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ALM

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Limiting an office lease's impact on the bottom line

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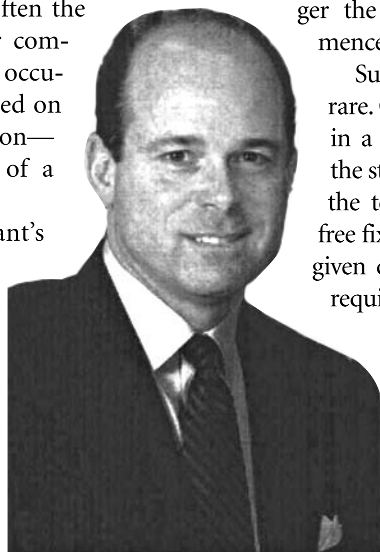
COMMERCIAL *Office Leasing*

THE FINER POINTS *OF* LANDLORD/TENANT NEGOTIATIONS

Costly obligations await ambiguity over operation expenses, tenancy start date

By JONATHAN B. MILLS



Other than employee costs, real estate expenses are often the largest overhead item for companies leasing space. Such occupancy costs—whether based on rent or space construction—often exceed 15 percent of a business' annual revenues.

Accordingly, a tenant's counsel in commercial office lease transactions should focus on the business terms and lease documentation during negotiations. Failure to address potential problems before closing a transaction can lead to costly obligations that run for the life of the lease term.

A tenant's rent commencement in a lease is often problematic. In the simplest transactions, the space is empty and ready for occupancy, and requires no initial construction work on the part of the landlord. The parties need only execute the leases and have the landlord grant access to the space to trigger the lease term and rent commencement.

Such simple arrangements are rare. Often, various business points in a given transaction complicate the start of a tenancy. For example, the tenant may receive an initial, free fixed rent period that ends on a given date, or the landlord may be required to perform certain, pre-occupancy construction work, or the premises may be occupied by another party who must move out before the new tenant takes occupancy.

It is thus important that the lease term and any free rent period not start under the terms of the lease until the landlord delivers exclusive possession of the space (free of any prior tenants and their property), and with all landlord construction work, if any, "substantially completed."

Defining "substantial completion" in a lease is also helpful, since the phrase carries different meanings. Most tenants seek a substantial completion standard that requires the premises to be finished such that the tenant may move in and commence its business operations, with only minor items remaining to be completed—items that will not interfere with the conduct of the tenant's business.

Sometimes, an architect's or contractor's sign-off, confirming completion, is negotiated to avoid construction disputes. Tenants also sometimes require the issuance of a certificate of occupancy from local building authorities, to confirm completion and ensure that the premises may be legally occupied.

As an additional protection, a tenant may propose that the landlord provide advance notice of substantial completion.

Operating Expenses

Operating expense clauses in commercial leases can be complex, and vary widely. Typically, they involve charging the tenant its proportionate share of all operating expenses incurred in connection with the office complex. Maintenance, repair and cleaning costs, insurance premiums, real estate taxes and common area utility charges for the building (as opposed to utility charges applicable to each tenant's premises) are the most common operating expenses.

Operating expenses at some properties can reach an annual rate of $12 per rentable square foot or more, and are always charged in addition to the tenant's fixed rent. Since operating expenses can be costly and escalating obligations, they deserve attention.

Most landlords, not inappropriately, want flexibility in their operating expense provisions, because the nature and extent of many operating costs (such as real estate taxes and insurance) are beyond their control. Broad language is typically proposed, allowing the landlord to recover all expenses relating to the operation, maintenance, management and repair of the building and related amenities (e.g., parking areas). Sophisticated tenants will seek to negotiate a more narrow definition of operating expenses, including lists of includable expenses, as well as items that must be excluded. Normally, the parties will agree to expressly exclude items that are closely tied to the ownership of the property, such as the landlord's financing costs and debt service, any operating or capital reserves, leasing commissions, marketing expenses, tenant improvement allowances, property development and transfer costs, and like items.

The most common sticking point in operating expense negotiations concerns capital expenditures. Many tenants resist paying for any capital items, viewing them as a cost of ownership rather than a normal maintenance or operating expense.

A typical compromise is to allow a landlord to include only those capital expenditures that result in lower operating costs (and better efficiency), as well as capital expenditures required by laws and regulations.

Since capital items often have long useful lives, some tenants insist that any such expenditures be amortized over the useful life of the capital item in question. The tenant is then not penalized with subsidizing a large capital charge in a single lease year for an item (such as a roof replacement) that will benefit the building long after the tenant's lease ends.

Audit Rights

In addition to defining operating costs, well-advised tenants usually request a right to audit, review and copy the landlord's books and records relating to operating expenses.

