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Tax law gives condo builders a new headache

■ IRS tax rules require developers to pay up on projects they're still building. That burden could slow down the pace of new construction.

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Call it the law of unintended consequences.

South Florida condo developers thought they had struck gold when they realized they could finance their luxury towers with hefty, all-cash deposits from buyers. No more worries about an economic downturn scattering investors to the wind. No more begging banks on bended knee for a loan to get a project off the ground.

But the new deposit structure has a downside for developers: It's made them vulnerable to federal


COOPER

accounting rules that require condo builders to pay tax on projected income from towers they are still building.

In other words, on money they don't have.

"It's basically phantom income," said Edward Cooper, director of tax services at the South Florida accounting firm Berkowitz Pollack Brant.

That means that in order to avoid substantial In-

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ternal Revenue Service penalties for not paying taxes, developers may have to dig the money out of their own pockets, or sell valuable land in order to generate funds. In the current banking climate, getting a loan to cover the costs could be tough — and would create the same types of risk the deposits were designed to avoid.

In response, more aggressive developers are arming themselves with legal opinions showing they don't actually need to pay the taxes until the projects are finished.

They're caught between an accounting Scylla and Charybdis: either bite the bullet and pay the taxes from their own pocket — if they have enough cash or land on hand — or leave the IRS hanging and hope the auditors don't come calling.

It's a touchy subject: Almost no developers were willing to talk on the record for this story.

The ones who will speak publicly aren't happy.

"It's detrimental to business," said Neil Fairman, president of the Plaza Group, a developer building a $600 million luxury condo-marina complex in North Miami Beach. "It stifles cash flow and it prevents us from investing in other projects because we have to make plans to pay the taxes in advance before we get the profits from our condominium sales."

The tax rules present a problem for South Florida's overall real estate market, which is heavily slanted toward condos. Seventy-eight condo towers housing more than 9,200 units are under construction in Miami-Dade County east of Interstate 95, according to Cranespotters.com. An additional 127 towers have been planned or proposed. Broward County has 29 towers under construction with about 1,600 units, and another 50 in the pipeline.

And the IRS issue is just one of many developers face: Land prices and construction costs are skyrocketing, and sales are slowing.

"The market is getting more and more competitive and that means tighter margins for developers," said Peter Zalewski, a South Florida condo analyst who runs CraneSpotters. "The tax issue is another burden that's going to make developers dig into their pockets. Some developers might simply say that when you look at all these factors it makes more sense to hold off on a project until the market is a little stronger."

Privately, developers are kicking and screaming about the tax rules.

"It's an unfair law," said Alan Lips, a partner at the Miami-based accounting firm Gerson Preston Robinson, which has several real estate clients. "You don't know when you're going to close, yet you're recognizing income on the construction before you've received dollar one of real income."

"Very few developers took this into consideration initially," Lips added. "Larger groups already understand the issues but smaller developers are less informed. It's not going to stop development but it is a serious financial headache."

Real estate development can be a risky game. Builders don't see income until after their projects are done.

But IRS rules state that condo developers must recognize revenue during construction based on the income they expect to earn when the project is done. The amount of tax they then must pay depends on how much of the building they've built and how many units they've sold.

For example, if a developer completes 50 percent of construction in a project's first year and sells 50 percent of its units, the company would be expected to pay tax on 25 percent of its projected profits for the entire tower. But the developer won't actually see the cashflow needed to pay the tax until the building is finished, which could take several years.

"It could be a real negative and nuisance for developers, especially on big projects and underfunded projects," said Jack McCabe, a housing market analyst based in Deerfield Beach. "Some of these billion-dollar projects, they could be facing a substantial tax bill."

The pay-as-you-go rules apply only to condo developers, not single-family home builders — leading many in the real estate industry to criticize the regulations. The rules were originally designed for contractors working on big construction projects. But an exception carved out for home builders failed to include condo developers.

The tax regulations weren't as much of a problem in the last cycle. They apply specifically to "long-term contracts" between developer and buyer.

In the last boom, buyers only put down deposits of 10 to 20 percent for condo units. Developers made the legal argument that these agreements were simply options-to-buy, not binding contracts, and therefore the rules didn't apply. Instead of paying taxes during construction, developers paid after completion, when they had cash on hand. The IRS didn't challenge them.

The new deposit structure of today's boom changed all that: If buyers are putting down 50 percent deposits, there's no question they have entered into a contract with developers. If developers have a contract, they must abide by the pay-as-you-go rules, which are known as the "percentage-of-completion" accounting method.

A resolution is in sight — though it's not yet clear when it will materialize.

During the downturn in 2008, federal officials and the nongovernmental private groups that set national accounting standards proposed new rules that would allow condo developers to pay their taxes after finishing projects. Those more favorable rules are called the "completed contract" method.

But the gears of government grind slowly. The regulations still haven't gone into effect, and the public comment period designated by the IRS doesn't end until September 16.

"There is no set time frame for regulations to be issued and/or become final," wrote Michael Dobzinksi, a spokesman for the IRS, in an e-mail.

In the meantime, many developers are turning to lawyers for guidance. Will the IRS come after them if they pay their taxes after their towers are finished, instead of paying as they go?

"Our law firm is comfortable relying on these proposed regulations," said Jeffrey Rubinger, a partner at Bilzin Sumberg. Rubinger said several developers have come to the law firm seeking advice.

Lips, of accounting firm Gerson Preson, has advised clients that they "can use the proposed regulations with a caveat from a law firm saying that it's more likely than not that this is OK."

But it's a gamble. "Cautious clients, especially those with institutional dollars, don't want to take the risk," Lips said.

For some real estate players, there's too much uncertainty.

Plaza Group is taking the "conservative viewpoint," and paying its taxes as it goes, Fairman said. "We don't want to take the chance and get fined and have to pay the penalties," he said.

"My opinion is that the proposed regulation is not valid at this point," agreed Cooper, the Berkowitz Pollack accountant. "I tell my clients that relying on the proposed reg is questionable. It could lead to penalties if the [IRS] decides to impose penalties for failing to adhere to the regulations."

"I make an annual call to the IRS to find out if there's any movement on finalizing the regulation," Cooper added. "I'm told that it's still a priority, but not the highest one."