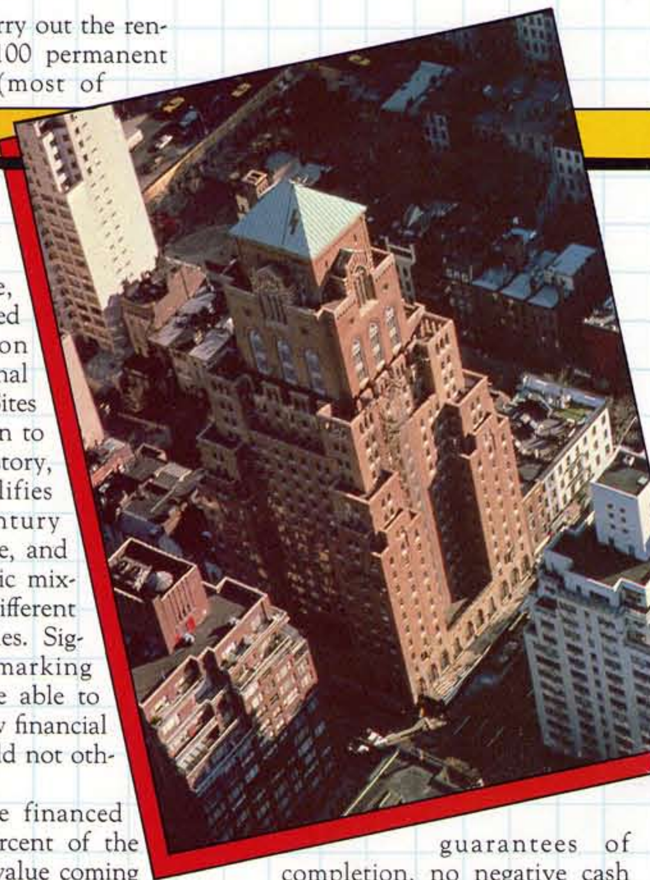
plus property by the General Services Administration, which then invited a local non-profit preservation group—the New York City Landmarks Conservancy—to choose a developer to renovate the building. Teitelbaum Holdings was given this assignment in 1977 and, because of the building's large size, decided to do a mixed-use facility consisting of 347 cooperative apartments and a commercial mall.

The building is located in an area that is undergoing transition, mainly through the conversion of many old and derelict warehouses to residential units. Because of the demonstrated strong market demand for these and other types of facilities, it was decided that the first three floors of the building should be a mix of commercial space (at present market rates) and semi-public space (at a special discounted rate) with the remaining seven floors to be composed of two separate cooperative apartment developments. In addition, the roof will contain an additional level of penthouse apartments along with a full-service fitness center, complete with swimming pool and running track.

## The Barbizon Hotel

New York's Barbizon Hotel, on the other hand, was a totally different kind of landmark project. Known worldwide as a hotel for women, it had for decades served as home to many a young lady who wished to launch her career in Manhattan. When we bought the property, however, it had declined into a single room occupancy (SRO) hotel with a dilapidated infrastructure and over 100 permanent residents who were protected from relocation by rent control laws. Despite the fact that only 25 percent of the rooms had private bathrooms, the building still worked best as a hotel. So Teitelbaum decided to convert it into a first-class hotel, retain some of its smaller rooms, and carry out the renovation with those 100 permanent residents in place (most of them were relocated to their own wing in the building).



At the same time, Teitelbaum also applied to have the Barbizon placed on the National Register of Historic Sites and Places. In addition to the hotel's social history, its structure exemplifies early twentieth century skyscraper architecture, and its facade is an eclectic mixture of at least six different historic building styles. Significantly, by landmarking the Barbizon we were able to take advantage of new financial mechanisms that would not otherwise be available.

Both projects were financed similarly, with 70 percent of the completed appraised value coming from Manufacturers Hanover Trust Company. The equity needed to complete the rehabilitation work was raised through a partnership that Bache Halsey Stuart Shields syndicated on a national basis.

## Structuring the Barbizon syndication

The Barbizon syndication, aside from some new wrinkles introduced to take advantage of the tax benefits provided under ERTA, was structured along conventional lines. The syndication partnership provided all of the equity funds required for the completion of the project, in this case $9.4 million. Their share of the profit and losses, tax credits, and cash flow is 85 percent, while Teitelbaum retains a 15 percent interest. Investors are protected from making additional contributions through Teitelbaum's guarantees of completion, no negative cash flow, and guarantee of a maximum project cost of $32.5 million.

