued between $6.9 and $7.4 million—around $104 per net square foot. The same property, reduced in size through a partial taking to 40,000 square feet, should thus be worth $4.2 million, right? Wrong.

The 40,000-square-foot property is not large enough to be considered an "A" class property by institutional investors or lenders. Best case, it is a "B" property, which means the cap rate jumps upward a minimum of 100 basis points. Your operating expenses per foot will go up as well; you have the same basic fixed costs such as manager's salary, advertising, etc. Your variable costs (utilities, property taxes, insurance, etc) will decrease in total, but only on a pro-rated basis.

Thus, say you have a 40,000 square foot property, generating revenues of $35,700.00 per month (40,000 square feet times $1.05 per foot times 85 percent occupancy). You have monthly expenses of $4.46 per foot or $14,896.09 per month, netting you $20,803.91 per month before debt service and capital items. Even using the "A" cap rate, the property's value has dropped to $3,566,384.57 (using a seven percent cap) or $89 per square foot. Using a more realistic eight percent cap, the value drops even more, to $3,120,586.50, or $78 per square foot.

Your compensation should be for two different negative affects on your property's valuation: one from the reduced square footage available to lease, and two, the change in the valuation due to the higher capitalization rate. The condemning authority will have to compensate you for the demolition of the property that is taken and the cost of repairs to restore the balance of your property. Whether or not you receive compensation for lost revenues during the construction and demolition period is complicated and is subject to negotiation on a case-by-case basis.

Other Considerations

You may want to handle the condemnation process yourself, However, I recommend hiring an experienced, specialized attorney and appraiser to represent you. As condemnations are a very special niche of the law, research your area for professionals who have learned the process on someone else's nickel and are willing to give multiple references.

A typical condemnation attorney in my area will charge in the range of $300 to over $400 per hour, take five to eight percent of the total proceeds, or take 20 to 35 percent of the increase they are able to obtain for you after the initial offer from the condemning agency. In all cases, you will be expected to pay for out of pocket expenses such as appraisals, travel, surveys, etc.

The condemning authority's goal is to acquire your property without delaying public projects and to ensure that public money is spent appropriately. I have been told by right of way acquisition authorities that their goal is to pay exactly what the target property is worth and "not a penny more nor a penny less."

You will be compensated based on the value of your property, which is a function of profitability (unless the land is worth more vacant). Thus, you should be managing your property no differently than you would normally—maximizing revenues

and minimizing expenses. Do not stop maintaining the property because of a pending condemnation.

Most condemning authorities deem it a failure if condemnation proceedings have to be initiated; instead, their objective is to settle with the property owner as it saves time, possible delay in the start of the project, increases acquisition costs (legal, appraisal, etc), and damages relationships with the public. According to the U.S. Department of Transportation, 80 percent of all right-of-way acquisitions are settled without initiating condemnation proceedings.

Tax Codes And Replacement

The proceeds from either a partial or total taking should allow you preferential tax treatment. When a property is condemned, the proceeds are treated under a tax code similar to the 1031 exchange, which is known as Section 1033. These exchanges of "converted property" are subject to different rules from that of a 1031 exchange.

If a taxpayer's property is involuntarily converted, Section 1033 can provide relief. An involuntary conversion occurs when property is destroyed, stolen, condemned, or disposed of under the threat of condemnation, and other property or money is received in payment. In this case (the sale does not have to be to the condemning authority), and if the investor has a gain resulting from the involuntary conversion, he or she may elect to postpone recognition of that gain by buying a qualified replacement property within a specified replacement period. The basis of the investor's replacement property is reduced by the non-recognized gain, similar to a 1031 exchange.

The tax deferral provisions of Section 1033 are in many ways more generous to the investor than Section 1031 rules. For example, the Section 1033 roll-over exchange does not require application of the technical rules of a Section 1031 exchange. As a result, there are no concerns about the investor's constructive receipt of funds and no requirement that a qualified intermediary be involved in the transaction.

The involuntary conversion rules permit investors who sell under the threat or imminence of requisition or condemnation to defer the gain on the sale. The IRS position is that the threat or imminence of requisition or condemnation exists when the taxpayer learns through a reliable source that a governmental or quasi-governmental entity intends to acquire the taxpayer's property, but only if there are reasonable grounds to believe that the condemnation or requisition will actually occur (See *Rev.Rul.63-221*).

The threat or imminence of condemnation thus exists if a taxpayer is faced with the alternative of either selling the property to the governmental, quasi-governmental entity, to a third party, or having the property condemned. A threat of condemnation need not be a certainty. It exists if it might reasonably be believed

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from representations of government agents and surrounding circumstances that a condemnation is likely to take place.