Most commercial landlords, along with their property managers, endeavor to calculate and charge operating expenses in a fair and accurate manner. Given the detail and scope of this task, however, most building owners recognize that errors can occur. As a result, many landlords, at least for larger tenants, will allow an audit clause in their leases, but subject to various limitations.

Frequently, landlords insist on a confidentiality clause when granting any audit rights. These provisions bar the tenant and any auditor from sharing any audit results with third parties. Landlords have adopted this approach to avoid the threat of overcharge disclosures to other tenants in the building, which some tenants and auditors have used to extort settlements that greatly exceed the overpayment at issue. Most tenants will accept a confidentiality requirement to obtain an audit right that otherwise would not be granted.

A tenant's remedies following successful audits also are frequently negotiated. The most obvious recovery is to grant the tenant the amount of any overpayment determined by the audit. In some cases, the overpayment plus interest is permitted. Less often, landlords will agree to reimburse the tenant's reasonable, out-of-pocket auditing expenses if any overcharge exceeds a certain threshold.

Given the lasting, financial impact of a commercial office lease, dealing responsibly with these transactions is critical. A tenant's counsel should coordinate the transaction with the client's brokers and architects to help review and negotiate all lease documentation.

Addressing these issues during negotiations, rather than after the transaction closes, will help a client control its real estate costs and enhance its bottom line. ■

Jonathan B. Mills is a principal at Stamford-based Cummings & Lockwood LLC. His commercial real estate practice includes representing landlord and tenant clients in commercial lease transactions throughout the northeast.

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BENEFITS OF 1031 EXCHANGES OUTWEIGH THE RISKS

Finding quality replacement property, however, is increasingly difficult

By ALLEN J. POPOWITZ and JASON A. RUBIN

Anyone paying attention to trends in the world of real estate transactions has surely noticed the growing frequency with which Internal Revenue Code Section 1031 exchanges have been occurring over the past decade.

A 1031 exchange allows a taxpayer to relinquish a property or properties they already own and reinvest the proceeds in another property or properties of equal or greater value without recognizing any gain on the transaction. The realized gain is deferred until the taxpayer disposes of the property in a later taxable transaction. When structured properly, 1031 exchanges can be used by real estate investors to defer gain on their property until a later tax year, or theoretically until the property is eventually passed on to their descendants.

It sounds like an easy concept; you sell property and then purchase another property and defer the taxable gain. Except, finding quality replacement property has become very difficult. All too often, taxpayers have found themselves with a buyer that is ready, willing and able to pay a premium for their property, however, the replacement properties currently available in the marketplace do not come close to the quality that the taxpayer is seeking to own and manage. It is this lack of acceptable, quality replacement properties that has led some real estate investors to utilize a rarely used form of a 1031 exchange referred to as an improvement (or build-to-suit) exchange.

Allen J. Popowitz is a partner and co-chair and Jason A. Rubin is an associate of the investment real estate department at WolfBlock Brach Eichler of Roseland, N.J.

When structured properly, 1031 exchanges can be used by real estate investors to defer gain on their property until a later tax year, or theoretically until the property is eventually passed on to their descendants.

An improvement exchange allows a taxpayer to improve a replacement property to their specifications before taking title. The type of improvements made to the replacement property can range from enhancements to an existing building, to the complete construction of a new building or facility from the ground up on vacant, unimproved land. Such an arrangement provides the taxpayer with a significantly wider range of potential investment opportunities; and, therefore, more flexibility when searching for a property to complete their exchange. However, as with all 1031 tax deferred exchanges, the improvement exchange does not come without its share of risks and limitations. The following sections set forth some of the steps required to complete either a forward improvement exchange or a reverse improvement exchange.

Forward Improvement Exchanges In a forward improvement exchange, the taxpayer first relinquishes a property or properties they own, and then acquires one or more replacement properties. To facilitate this exchange, the taxpayer will need to retain the services of a Qualified Intermediary. The QI will in turn form an Exchange Accommodation Titleholder for the purposes of taking title to the relinquished property.

According to the IRS, the QI must be a party other than the taxpayer, who is not a “disqualified person” (basically a related party). The EAT is an entity, typically a single purpose LLC, set up by the QI to hold title to the property during the exchange, to prevent the taxpayer from achieving any form of ownership of the replacement property. The EAT will be treated as the beneficial owner of the property for all federal and state income tax purposes. If it is determined that the taxpayer manifested any indicia of ownership of the replacement property, the 1031 exchange will fail.

Once the QI has set up the EAT, and all of the agreements are in place, the taxpayer is ready to structure their 1031 exchange. The taxpayer will first negotiate a Purchase and Sale agreement with a buyer containing a clause where the buyer will agree to cooperate in the 1031 exchange, and then assign its rights under the contract to the QI. At closing, the taxpayer will transfer title to the buyer, who will in turn transfer the purchase proceeds to the QI.

