

Issues to consider before jumping into a zero cash flow deal



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Zero cash flow deals, sometimes referred to as “Zeros,” are deals that are structured similar to bonds and usually take advantage of high debt to equity ratios (loan to value ratios in excess of 85 percent).

The leases, which are typically “triple net,” are structured under Section 467 of the Internal Revenue Code so that the rent paid by the Tenant equals the debt service for the property.

Because these properties are highly leveraged, lenders require tenants with strong creditworthi-

ness (usually with a credit rating of BBB or better), which is why Zeros typically involve drug stores such as CVS, Rite Aid or Walgreens.

Although the real estate investment does not provide a positive cash flow, the depreciation generated from these investments at the beginning of the ownership period can produce a net loss that can offset other taxable income, which can be advantageous to the investor.

It is important for anyone seeking to purchase a Zero to consult with their financial and tax advisor to determine how such an investment will impact them.

Although a fee transfer (or assignment and assumption of lease in the case of a leasehold interest in a ground lease) is usually permitted under the existing loan, the preferred method of transfer is through the purchase and sale of the ownership interests of the borrower entity (“Entity”). Lender fees tend to be slightly less for



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transfers of ownership interest and a new loan policy may not be required.

In addition, no start-up organizational costs will be incurred since the Entity is already in existence.

Also, in a handful of states (including Florida, Nevada and Ohio), transfer taxes are not applicable to the sale of a controlling interest, as compared to a transfer of a fee interest, which would trigger transfer taxes in such states.

Because the Entity is a disregarded entity for federal income tax purposes, the acquisition of the ownership interests qualifies as “replacement property” under Section 1031 of the Internal Revenue Code.

In some cases, the existing loans are structured to allow for a paydown/re-advance, which is a convenient feature for purchasers with 1031 funds in excess of the cash portion of the purchase price.

This enables the purchaser to pay down the loan to an amount not less than \$1.00 and subsequently cause the Lender to re-advance the funds so that the remaining loan balance after the re-advance equals the principal balance prior to the paydown.

If the Seller’s existing owner’s policy is a 2006 ALTA Title Insurance Policy, a purchaser of ownership interests may also have the benefit of being able to rely on such policy.

It is important in this case, however, to run a last owner’s search to confirm no title defects exist since the date of the existing policy.

When selecting a title company, consider engaging a national title underwriter (as opposed to a local abstract company), which is familiar with this type of transaction. Because of their familiarity with the loan and transfer documents, closings are conducted with efficiency and professionalism. To protect against any liens that may

affect the ownership interests being acquired, also consider a UCC insurance policy, which insures the lien-free status of the ownership interests in the Entity.

One such policy is the Eagle 9 UCC Insurance Policy for Buyers, offered by the UCC Division of First American Title Insurance Company.

For an additional fee of 10 percent of the premium amount (or \$250 minimum), a purchaser can obtain a Buyer’s Equity Ownership Endorsement, which insures rights in the acquired Entity interests as a certificated security pursuant to Article 8 of the Uniform Commercial Code.

With the Buyer’s Equity Ownership Endorsement, the purchaser would then be protected from any adverse claims (as defined in Article 8) in the ownership interests that accrued prior to the effective date of the policy.

It is also important to note if any bulk sales laws are applicable to the transaction because the failure to comply with any such laws may expose the purchaser to potential liability that is otherwise the responsibility of Seller.

To illustrate just how significant the liability may be, in a recent transaction involving a Zero located in New Jersey, the Division of Taxation of the New Jersey Department of the Treasury (after compliance with such State’s bulk sales law) required the placement of funds in excess of \$200,000.00 in escrow, which amounted to almost 23% of the net cash purchase price.

Finally, when selecting an attorney, it is important to consider the practitioner’s level of experience with respect to Zeros.

Although most transactional attorneys can navigate through a Zero purchase or sale, an attorney who has extensive experience in this area will help to ensure a smooth and efficient transaction.