

Reflections on Real Estate

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What to Look For When Buying Land

By Mike Souza

When contemplating the purchase of land, especially when acquired with the intent of eventual development, it is vitally important to carry out thorough due diligence. Due diligence should include the process of researching all attributes of a property to determine its strengths and weaknesses. In this article, we will explore areas which should be researched when analyzing a property before purchase.

TOXICS

Toxic contamination is the single most difficult issue facing property owners today. If a property is determined to have contamination, it will be impossible to finance, very difficult to develop, and resale will be jeopardized. Contamination can take many forms and needs to be looked for in a number of places.

The first place to start is to hire an environmental consultant to do a Phase

I investigation of the site. For approximately \$2,000, the consultant will search county and state records of the site and neighboring properties, do a site visit, and a title search. Any problems that have been previously discovered on the property or neighbor-

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ing properties should show up in a Phase I. The Phase I will also discover any obvious signs of contamination on the site, such as evidence of a gas tank or dump site.

There are often indications that further research than a Phase I is necessary. These include the disclosed

presence, currently or in the past, of an underground fuel tank, any easements for gas or oil pipelines that currently or in the past were under the property, dump sites, heavy use of pesticides or herbicides, or a neighboring property with any of these indicators.

If any of these conditions exist, it is advisable to do a Phase II study. This requires submitting a work plan with the county and taking soil and groundwater samples to determine if there are any contaminants. This step is much more costly and could end up putting the property on clean-up lists with the county and state. If you are a seller, and a potential purchaser feels there is a need to conduct a Phase II investigation, it is advisable to involve legal counsel to determine exactly how to proceed. It may be a safer move to lose the sale and

see Land page 2

Bush Passes Bonus Depreciation Allowance

Until recently, owners and managers of nonresidential buildings had to depreciate the leasehold improvements they made to tenants' leased space over a period of 39 years. For five years, the National Association of REALTORS® (NAR) and its commercial affiliates have sought to reduce this unrealistic depreciation period to a more reasonable 10-year span. Finally on March 9, President Bush signed legislation that created a so-

called "bonus depreciation" allowance. This provision permits commercial owners to deduct 30 percent of the cost of leasehold improvements in the first year they are installed. The remaining 70 percent of the cost is still depreciated over 39 years.

As an example, assume that a landlord makes improvements for a tenant costing \$100,000. When the improvements are placed in service, the landlord is able to claim a bonus depre-

ciation deduction of \$30,000 (30% x \$100,000). The remaining 70 percent of the cost is depreciated on a 39-year schedule. This means that the landlord may take a deduction for 1/39th of the remaining \$70,000 (in addition to the \$30,000 deduction) in the year that the improvements were put into service. The depreciation schedule then continues based on 1/39th of the \$70,000 each

see Allowance page 2

Allowance continued

year for the life of the improvements.

At the end of the lease, if the leasehold improvement property is abandoned, any balance remaining in the depreciation account may be deducted. Since there is no detailed guidance on what constituted an abandonment, whether property has been abandoned will vary depending on each property and the circumstances involved. At the termination of a lease, owners may wish to review what leasehold improvement property can be treated as abandoned with their tax advisors.

Under the new rules, any improvement made pursuant to a lease to the interior space (but not common areas such as elevators or lobbies) of a nonresidential building qualifies for bonus depreciation. The leased area must be occupied solely by the tenant (or subtenant) for whom the improvement was made. Thus, improvements to owner-occupied space or space leased to related parties such as family members or a subsidiary of the owner do not qualify.

The bonus is available only when the building has been in service for more than three years. The purchaser of an existing building that is more than three years old

will qualify for the bonus depreciation for leasehold improvements made pursuant to leases entered into after the purchase.

Expansion of a building—such as an addition—or improvements to the internal structural framework of a building do not qualify for the depreciation bonus. These are considered a part of the real property and must still be depreciated evenly over 39 years.

The bonus may be taken by either the landlord or the tenant (or subtenant), but not by both. Agreements for allocating the deduction and paying for the improvements will take place in the ordinary course of negotiating lease terms.

The new provision is not permanent. It is available only for leasehold improvements made after September 10, 2001, and before September 11, 2004.