This begins the exchange, and the timing provisions kick in. Beginning with the closing date on the sale of the relinquished property, the taxpayer has 45 days to iden-

■ See **STRUCTURING** on PAGE 8

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BREAKING DOWN THE EPA'S NEW AAI RULES

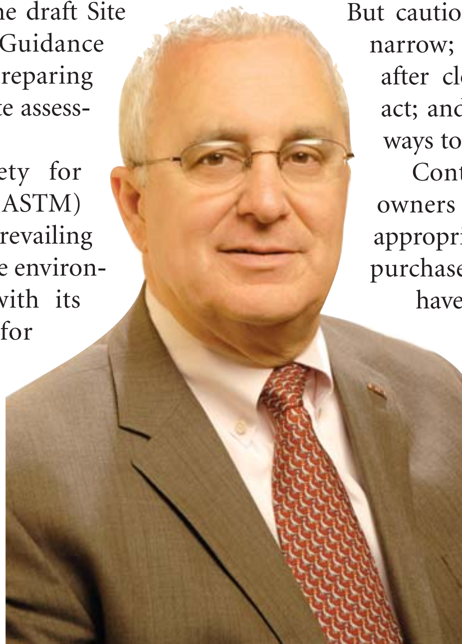
'All Appropriate Inquiry' regulations will add to reports' thickness, cost

By NICHOLAS J. HARDING

Some industry experts are projecting cost increases in the range of $1,500 and $2,000 or more, potentially doubling the cost of assessments.

For ages Connecticut environmental professionals have been guided by the state Department of Environmental Protection's Transfer Act Site Assessment Guidance Document (1991) and the draft Site Characterization Guidance Document (2000) in preparing environmental Phase I site assessment reports.

The American Society for Testing and Materials (ASTM) later set the national prevailing standard for pre-purchase environmental due diligence with its "Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process," issued in 1997 and updated in 2000.



Subsequently, Congress decided that the EPA should get into the business of setting standards as well. The 2002 Brownfields Amendments to the Superfund law provided additional conditional CERCLA liability protection to landowners who qualify as *bona fide* prospective purchasers, contiguous property owners or innocent landowners under the act. To qualify for these protections, prospective purchasers must, among other things, make "all appropriate inquiry" to determine whether the property may be contaminated. The Brownfields Amendments required that the EPA establish standards and practices for "all appropriate inquiry" (AAI) by regulation.

The AAI regulations became effective on Nov. 1, 2006. The AAI regulations do not reflect a climate change, but they will add to the thickness of reports and their cost, and have already resulted in an amendment in 2005 to the ASTM's Standard Practice for Environmental Site Assessments.

Only those seeking the protections of the Brownfields Amendments to the Superfund law or CERCLA are required to meet the AAI rule. Those are parties who wish to qualify as *bona fide* prospective purchasers, contiguous property owners or innocent landowners under CERCLA. A word of caution: innocent landowners in Connecticut must also qualify under C.G.S. § 22a-452d *et seq.*, a topic not covered here, if they wish to use the defense with the Connecticut DEP. These new federal defenses are not useful under other federal environmental law.

A CERCLA *bona fide* prospective purchaser must perform all inquiry prior to purchase, and may close on the property knowing, or having reason to know of, contamination on the property and may obtain certain defenses under CERCLA. But caution: these defenses are narrow; remaining qualified after closing is a high wire act; and there may be better ways to obtain protections.

Contiguous property owners must perform all appropriate inquiry prior to purchase and not know or have reason to know of the contamination to receive protection. An innocent landowner must perform all appropriate inquiry prior to purchase and must not know or have reason to know of the contamination to receive protection. Heirs continue to be innocent owners.

FDIC Guidelines

In practice, many polluted properties never become of interest to the EPA. So why the fuss over the EPA's new rule?

Two other agencies have important roles in the acquisition of real estate: the FDIC and our local DEP. On Nov. 13, 2006, the FDIC issued updated Guidelines for Environmental Risk Program (FDIC Guidelines) by Financial Institution Letter, FI L-98-2006, to reflect changes related to the EPA's AAI Rule. The highlight of the FDIC Guidelines is that, as part of its environmental risk analysis of any particular extension of credit, a lender should evaluate whether it is appropriate or necessary to require the borrower to perform an evaluation that meets the standards and practices of the EPA's AAI Rule.

Under the FDIC Guidelines, examiners will review an institution's environmental risk program as part of the examination of its lending and investment activities. When analyzing individual credits, examiners will review the institution's compliance with its own environmental risk program. "Failure to establish or comply with an appropriate environmental program will be criticized and corrective action required." Transactions that involve financing with FDIC insured institutions will be subject to lender policies which in many cases will need to comply with the EPA's AAI Rule.