Investors are granted a period in which to replace the involuntarily converted property (IC Property). IC Property refers to property subject to the threat of imminent conversion or condemnation and also includes property subject to a notice of conversion or condemnation where the actual transfer of title has not taken place. The time period within which replacement can take place begins on the date of disposition of the IC Property, which may refer to the date of destruction, seizure, or condemnation; the date of the sale of the property under threat of condemnation; or the earliest date of the threat or imminence of condemnation. The replacement period ends three years after the close of the first taxable year in which any part of the gain upon condemnation is realized—the third anniversary of the end of the year in which the involuntary conversion took place (*IRC Section 1033[g] [4]*).

The replacement property may be improved or unimproved under these rules.

For real estate used for investment or business purposes, qualified replacement property is "like-kind property" as defined under the rules of Section 1031 tax-deferred exchanges (*Regs. Section 1.1033[g]-1[a]*). This means that any type of real property held for investment purposes will qualify for replacement of the sale of the converted property. The replacement property may be improved or unimproved under these rules. It is even possible to construct improvements on land that the investor already holds title on.

There are no requirements for escrowing cash received from a condemnation sale under Section 1033. Investors can use the cash as they wish. The replacement property may be 100 percent financed without using any of the cash you received from the sale of the condemnation property. There are no requirements for use of the condemnation sale cash for closing on replacement real estate. Replacement of the condemned property must be completed by the end of the 1033 replacement period.

Unlike Section 1031, unless the relinquished property is directly converted into qualifying replacement property, the taxpayer must make a valid election to qualify for the Section 1033 roll-over. The election is made by the taxpayer purchasing the replacement property within the replacement period and filing a claim for the 1033 deferral for each year in which gain from the conversion of the condemned property is deferred.

To avoid recognition of all the gain, the cost of the replacement property must be equal to or more than the net proceeds received for the condemned property. (Net proceeds are total proceeds, less expenses incurred and any special assessments levied against the remaining property as a result of the installation of an improvement.) If the cost is less, the difference is recognized as gain and the excess is treated exactly like boot received in a Section 1031 like-kind exchange; it's taxable.

The rules for "replacement" of the converted property are much more workable than those for a 1031 exchange. For instance, the investor can qualify for a 1033 exchange by buying stock in a corporation owning qualified replacement property; however, the investor must buy a controlling interest. ("Controlling interest" means ownership of 80 percent or more of the total combined voting power of all classes of stock entitled to vote and 80 percent or more of the total number of shares of all other classes of stock of the corporation.)

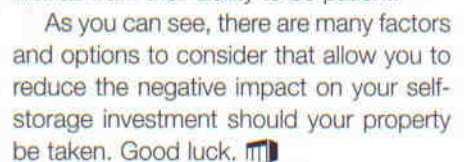
Forming a new corporation to acquire the replacement property is also permitted, however, the qualified replacement property must be owned by the corporation at the time the taxpayer gains control of the corporation. Additionally, the taxpayer may reinvest the net awards into a property that is already owned as long as the like-kind test is met. (See *Davis v. United States, 411 F. Supp. 964 [aff'd, 589 F.2d. 446]*.)

Additional Information

You will find many useful sources of information by doing a Google search with your state's name and "Department of Transportation," "condemnation," and specific road widenings by name. The Texas Department of Transportation's Web site, www.txdot.gov, offers useful links including one to four condemnation manuals: *Appraisal and Review Manual*, *Right of Way Acquisition*, *ROW Procedures Preliminary to Release*, and *Eminent Domain*. These manuals contain information that may be helpful no matter which state you live in. They contain over 1,000 pages of specific instructions on the valuation and condemnation processes, which illustrate a governmental entity's processes and procedures.

Finally, there are several funds now being formed to acquire properties that are under the threat of condemnation. The stakeholders of these funds believe that there is a window of opportunity created because an owner may not be able to sell his or her property or to borrow against it because of the pending condemnation, which could drag on for years.

These funds are created with the intent to buy these properties at a discount (netting out legal fees, brokerage fees, normal closing costs, and carrying costs), thus providing an owner with immediate funds. The stakeholders intend to profit from adding their expertise to the condemnation process (read highly-paid and experienced condemnation lawyers and appraisers) as well as from their ability to be patient.



As you can see, there are many factors and options to consider that allow you to reduce the negative impact on your self-storage investment should your property be taken. Good luck.

R. O'Neal Gray is Chief Operating Officer of Rearden Capital Corporation, a Dallas-based self-storage operator.

Editor's Note: This article contains legal information that is generalized to illustrate legal principles and laws, and should not be substituted for the advice of your own attorney.