Further, Teitelbaum has entered into a long-term contract for the management of the hotel that provides for a base management fee as well as an incentive fee based on its performance. It is anticipated that during the first five years the project will generate $17 million of cash flow, $7.5 million in tax losses, and $4 million in ITCs. With some additional tax benefits provided in the syndication partnership, an investor's internal rate of return in the Barbizon project is roughly 80 percent.

Obviously, one of the prime factors contributing to this significant return is the historic rehab credit. To ensure Teitelbaum's eligibility for the ITC, the deal had an unusual twist. Current tax law requires that qualified rehab costs exceed the greater of $5,000 or the adjusted cost basis of the property. The total purchase price of the building was approximately $16 million, and Teitelbaum's anticipated costs were $16 million. Had there been any cost savings, there was a chance Teitelbaum's rehab costs would not have exceeded the cost basis of the property. Thus, simultaneously with the purchase of the property by the hotel partnership, Teitelbaum, as the developer, purchased the top five floors for $5.7 million—thus reducing the adjusted cost basis of the building and assuring that Teitelbaum would meet the "significant rehabilitation" test to be eligible for the 25 percent ITC. Teitelbaum is now developing the five floors as a separate project.

## Structuring the Archives syndication

While the structuring of the Barbizon deal was relatively straightforward, the Archives project was quite another story. Teitelbaum calculated that the building could be developed at just under $100 a square foot with a sellout of over $200 a square foot. The syndication investors were also given many guarantees, including:

- a total project cost not to exceed $63.5 million
- purchase of the investor's partnership units at a fixed price of $31 million
- a guarantee of no negative cash flow, and
- a full completion guarantee

Here again, the ITC will be a major benefit. Because construction is going to take more than two years, Teitelbaum will elect to take advantage of the 25 percent credit on a progress payment basis—i.e., as construction costs are incurred instead of at the end of the project. This means Teitelbaum's investors will get a return through tax benefits before the project is completed and before all the residential units are sold.

The tax situation for investors is also quite advantageous. The reason: Teitelbaum has structured the deal so that upon sale of the residential units, investors will be assessed at capital gain rates rather than at ordinary income rates. To accomplish this, Teitelbaum divided the project into two separate partnerships. One owns the cooperative units, and the other owns the commercial areas of the building. Initially, the investors will own a portion of both—although their ownership interest will be different in each partnership. In the long run, however, they will retain ownership of only the commercial facilities.

Things are a bit more complicated on the residential side. If an investor sold a cooperative unit, the sale would be taxed as ordinary income, generally at the 50 percent rate. About a year after the partnership is formed, however, an investor in the Archives has a right to put his or her *partnership interest* to the developer at a predetermined aggregate price of $31 million. Because the investor is selling an interest in the partnership rather than an inventory item (i.e., residential unit) it is a capital transaction and thus taxed at capital rates.

In addition to this benefit, Teitelbaum has also increased the percentage of the total project cost eligible for the historic rehab tax credit. Basically, when Teitelbaum sells its co-op units, the buyer is getting a space that Teitelbaum has defined in an unusual manner. Through its lease, the residential partnership owns the *interior space* of each apartment—i.e., the space as measured horizontally from the exposed surfaces of the interior walls, doors, and windows that divide each apartment unit from the others and from the common areas—and measured vertically from the exposed surfaces of the floors and ceilings.

In other words, the commercial partnership will own the walls, the corridors, and all other mechanical parts of the building as well as the commercial and semi-public areas.

Traditionally, one would expect to allocate the ownership in such a building at 75 percent for the residential and 25 percent for the commercial. Under this structure, however, Teitelbaum will retain ownership of (including the obligation to maintain) 61 percent of the entire project (designated commercial) with 39 percent sold as residential. As a result, the percentage of the project cost eligible for the ITC is significantly increased, giving the Archives a rehab credit in excess of $8.5 million.

This is one of the reasons why the syndicating partnership was able to raise $16.5 million in less than 48 hours. In fact, the syndication was oversubscribed, and units wound up being sold on a lottery basis. The investors contributed $1.2 million in cash ($12,000 each) secured a bank loan of $11.8 million collateralized by their notes and letters of credit, and provided notes and letters of credit for the balance. In return, over the first five years the investors will receive net cash distributions above their return of capital of $18.4 million, tax losses of $13 million, and tax credits of $5.7 million. These benefits will provide each investor with an IRR in excess of 100 percent.

Building costs have created their own prohibitions on new construction. However, there are many situations where the existing stock of historically significant buildings is much more valuable than the property's new construction potential. Owners and investors can be rewarded for adaptive reuse—even if it doesn't involve landmark buildings. The new tax act has created but one of the major incentives that make redevelopment feasible as well as profitable. □

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