



# REAL ESTATE LAW & INDUSTRY



## REPORT

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### SURPLUS INDUSTRIAL PROPERTY

## Dealing With Surplus Industrial Property Calls for Attention to Liabilities, Incentives



BY PAUL DIAMOND AND DAVID RESNICK

One byproduct of the Great Recession is a marked increase in surplus industrial real estate in the United States. In many instances, because they are understandably reluctant to take a tax loss on these properties, businesses deal with these properties passively. It's just not a high priority. Nonetheless, the carrying costs for unused properties can be extraordinary, and vacant properties often contribute to blight in many of our cities and rural areas. The movement of jobs

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overseas led to the presence of numerous vacant sites on the books of American companies before the downturn, and the recent economic crisis has only worsened the state of affairs. Our cities and rural areas are dotted with vacant buildings, many of which have minimal market value, regardless of where we are in the economic cycle. Plainly, they are an economic liability.

Whether dealing with an existing surplus property or facing the possibility of vacating a property in the future, a business will have a number of direct economic considerations, the most immediate of which relate to the physical real estate in question. For instance, security costs in connection with vacant property can be substantial, since vacant buildings are particularly prone to vandalism and the theft of building components. Some municipalities have modified their ordinances so that merely boarding up vacant buildings is no longer sufficient, and costly steel materials must be used to seal all points of entry.

Questions of valuation are also of immediate relevance. If the market value of a surplus property is limited, then the business must decide whether or not to demolish the improvements on the site. In other words, do the high expenses, net of lower taxes following demolition, make demolition an attractive option? Demolition will almost immediately result in lower carrying costs, including diminished real estate taxes, and savings on insurance, security, maintenance utility, and environmental remediation costs. Municipalities may object to the demolition since it often limits the potential for the replacement of lost jobs, but it may be the best strategy for the bottom line.

But besides the obvious economic implications, surplus properties can give rise to a host of legal issues in a variety of areas, including insurance, environmental compliance, taxation, and municipal law. The following is a brief summary of these potential issues.

**Insurance.** When a company is engaged in ongoing business on a parcel of real estate, it should and typically does maintain insurance for some or all of the associated risks. Broadly speaking, the company will maintain both property and liability insurance; but what happens with those policies when the company suspends or ceases operations at the site?

Some business owners may be tempted to cancel all or some insurance coverage in order to save money on insurance premiums. That may be a rational decision in some circumstances, but companies would be wise to review their insurance coverage carefully, notify their insurers about the change occurring at the site, and make thoughtful decisions about possibly changing their insurance programs.

If the business owner is a tenant of the property, the lease may include a requirement that the tenant maintain insurance, both for itself and the landlord. Canceling the policy when the property is vacant may constitute a default under the lease, with all the potentially adverse consequences of any default.

But perhaps more importantly, canceling policies would leave the company—whether it leases or owns the property—without coverage for the risks associated with the now-vacant property. At the same time, merely maintaining the existing policies may not be the best answer either. The insurance policies were issued to cover the risks associated with ongoing operations, not vacancies. Some of the damage and liability scenarios described above will be very different from the risks that existed when the facility was in operation, and those may not be covered by the existing policies. For example, as explained later in this article, that vacant property might attract illegal dumping and resulting environmental liability. Because the company may not face significant environmental risks in its normal operations, it may normally not carry coverage for environmental liabilities. Therefore, when the company closes a facility, it may be prudent to consider purchasing environmental impairment or pollution liability coverage. Even if the company already had environmental coverage, almost any insurance policy will exclude coverage for “expected or intended” damage (e.g., damage caused by a leaking storage tank if the leak was the expected result of the policyholder ceasing its regular maintenance of the tank). In that scenario, a review of the policy could help the company decide that, in closing the facility, the tank maintenance program should be continued or perhaps the tanks should be removed.

Nonetheless, in some circumstances, the closing of a facility can offer a company an opportunity to save money on its insurance coverage. For example, if the storage tanks just described are removed from the premises, then any pollution liability coverage the company was maintaining for the site may be (but not necessarily is) a candidate for cancellation. Or, if the operations included work with flammable materials, then the property insurance coverage could become much less expensive when that operational risk ends.

**Environmental.** Property owners might think they can’t be liable for materials illegally dumped on their properties. After all, they didn’t do it—someone else did. Those owners may be wrong. In the worst case, an owner could be sued by a federal or state environmental agency, ordered to remove the materials and conduct a clean-up of contamination caused by the dumping (and pay attorney’s fees to defend the action). Some courts have found property owners liable for such dumping “by virtue of their studied indifference” to the resulting hazardous conditions, even though the problems were indisputably caused by others.