Institutions either have or will review their Environmental Risk Programs and establish guidelines and methods to evaluate whether it is appropriate or necessary to require a borrower to perform an evaluation that meets the EPA AAI Rule. As in the past, one expects commercial, industrial and other nonresidential properties to be subject to a Phase I site assessment requirement.

One- to four-family residential housing will continue to be generally exempt from such requirements. Neither the EPA nor the FDIC requires AAI, but lenders know that they will have to justify noncompliance with AAI to bank examiners.

Brownfield Developers

AAI probably will have little or no effect on Brownfield developers. Those developers that specialize in acquiring contaminated properties, correcting the environmental deficiencies, and then putting the properties to good use or sale might benefit from the *bona fide* prospective purchaser defense, but most will move quickly, albeit cautiously, in acquiring and remediating any properties.

AAI does not require any sampling. Brownfield development is a field for consenting adults. Those developers usually undertake extensive examination of contaminated properties pre-purchase. They have a very good idea as to what they are acquiring, what the costs of remediation will be, and how long it will take. Most, if they have a property of interest to the EPA, will seek the additional protections afforded by entering into pre-purchase agreements with EPA.

Properties which are suitable for AAI investigations are probably suitable for examination under the Connecticut DEP standards, either under the Transfer Act or under prudent practice driven by the doctrine of *caveat emptor*.

Cost Analysis

AAI, however, will affect real estate practitioners and their clients. EPA's cost analysis provided in the preamble to the proposed rule forecasted only a $41-$47 increase in the cost of site assessments. Some industry experts are projecting cost increases in the range of $1,500 and $2,000 or more, potentially doubling the cost of assessments.

For those who wish to read the rule, it can be found at 40 CFR Part 312. My intent is not to provide the real estate practitioner with a detailed description of

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the EPA's AAI Rule or a short synopsis. Instead, some observations and rules of thumb are presented that may be of use to the real estate bar.

The purpose of pre-acquisition environmental inquiry is to provide the prospective buyer with an evaluation of the target property for potential environmental contamination and to assess the potential for liability after purchase.

The new AAI rule can be avoided by using seller financing in those cases when the Connecticut Transfer Act does not apply. A good rule of thumb for any real estate transaction that involves seller financing of commercial or industrial property is to perform a site assessment. If seller financing or other financing (like taking out a home equity loan to avoid the bank's requirement for a site assessment) is involved in an effort to avoid an inquiry into the environmental history of the property, the property is probably environmentally challenged. Experience has shown that those properties that are not subject to environmental investigation by plan are the properties that warrant investigation.

Required Reports

AAI requires the use of an environmental professional, which is a defined term under the rule. The environmental professional is to prepare a written report that summarizes the results of the inquiry and opines "as to whether the inquiry has identified conditions indicative of release or threatened releases of hazardous substances … on, at, in, or to the subject property."

The environmental professional's report must identify data gaps in the information developed that adversely affect the ability of the professional to identify property conditions. To the extent data gaps are noted, the environmental professional's report must include comments regarding the significance of the data gaps to the ability to provide an opinion.

The environmental professional's inquiry is to be conducted within one year prior to the date of the acquisition of the property. Certain components of the inquiry, including interviews with past and present owners, operators and occupants, the review of government records, and the visual inspection of the property, must be conducted or updated within 180 days before the date of acquisition. Old or stale reports will need to be updated before purchase. Even before the adoption of AAI, reliance on a dated Phase I has never been a prudent practice.

The rule allows allocation of responsibility between the environmental professional and the party for whose benefit the inquiry is conducted. It assigns to the purchaser the obligation, if not undertaken by the environmental professional, to search for the existence of environmental cleanup liens against the property filed of record under federal, tribal, state or local law.

Consideration of (a) the party's specialized knowledge of the subject property; the area surrounding the property; the conditions of adjoining properties and any other experience relevant to the inquiry; (b) the relationship of the purchase price of the property to the value of the property were it not contaminated; and (c) commonly known or reasonably ascertainable information within the local community about the property, to the extent not otherwise obtained by the environmental professional, may be done by the purchaser. If so, good practice would include memorializing the effort.

The new AAI rule can be avoided by using seller financing in those cases when the Connecticut Transfer Act does not apply.

Additional Tasks

If information from a previous Phase I is used, the report must include a summary of any relevant changes to the conditions of the property since the time of the previous Phase I. The rule places a greater emphasis on documenting the sources of information consulted by the environmental professional.

When reviewing Phase I environmental assessments, the real estate lawyer should look for a statement from the environmental professional that the investigation was done in accordance with ASTM Standard Practice E 1527-05 for Environmental Assessments (ASTM, 2005), the DEP Transfer Act Site Assessment Guidance Document (1991) and the DEP draft Site Characterization Guidance Document (2000).

