

Real Estate Advisor

First Quarter 2011

Protect Your Profits in a Joint Venture

Recent years have witnessed a considerable rise in joint ventures and strategic alliances.¹ Through partnering, many small companies are able to achieve business goals that would be too costly, time-consuming or difficult to accomplish otherwise, such as:

- New product innovation
- A wider circle of supplier relationships
- Expansion without adding employees
- Access to new markets
- Improved technology
- Enhanced profitability
- The ability to overcome legal and trade barriers
- Increased stability

Within the real estate industry, similar companies may join forces to capitalize on their complementary strengths. For an alliance to be successful, the businesses must be pulled together by some essential strategic force. In addition, the partners should have more strength when combined than they would have had independently. Finally, top executives from both companies must share a cooperative spirit and trust each other to resolve any difficulties.

A strategic alliance or joint venture must be a win-win situation. To prevent internal dissension, the business structure, operations, risks and rewards must be fairly apportioned between all members. At the operational level, careful coordination of plans and projects is critical. The alliance must offer an opportunity for growth and have a clear purpose, as well as concrete objectives, specific timelines, divisions of responsibilities and measurable results. In addition, the alliance must have the commitment and support of top and middle management – or be destined for failure.

If you believe your company might benefit from a strategic alliance or joint venture, the following five steps can help.

Step 1: Know your company's mission

Will you be able to achieve long-standing company goals more effectively as a result of the partnership you are considering? Will your company, through the proposed alliance, be forced to give up business practices that have previously been critical to its success? These are just two of the questions to ask before becoming part of any strategic alliance or joint venture. Without knowing your company's mission, you won't be able to answer correctly.

Step 2: Decide if an alliance is right for you

Joining forces is not always the best answer. If your partner is a direct competitor that shares much of the same geographic area, an outright acquisition may be the best approach to avoid potential turf conflict.

Step 3: Focus on the strengths of both partners

Find the areas where the alliance results in an advantage in either size or experience, and focus on those areas. Choose the right partner. It's rare for one partner to succeed when the other fails. Plan so that both partners bring something to the relationship and both partners benefit.

Step 4: Set realistic goals for the strategic alliance or joint venture

Too often, partners set unrealistic goals, making failure and the "blame game" nearly inevitable. By setting attainable goals early, partners can more smoothly navigate the rough waters that often accompany the early years of a partnership.

Step 5: Reward all participants fairly

In the end, partnerships don't work if one partner takes advantage of the other. Soon enough, the losers will understand their position and pull out of the effort. For any partnership to grow and prosper, the rewards must be economically beneficial to both sides.

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Understanding the Bad Debt Deduction in Today's Real Estate Market

Introduction

We are three years into a severely depressed real estate market and many developers and homebuilders are continuing to seek new sources of financing. Such financing might include alternative funding arrangements with existing investors or with new sources. Conversely, lenders (both new and old), must evaluate the borrower's ability to repay his or her debts. Section 166 of the Internal Revenue Code ("Code Section") allows a bad debt deduction on wholly or partially worthless debt that is not considered a security as defined under Code Section 165(g)(2) (C). Only a bona fide debt qualifies for purposes of Code Section 166. A bona fide debt is a debt that arises from a debtor-creditor relationship. In this article we discuss the character and timing of the bad debt deduction within Code Section 166.

Business Bad Debt

The term "business bad debt," as defined in Code Section 166, is (1) a debt that was created or acquired in connection with a trade or business of the taxpayer, or (2) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. Treasury Regulation Section 1.166-5 provides that the determination of whether a debt is a business bad debt or a non-business bad debt depends on the relationship between the worthless debt and the taxpayer's trade or business when the loan was made or became worthless. The most common example of bad debts dealing with the first rule are trade accounts and notes receivable acquired or incurred in the ordinary course of a trade or business for services rendered or from the sale of property held primarily for sale to customers.

The second rule has been a difficult area of determination and has been fraught with much litigation between the IRS and taxpayers. A taxpayer is not permitted a business bad debt deduction unless the taxpayer can establish that it is engaged in a trade or business, and that the acquisition or worthlessness of the debt is proximate in relation to the conduct of such trade or business. The standard for determining a proximate relationship was set in the U.S. Supreme Court Case, *E. Generes*.¹ The Court closely examined the language in the statute pertaining to a "proximate" relationship that is required by the statute in order for a taxpayer to claim a business bad debt deduction. The Court decided that a dominant motivation must exist in determining a proximate relationship. Some common types of debts that may avoid non-business status include loans (but certainly not limited to just these types of loans) made in the course of promoting, financing, or lending activities of the trade or business and are germane to such business on a regular and continuous basis. As is often the case, this is largely based on facts and circumstances.

¹ E. Generes, SCt, 72-1, USTC ¶9259, 405 US 93.

Non-Business Bad Debt

The code and regulations do not provide an affirmative definition of non-business bad debt. Instead, it is described as a debt other than (1) a debt created or acquired in connection with a trade or business of the taxpayer, or (2) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. Again, this falls into the debt having a "proximate" relationship to the taxpayer's trade or business. As with most cases, the determination is based on facts and circumstances; however, the use of the borrowed funds is not considered when determining business or non-business debt.² The underlying principle for the non-business provisions is to put non-business investments in the form of loans on the same footing as other non-business investments.³

If a non C-corporation taxpayer establishes that a non-business debt has become wholly worthless within the taxable year, the loss will be treated as a loss from the sale or exchange of a short-term capital asset. As such, the loss is subject to the capital loss limitations and the capital loss carryover rules. Moreover, a loss on a non-business debt can only be claimed when the debt has become wholly worthless, and no deduction is allowed for a non-business debt that is only considered partially worthless.