In order for property placed in service after September 10, 2001 to qualify for the bonus depreciation, the contract for the improvements' construction must have been signed after September 10, 2001. If property is contracted for, but not yet placed in service, as of September 11, 2004, the bonus will continue to be available so long as the property is placed in service before January 1, 2005.

Land continued

handle the problem on your own terms.

When due diligence discovers the presence of contaminants on property you are interested in purchasing, or property you are trying to sell, it is imperative that you seek expert advice immediately. The outcome of the investigation could drastically impact the value of the property.

PRELIMINARY TITLE REPORT

The second most important area to research is the title of the property. A preliminary title report will disclose any encumbrances on the property. Be especially mindful of easements. Many easements were recorded long ago and no longer affect the property. It is important that you determine the location and current use of all easements over a property. Easements often restrict the use of the property, so their

location is very important.

Another item to look out for is an oil and gas lease. Although an oil and gas lease in and of itself is easy to deal with, it takes on a whole new dimension if it includes surface rights. Many oil and gas leases with surface rights give the holder of the lease the right to drill anywhere on the property, effectively excluding the property owner from building anything on the property. Surface rights can be worked around, but you need to be certain you understand the terms of the lease.

Other items a preliminary title report will disclose include unpaid taxes, bonds and assessments, loans, leases, option agreements, and financing statements. Each and every exception on a title report should be understood and approved before a

see Land page 4



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According to Tracy's most recent Urban Management Plan, which describes a total planning area of 72,570 gross acres, Tracy has more than 6,700 acres of undeveloped land designated for industrial development and almost 2,000 acres designated for commercial/retail development.

City of Tracy Economic Development Strategy June 2002

Land continued

property is purchased.

PRESCRIPTIVE EASEMENTS

An easement by prescription is defined as follows: "Continuous and uninterrupted use for five years where such use is hostile and adverse (i.e., without license or permission from the owner), open and notorious (i.e., the owner knows of the use or may be presumed to have notice of the use), exclusive (i.e., although use is not necessarily by one person only, yet it is such as to indicate to the landowner that a private right is being asserted), and under some claim of right" (*California Department of Real Estate Reference Book, 1987-88, page 103*).

Most often in land transactions, prescriptive easements are found where irrigation districts deliver or drain water over the property without a recorded easement, or in instances where access is gained over a property. Upon a site inspection, it is important to identify all water delivery and drainage facilities and roads, determine who uses them, and check if an easement exists on title for that use. If an easement does not exist, it is possible someone has a prescriptive easement over the property. There are cases where holders of prescriptive easements charge a property owner to release their claim on the property. If you think there is a prescriptive ease-

ment, research it before you purchase the property so you do not have any surprises if you later want to obstruct the use of that ditch or road.

ENVIRONMENTAL ISSUES

Any purchaser of land must be wary of what critters and habitats exist on a property. Endangered species, wetlands and vernal pools are commonly found on properties in San Joaquin, Contra Costa, and Alameda Counties. One

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should enlist the help of a real estate professional who is familiar with endangered species and habitats which are indigenous to an area, and help determine if the property being considered is likely to be home to such things. The existence of an endangered species or habitat could require mitigation affecting the cost of future development.

San Joaquin County has developed a county-wide habitat conservation plan (HCP) which designates certain portions of the county as habitat conservation areas. Contra Costa County is also in the early stages of developing an HCP

for east county lands. It is important to know if property you are purchasing is in an HCP, and what effect an HCP might have on the property.

UNRECORDED LEASES

Not all leases will be recorded and show up on the preliminary title report. A potential purchaser must verify with the seller what leases exist on the property and review all the lease documents.

GENERAL PLAN DESIGNATIONS & ZONING

General plan designations and zoning should be researched prior to all property purchases. Be sure to check both county and city jurisdictions as county property may also have a designation in a city general plan. Also be sure the property can be used for what you intend to use it for, or try to develop a comfort level for whether or not the designation and zoning can be changed.

The aforementioned issues are not intended to be all inclusive but are used here as an example of some of the areas which need special attention when making a land purchase.

As is evident in this article, there are numerous items which must be researched before you determine a piece of property is right for you. At SR&D we have extensive experience in due diligence research, and would be happy to help you determine the suitability of a property for your intended use.



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