The real estate lawyer also should examine the certification of the environmental professional to ensure that the environmental professional has declared that he or she is a professional as defined in Section 312.10 of 40 CFR Part 312 and has certified to the education, training and experience to assess the property, the nature, history and setting of the subject property, and that he or she has developed and performed all appropriate inquiries in conformance with the standards and practices set forth in 40 CFR Part 312.

Of course, reviewing the Phase I for substance will only tell whether there is a potential for contamination of the property, and whether the report was done in accordance with the AAI Rule and appropriate state standards. It will not tell anything about the extent and degree of contamination. It will inform you and your client if, in the opinion of the environmental professional, there are areas that warrant further investigation. And the answers to those questions will be found in investigations done by an environmental professional that are beyond the scope of the EPA's regulation on all appropriate inquiry. ■

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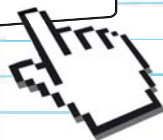
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ABCs OF BROWNFIELD REDEVELOPMENT

Legislature exploring ways to turn more ghosts into greenfields

By ANN M. CATINO

Scattered throughout Connecticut's landscape are the neglected and abandoned relics of Connecticut's manufacturing past.

While these structures are found in almost every town, the vast majority are clustered in the urban centers. Once thriving and alive with activity, these former manufacturing complexes are located along roadways, rail lines and rivers.

Largely since the 1950s, urban flight away from our state's manufacturing base has led to suburban development and these complexes have become ghosts. Lost are thousands of acres of open space and found are more abandoned structures. This trend is continuing and will continue if left unchecked.

In 2006, and again this session, the General Assembly is focusing on brownfield reform to restore the economic and community value of these properties.

Gov. M. Jodi Rell also heralded the issue and, in October, formed the Office of Responsible Growth through Executive Order No. 15. Among various collaborative planning initiatives to marry job creation and housing with mass transit, the new office is to scrutinize consistency with responsible growth objectives when a project seeks funding or bonding.

One way to achieve the responsible growth objectives is to encourage development of the idle manufacturing structures that are brownfields. These sites, however, pose many challenges. Brownfield redevelopment is not only about the location and the market. Questions of cost, timing, regulatory certainty and liability loom large. The challenge is to create and implement programs to stimulate private sector investment in brownfields. The key to responsible growth lies in turning around brownfields. But how?

There are some fundamental ABCs of brownfield development that can apply to any site.

One-Stop Shop

"A" is initially for agency. Brownfield redevelopment often has to navigate many agencies beyond local approvals. Virtually all sites require the involvement of the Department of Environmental Protection. If state funding is sought, then the Department of Economic and Community Development and the Connecticut Development Authority are involved.

In 2006, the General Assembly, recognizing the myriad of programs and agencies, created a new office—the Office of Brownfield Remediation and Development (OBRD). Among other tasks, the OBRD is to centralize and coordinate the application of these programs to any given project developer. It is a one-stop-shop for advice and guidance. The project developer would have someone to call and navigate through the DECD, CDA and DEP's program maze. The "A" in agency, therefore, is the OBRD.

"B" is for budget. Projecting development costs for an undeveloped site is an easier task than for a brownfield site. Projecting costs from the ground surface up deals with what is known. Projecting costs from the ground surface down is far trickier. And, brownfield sites often have hidden infrastructure costs relating to the existing building (e.g., asbestos, PCBs, lead paint).

Many developers (including municipalities), however, are not as well-versed in the costs associated with investigating and remediating a brownfield site. Many construction companies also bid on projects without including remediation and abatement costs. The construction company that includes the real costs will likely not be the winning bidder. However, the project will suffer with change orders or be stalled completely until the environmental conditions are addressed.

Managing, staging and planning the project to incorporate the remedy into the development saves time and cost. Prior planning to identify the issues and the hidden costs (or categories of costs) brings a project in on budget.

"C" is for coordination. The right consultants, contractors, architects, engineers and attorneys are key to a successful project. Brownfield development often requires disciplines unfamiliar to a typical real estate deal and necessitates having the right people in place to coordinate steps A and B.

Capping Liability

"D" is about the dirt and what is in, above and below the dirt. The type, concentration and location of the contamination can alter the development. Zoning restrictions may need to be altered to accommodate the development given its environmental condition. Environmental Land Use Restrictions may restrict certain types of development or land uses today, but their effect on subsequent purchasers, the value of the property and the impact on a town's plan of development (or zoning) require heightened evaluation.

Above all else, the developer needs to know that, when the dirt has been cleaned up sufficiently, it can walk away and be confident that the state's regulations have been achieved, that the consultant's work will achieve DEP scrutiny and that liability (risk) is capped.

"E" is evaluation, the earlier the better. On-site and off-site impacts should be investigated. If you know what is there, the costs can be projected and the site managed. Early evaluation leads to an efficient environmental clean-up, which also leads to another "E," economic development, which is the goal.