Worthlessness

Where the surrounding circumstances indicate that a debt is worthless and uncollectible, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under Code Section 166. It should be noted that legal action to enforce payment is not required to prove worthlessness, if the legal action would in all probability not result in an enforceable judgment in favor of the lender. However, with respect to non-business bad debt, IRS Publication 550 (Investment Income and Expenses) states that the following information must be disclosed in the tax return for the year the non-business deduction is claimed:

- A description of the debt, including the amount, and the date it became due;
- The name of the debtor, and any business or family relationship between you and the debtor;
- Efforts the creditor made to collect the debt; and
- An explanation of why the creditor decided the debt was worthless.

Note that the taxpayer has the burden of proof to establish that a debt is worthless and that the deduction should be claimed in the first tax year where facts and circumstances support the debt's worthlessness.

To learn more, go to: <http://mcgladrey.com/Publications/Real-Estate-Advisor>

² Reg. Section 1.166-5(b)

³ Putnam v. Commissioner 352 U. S. 82, (1956).

Using Alternative Dispute Resolution to Avoid Litigation

In the past, you may have had to resort to litigation to collect overdue payment. And if you've been involved in litigation, you're probably aware that the costs associated with it – such as attorney and expert witness fees as well as staff time – can eliminate job profit. Even a minor lawsuit can involve tens of thousands of dollars.

Thankfully, you can control litigation costs through alternative dispute resolution (ADR). The goals of ADR are to reduce the time wasted by both parties and avoid both legal expenses and the animosity of the litigation process. ADR methods include:

- **Negotiation** – The parties resolve difference among themselves by coming up with a mutually agreed-on solution.
- **Mini-trial** – A neutral person presides over the trial, which takes place over a set time and generally results in a nonbinding settlement.
- **Dispute board** – An independent group specified in the contract resolves differences and makes either a nonbinding or binding decision.
- **Mediation** – Both parties agree to have an independent party make a nonbinding decision or help the parties in their negotiations.
- **Arbitration** – The most formal ADR method, in which a third party makes a binding decision to settle the disagreement.

Looking for the Resolution Clause

Arbitration and mediation are the most commonly used methods. If you are involved in a dispute, examine your contract to see how relief is to be sought.

If the contract designates arbitration as the ADR method, the formal process can be used. The wording of the arbitration clause may be something like: "Any controversy, dispute or disagreement arising out of this agreement or the breach thereof shall be settled by arbitration in accordance with provisions set forth in paragraph [X] of this agreement, and any award shall be enforceable in any court having jurisdiction of the parties."

Alternatively, a contract may include a provision for mediation: "If, during this contract, the parties are unable to resolve a dispute or controversy among themselves, they shall first endeavor to settle such dispute in a nonbinding, voluntary manner by referring same to [x firm] prior to filing for arbitration or having recourse to a judicial forum."

Arbitration and mediation can help you reach a settlement that satisfies all parties. It's crucial, however, to understand the steps involved in each process.

Arbitration

A typical arbitration follows these five steps:

1. **Agree to arbitrate.** Both parties must willingly agree to use the arbitration process.

2. **Select an arbitrator.** Each party reviews an identical list of proposed arbitrators, eliminates any objectionable names and selects an arbitrator from those remaining.
3. **Prepare for the hearing.** This includes selecting a hearing date, interviewing witnesses, assembling documents and papers, and reviewing relevant evidence.
4. **Present the case.** Arbitration hearings are less formal than a court case. A typical hearing involves opening statements, presentation of evidence, introduction of witnesses and closing statements.
5. **Accept the award.** This is the decision reached by the arbitrator and is legally enforceable.

Keep in mind that because arbitration is the most formal ADR method, costs can be high if the parties become adversarial. Mediation differs from arbitration because it's a voluntary, non-adversarial process. If mediation fails, neither party has given up any of their contract or litigation rights unless they agreed to make the mediator's decision binding.

Mediation

The agreement of both parties, the request of one party or a mediation firm can initiate the mediation process. Here's how it typically works. The parties:

1. **Agree to mediate.** Both parties agree to mediate the dispute. Many times one party can persuade the other party to mediate by explaining the process, its cost-effectiveness and its timeliness.
2. **Select a mediator.** The parties share and review biographical information on prospective mediators. Either party can object to a proposed mediator, in which case new mediators are submitted and reviewed until one acceptable to both parties is selected.
3. **Submit a statement of position.** Each party submits its version to the mediator. All information and material is considered confidential.
4. **Attend the mediation session.** Both parties are generally present at the initial sessions. Subsequent sessions may be separate or joint as the mediator deems necessary to move the parties toward a settlement.
5. **Review the settlement decision.** Settlement through mediation is an agreement and is always within the control of both parties. Therefore, the decision is generally nonbinding.

Staying out of the courts

Arbitration, mediation, negotiation, mini-trials and dispute boards are effective ways to reduce the need for litigation. For more information on these ADR methods or for assistance in interpreting a contract's ADR clauses, please contact us. We'll be glad to help your company solve disputes cost effectively.



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