Even if an owner is not ordered to do a clean-up, or is not pursued at all by the government, the owner will still have to address the effects of the illegal dumping if it wants to lease or sell the property. Certainly in the case of a prospective sale, any potential buyer will conduct its own due diligence and inquire about past releases and acts of disposal on the property. The owner may have to disclose that the dumping took place and how the owner responded to it. And if the contamination is still there, it could dissuade a buyer from pursuing its acquisition or result in a significantly reduced purchase price.

While dealing with dumped household goods or general refuse may be a relatively easy and inexpensive task, addressing serious contamination from chemical disposal would be a much more complex and expensive problem. Property owners should take the actions necessary, to the extent feasible, to minimize the possibility of midnight dumping.

The presence of storage tanks below vacant property also presents unique challenges. Just because underground storage tanks are no longer in use doesn’t mean they are no longer subject to environmental regulations. Generally, an underground tank owner is required to do one of two things with inactive tanks: remove them or fill the tanks with an inert, chemically inactive solid (and address any contamination, if present). Either option can be expensive and time consuming. However, a third option may be possible: determining whether the regulating agency (usually the state fire marshal or local fire department) will allow the tank to remain untouched until the owner knows what will happen with the property—a far less expensive option.

**Government Programs.** Municipalities employ a variety of programs to encourage development of unused property, including the issuance of recovery zone bonds, tax increment financing, and enterprise zones.

The American Recovery and Reinvestment Act of 2009 created recovery zone facility bonds in an effort to support bond issuance and economic development in areas of economic distress designated by local authorities as recovery zones. These bonds provide funding for a wide variety of projects. Generally, any commercial project is eligible, other than residential property and certain leisure businesses. Projects may only be funded if they commenced after the county or municipality has designated the recovery zone, and the Treasury Department has allocated funds among counties and large municipalities throughout the country. The counties and municipalities then choose which private projects to fund with the bonds. Generally, an applicant for these bonds must obtain a letter of credit or other private credit enhancement. Under current law, the recovery

zone bonds must be issued by Dec. 31, 2010, but Congress may extend the program in the coming year.

Under a tax increment financing (TIF) program, a municipality establishes a special district in order to encourage development of a blighted area. In Illinois, which is a national leader in this program, TIFs typically last for 23 years. The "Increment," the central concept in TIF, refers to the increase in property taxes generated by increased assessed valuation of the subject real estate during the life of the TIF. The municipality transfers the increment into a TIF fund and uses it to finance certain public and private development costs under the terms of a redevelopment agreement. The private development helps to increase the assessed valuation over the years, and effectively pays for the increment it receives. Successful TIFs generate far more increment than they pay to developers. For maximum leverage of TIF revenues, towns often issue TIF bonds which may be backed by the increment, as well as other revenue sources.

Enterprise zone benefits include sales tax exemptions, utility tax exemptions, property tax abatement, and employment tax credits.

**Taxation.** Although government incentive programs can offer substantial benefits to the property owner, corporate income and real estate tax planning is perhaps the most critical consideration when addressing surplus properties.

The most straightforward cost-saving strategy in this area is to seek a reduction of real estate taxes based upon a property's vacancy. While some cities have proposed tax increases for vacant properties, ostensibly to discourage vacancies and compensate the community for the resulting blight, most jurisdictions in the United States continue to reduce taxes based on a vacancy alone.

Also, the outright sale of surplus real estate may result in a loss to the extent the sales proceeds are less than the basis of the sold real estate. Such a sale can be used to offset taxable income and therefore reduce overall tax liability of the taxpayer.

A like-kind exchange allows the taxpayer to defer capital gains taxes on any exchange of like-kind properties for business or investment purposes. Taxes on capital gains are not charged upon sale of a property if the money is being used to purchase another property; rather, the payment of tax is deferred until the replacement property is sold with no re-investment. Very intricate rules must be followed.

Businesses have been able to take charitable contribution deductions for federal income tax purposes on the value of a conservation easement donated to a qualified charity or public agency. The deduction has generally been limited to a percent of an entity's contribution base for the year in which the donation is made, with any excess allowed to be carried over a certain number of years. A charitable contribution is considered to be made "for a conservation or preservation purpose" if it protects land areas for outdoor recreation or for the education of the general public, natural environmental systems, open space where such preservation will yield a significant public benefit, or a certified historic structure or historically important land area. If the facts and circumstances permit, a taxpayer may be able to otherwise take a business deduction for such donation, thereby avoiding the percentage limitations discussed above.

One additional option for the taxpayer is a combination sale-and-contribution to a municipality. Value can be recovered in part from the sale of the property at a discounted price, and the taxpayer can simultaneously take advantage of a tax deduction for the sale discount. In limited instances, a municipality will cooperate in treating such a transaction as a partial condemnation, which would give the taxpayer the opportunity to reinvest the proceeds tax free in the ensuing two years.

In conclusion, businesses owning or leasing vacant property should address these issues sooner rather than later. Companies should revisit strategies regarding surplus property and seek to minimize risk and maximize cost savings at every opportunity.