Funding Options

"F" is for funding and financing. DECD has several potentially applicable programs to brownfield redevelopment—primarily the Urban Site Remedial Action Program and the Special Contaminated Property Remediation and Insurance Fund (SCPRIF). The Connecticut Development Authority also provides financing through Tax Incremental Financing (TIF) and, working with a municipality, agreements could be put in place for property tax abatement or relief.

But more is needed. Under Public Act 06-184, the legislature created the Brownfields Task Force to study the state's existing programs and to make recommendations for legislative change. The task force's report was issued in February 2007. Many bills have been introduced this legislative session to modify the state's brownfields programs, including two bills to implement the recommendations of the task force, which include further funding and financing mechanisms to stimulate private sector investment.

The solution, however, lies not in funding and finance reform alone; it requires programmatic and regulatory/liability changes addressing the aforementioned ABCs.

Certain programmatic changes are especially needed to get to "G," which stands for greenfields and preserving our state's open spaces.

The objective of Executive Order 15 will be achieved through brownfield redevelopment, which can be a win-win, if everyone pays attention to their ABCs. ■

Ann M. Catino chairs the Environmental and Land Use Practice Group at Hartford-based Halloran & Sage LLP. She is also co-chair of the Brownfields Task Force, which in February reported its findings and recommendations on brownfield reform to the Connecticut General Assembly.

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SUPREME COURT RULINGS ARE BREATH OF FRESH AIR

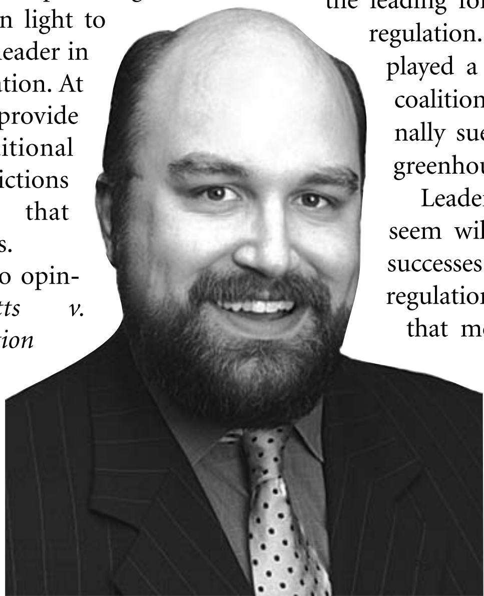
Connecticut a leading force in greenhouse gas regulation

By LEE D. HOFFMAN

In what is seen as a rebuke of the Bush Administration's energy and air pollution policies, the U.S. Supreme Court issued a pair of opinions earlier this month that not only strengthen the Environmental Protection Agency's ability to regulate both new and refurbished sources of air pollution, but also require it to regulate carbon dioxide and other "greenhouse gas emissions" from automobiles.

Taken together, these opinions give Connecticut the green light to continue its role as a leader in greenhouse gas regulation. At the same time, they provide regulators with additional tools to tighten restrictions on power plants that upgrade their facilities.

The first of the two opinions, *Massachusetts v. Environmental Protection Agency,* is likely to have far-reaching effects throughout the country, particularly in Connecticut. In the Massachusetts case, a 5-4 majority ordered the EPA to justify its decision to forgo regulation of carbon dioxide and other greenhouse gas emissions from automobiles. The Supreme Court ruled broadly that the EPA has the authority to regulate both carbon dioxide and other greenhouse gases, laying the groundwork for stricter carbon dioxide controls for automobiles and other sources of carbon dioxide.



Connecticut has been one of the leading forces in greenhouse gas regulation, playing a significant role in the coalition of 12 states that originally sued the EPA to regulate such emissions.

In reaching its decision, the high court held that the Clean Air Act gives the EPA the authority to regulate greenhouse gas emissions as pollutants, and that the EPA could decline to regulate such emissions only if it determined that such emissions do not contribute to climate change.

In its defense, the EPA argued that, because other countries, such as India and China, significantly contribute to greenhouse gas emissions, it has no duty to regulate such emissions, particularly since regulating automobile emissions would have a negligible impact on global warming as a whole.

Writing for the majority, Justice John Paul Stevens rejected that argument and held that "a reduction in domestic emissions would slow the pace of global emissions increases, no matter what happens elsewhere."

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'Historic Victory'

In addition to having far-ranging impacts on the issues of climate change and EPA's broader ability to regulate greenhouse gases, the case is of significance due to the local impact the decision will likely have.

Connecticut, as part of the Regional Greenhouse Gas Initiative, has been one of the leading forces in greenhouse gas regulation. Moreover, Connecticut played a significant role in the coalition of 12 states that originally sued the EPA to regulate greenhouse gas emissions.

Leaders in state government seem willing press their recent successes on the greenhouse gas regulation front, and it appears that more regulation may be coming. Connecticut Attorney General Richard Blumenthal hailed the recent decision as a "huge, historic victory," and vowed to continue "to fight for aggressive action to curb global warming—including our lawsuit with other states to force emission reductions by power plants that are the nation's biggest carbon dioxide emitters."

Gina McCarthy, the commissioner of the state Department of Environmental Protection, echoed those sentiments by calling on the EPA to "grant a required waiver to allow Connecticut and nine other states to implement California's motor vehicle greenhouse gas emission standards," which would require automobile manufacturers to reduce greenhouse gas emissions from cars by up to 30 percent. According to McCarthy, the implementation of the Regional Greenhouse Gas Initiative will be a key issue for the DEP. Under the initiative, "one of [the DEP's] top priorities is implementing this historic cap and trade system to limit carbon emissions from power plants."

The exact shape and scope of the regulation contemplated by the DEP and the Attorney General's office is not clear at present. However, what is clear is that both offices remain committed to regulating greenhouse gas emissions in Connecticut and will seek to have upwind states lower their contributions to Connecticut's greenhouse gas budget as well.

Unanimous Ruling

Unlike the sharp division that marked the Supreme Court's decision in *Massachusetts v. EPA*, the other Clean Air Act case, *Environmental Defense v. Duke Energy Corp.*, found the court speaking with one voice. In the *Duke Energy* case, it unanimously ruled to overturn a lower court decision allowing *Duke Energy* favorable treatment under the New Source Review (NSR) provisions of the Clean Air Act.

Under the Clean Air Act, NSR is triggered whenever a source of air pollution makes physical changes or changes in its method of operation that might result in new or increased emissions. If it's anticipated that such changes might have an effect on emissions, the source must obtain a permit prior to construction or risk being in violation.

Under the Clinton Administration, power plants were targeted for NSR enforcement in certain instances where the power plants performed maintenance activities that allowed them to run longer and potentially generate additional pollutants.

The chief issue in the *Duke Energy* case was whether to measure emissions on an annual or hourly basis to determine if there had been an increase in total emissions that would trigger a permit requirement. Duke Energy argued for an hourly standard, since the improvements it had made to its facilities allowed for fewer emissions to be generated per hour. Because those same improvements allowed the facilities to be online a greater percentage of the time, however, the EPA countered that on an annual basis the facilities generated more pollutants and therefore required permitting.

The Supreme Court agreed with the EPA's annual measuring methodology, noting that actual emissions of pollution are better measured in terms of actual operations over time, rather than on an hour-to-hour basis.

Although the ruling is a victory for the EPA, several observers note that the ruling upholds stricter, Clinton-era interpretations of the NSR program, rather than the more relaxed, permittee-friendly approach favored by the Bush Administration. ■

Residential Rental License Program City of New Haven

On June 13, 2005 the City of New Haven passed an ordinance requiring Residential Rental Business Licenses. The ordinance provides that certain residential rental properties in New Haven must be licensed. The ordinance was adopted for the purpose of protecting the health, safety and welfare of the people of the City of New Haven and to prevent blight in the housing stock of the City.

The ordinance applies to non-owner occupied dwellings containing two or more rental units and to owner occupied dwellings containing three or more units. The ordinance exempts dwellings owned by the New Haven Housing Authority; section 8 units whose vouchers are administered by the New Haven Housing Authority; motels; hotel; rooming houses; condominiums; and temporary housing.

Under the ordinance, affected residential rental property owners must file an application, remit the required application fee and allow inspections of the rental properties by a City code inspector. Upon a finding that the dwellings comply with minimum housing code standards, the code enforcement officer is required to issue the license to the property owner. Licenses are effective for a period of two years from the date issued and are not transferable.

If the license expires, the property is transferred, or the license is voided, the license must be renewed or reinstated. Any change in ownership must be reported within thirty days of the transfer and the new owner must apply for a new license, including inspection of the property.

The ordinance authorizes the City to impose penalties under Connecticut General Statutes §7-148(c)(10)(A) or §7-148 (c)(7)(H)(xv) against property owners who fail to comply with the ordinance and the implementing regulations.

The complete text of the ordinance and implementing regulations are available online at:

www.cityofnewhaven.com

For additional information contact the Livable City Initiative at (203) 946-2966

STRUCTURING 1031 EXCHANGES CAN BE TRICKY TASK

■ From **BENEFITS** on PAGE 3

tify a replacement property as well as the improvements to be made to the property. The taxpayer may identify: (i) up to three properties; (ii) any number of properties as long as the aggregate fair market value (FMV) of the properties does not exceed 200 percent of the aggregate FMV of the exchanged properties; or (iii) any number of replacement properties if the FMV of the properties received is at least 95 percent of the aggregate FMV of all the potential replacement properties identified. The identification of the improvements should also contain as much detail as possible; typically construction plans or blueprints would be appropriate.

In addition to the identification timing requirements, as with a straightforward 1031 tax-deferred exchange, the taxpayer has 180 days to take title to the replacement property and complete the exchange. Once an appropriate replacement property has been identified, the taxpayer negotiates a Purchase and Sale agreement containing a cooperation clause with the seller, and then assigns its rights under the contract to the QI. The QI pays the seller with the proceeds from the sale of the relinquished property and directs the seller to deed the property to the EAT. While the replacement property is parked with the EAT, the improvements are made. Once the improvements are complete, the EAT transfers title to the taxpayer to complete the exchange.

However, given the short period of time (180 days) to complete the improvements, in many cases a portion of the improvements are not completed by the time that title to the replacement property is required to be deeded to the taxpayer. This failure to complete all of the improvements will not affect the overall validity of the exchange. However, any improvements not completed by the date the title is transferred will not be included in the value of the replacement property for exchange purposes. By way of example, if 40 percent of the building on the replacement property is completed at the time of the transfer of title to the taxpayer, then this 40 percent shall be included as like kind replacement property and the 60 percent not completed shall not be included.

Reverse Improvement Exchanges

In a reverse improvement exchange, the taxpayer purchases a replacement property first, and then parks it with the EAT while the taxpayer works to sell the property to be relinquished. This type of exchange would make sense when there is pressure to close on the replacement property due to competition, or the closing on the sale of the relinquished property is delayed beyond the closing for the purchase of the replacement property.

The taxpayer begins by negotiating and signing a Purchase and Sale agreement containing a cooperation clause with the seller, and then assigns its rights under the agreement to the EAT. The taxpayer would then provide the EAT with the funds necessary for the purchase of the replacement property from the seller. Typically, in this type of exchange, the loan to the EAT would most likely come from the taxpayer directly, or in the form of seller financing, since outside institutional lending may be difficult to secure because the EAT will be holding title to the parked replacement property and, therefore, will be the borrower in connection with any such loans. In some cases, the taxpayer may have a relationship with a lender, who will allow the taxpayer to arrange for financing on behalf of the EAT by guaranteeing the loan. Once the EAT has the funds, it would transfer the funds to the seller who would transfer title to the EAT. The taxpayer now has 45 days to identify the property to be relinquished as well as the improvements to be made to the replacement property. Additionally the taxpayer has 180 days to complete the improvements on the replacement property and cause the title to the replacement property to be transferred from the EAT. As with the forward improvement exchange, any improvements not completed by the date title to the replacement property is transferred to the taxpayer will not be included in the exchange.

The complexities and tax implications involved with the facilitation of a 1031 exchange are obvious and require thorough planning from both a tax and real estate perspective. There are numerous intricacies in terms of how to draft the exchange agreements, and the structuring of the parties which could have a serious impact on the ultimate validity of the exchange. However, if structured properly, the advantages from both an investment and tax perspective far outweigh the risks associated with improvement exchanges and make them a unique and in many cases, wise investment alternative. ■

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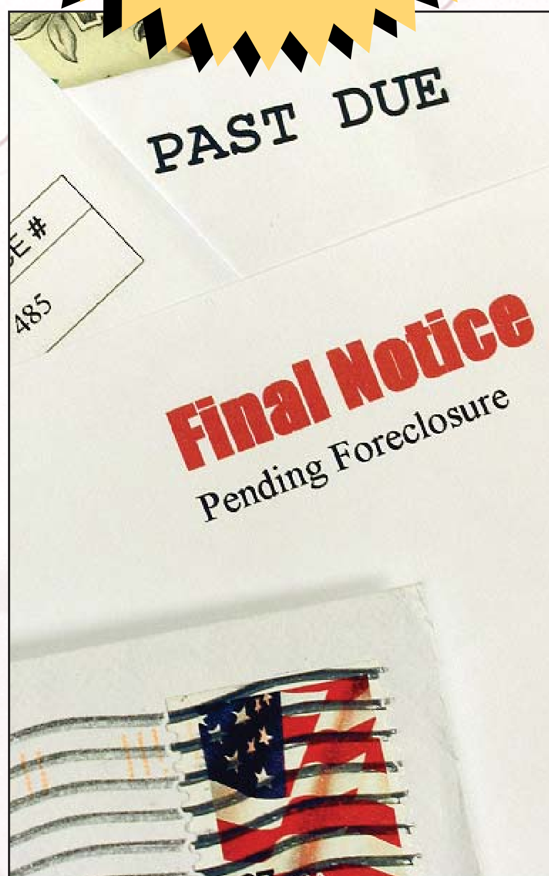

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