

## **COMMERCIAL ESCROW SETTLEMENT**

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A commercial escrow is one that involves the transfer or encumbrance of property other than residential, such as office, research, retail and industrial properties.

We recognize that there is no such thing as an easy commercial transaction. Each transaction is unique and the main role of the settlement agent becomes that of a coordinator and problem solver. Often a transaction will become so complex that the settlement agent is the only person who has a grasp of the entire transaction and all closing requirements. Handling commercial escrows requires unique skills on the part of the settlement agent.

### **Opening the Escrow Transaction**

An escrow transaction is commonly opened by the real estate agents or attorneys involved in the transaction. The specific transaction information required to open the order may be communicated to the escrow settlement officer by telephone, facsimile, by email or in person. The following minimum information is required at the time of opening:

- Sale Price/Loan Amount
- Property Address(es) and/or Legal Description
- Assessor's Parcel Number(s) (if available)
- Policy Liability Amounts (if available)
- Owners/Borrowers
- Buyers
- Contact Information for Professionals (such as listing/selling agent, attorneys and lenders)

### **Fee Quotes**

Escrow closing fees are provided by quote based on the closing location and the complexity of the transaction. To obtain a closing fee quote, use the Find an Office option located on this page to find an escrow closing office near you.

### **Deposit Funds**

Commercial escrow deposits are typically large sums of money held for long periods of time. Frequently multiple deposits are required through the course of the transaction as contract contingencies are fulfilled. At the time of contract negotiations, the principals to the transaction will typically decide which party will be entitled to any interest earned on those deposits at the successful close or cancellation of the transaction.

The party entitled to the earned interest will have to complete an authorization provided by the escrow settlement officer, as well as a Form W-9 providing the taxpayer identification number for the earning party. These two documents are required by the escrow settlement agent and the bank that will be required to hold the deposit in trust on behalf of the escrow settlement agent and the principals.

The bank will report the interest earned to the Internal Revenue Service based on the taxpayer identification number provided.

### **In General**

The escrow settlement agent will work closely with the principals and their representatives to ensure title issues are resolved, that authoritative documents are requested from the principals, future deposits and release of funds occur within the agreed upon time constraints.

## **Coordinating Title Issues**

Escrow settlement agent will make requests for inspections, survey requirements, owner's affidavit, leases (recorded and unrecorded) prior to closing the transaction.

## **Information Gathering**

During the contingency period, the settlement agent will work to gather the information and documents necessary to prepare the closing statement and closing documents. The list of documents and information required by the settlement agent may be revised throughout the course of the transaction as documents and information are received, the terms of the purchase agreement change, or if the parties request any additional services or products.

The initial list of documents and information needed by the settlement agent are as follows:

- Organizational Documents for the Entities
- Copies of Leases
- Rent Roll with security deposits
- A list of service contracts or other items to be prorated at closing
- A list of personal property to be included in the Bill of Sale
- At least two (2) copies of the survey
- Original documents as attached as exhibits to the contract for execution at closing

## **Organization Documents and Verifying Authority**

When the seller or buyer is not a natural born person, the settlement agent and title insurer must verify that the entity was properly formed and that the person(s) signing the documents are duly authorized and have the power to sell and/or loan money, or to buy and/or borrower money. If the closing documents are not signed by a duly authorized representative of the corporation, trust, company, partnership, etc., the transaction may be voidable.

## **Demand/Lien Information**

The settlement agent will obtain information from the Seller for all existing liens which will have to be satisfied or removed at closing. This includes information on trust deeds or mortgages to be paid off, and also includes tax liens, judgments, and defects in title or unrecorded leases. If a Seller is deceased, probate documents will be required. A Seller in bankruptcy will need a court order.

## **Prorations**

There may be many items to prorate in a real estate transaction. As in any other transaction, how an item is prorated will depend upon whether or not it is paid in arrears or in advance.

Items to prorate at closing include:

- Real estate taxes
- Personal property taxes
- Special assessments
- Rents
- Property owner's assessments • Common area maintenance fees

## **Rents, Tenant Deposits and Estoppels**

The Rent Roll is a list of tenants and units, rents due and delinquent, and tenant deposits. It is customarily obtained by the settlement agent from the seller or property manager. Rent may also include other items such as rental tax, liability insurance, common area maintenance, taxes, etc.

There are two distinct methods to prorate rents at closing:

1. Rents actually collected
2. All rents, as if collected

The purchase agreement should state the manner in which rents are to be prorated. If not, the settlement agent must ask the question of both sides of the transaction.

Tenant deposits are not prorated, however, the entire amount of the deposits are transferred from seller to buyer at closing in one of two ways:

1. charge (debit) the seller and credit the buyer (usual practice); or
2. charge the seller and issue a check to the buyer (by special request)

Tenant deposits may include such items as security or damage deposits and last month's rent, which are usually itemized on the rent roll.

A Tenant Estoppel is a document signed by the tenant confirming the terms of the lease. By the nature of an "estoppel", the tenant would be estopped (prevented) from asserting any other rights in the future other than those stated in the lease.

Tenant Estoppels are typically a contractual issue between buyer and seller. It is the responsibility of the seller to provide a form of Estoppel that is acceptable to the buyer, to obtain the tenants' signature and to deliver the estoppels to the buyer.

## **Tax Deferred Exchange**

Section 1031 of the Internal Revenue code of 1986 (as amended), offers real estate investors an opportunity to build wealth and save taxes. In a tax deferred exchange, the investor (Exchanger) can dispose of investment property and defer the capital gains tax by leveraging all their equity into replacement property. Two requirements must be met to defer the capital gain:

1. The Exchanger must acquire "like-kind property"
2. The Exchanger cannot take "constructive receipt of funds" (receive proceeds) Here

is what happens in such an exchange:

- The Exchanger must enter into an exchange transaction prior to closing on the relinquished property.
- The Exchanger enters into an Exchange Agreement with a Qualified Intermediary (Exchange Accommodator)
- The Intermediary acquires the relinquished property from the exchanger and transfers it to the buyer by a direct deed from the Exchanger
- The proceeds from the relinquished property are assigned to and held by the Intermediary in a separate, secure account.
- The Intermediary acquires the replacement property from the seller and transfers it to the Exchanger by a direct deed from the seller.
- The exchange funds are used by the Intermediary to purchase replacement property for the Exchanger.

There are strict time limits in which a tax deferred exchange must be completed with absolutely no extensions:

- The Exchanger has 45 days from the date the relinquished property closes to identify potential replacement properties in writing to the Intermediary. Once the 45 days has expired, the Exchanger may not change the property identification list and must close on one or more of the identified properties.
- The purchase of the replacement property must be completed within 180 days from the date of closing on the relinquished property.

Although property is deeded directly between seller and buyer, the Intermediary should be shown on the closing statement and should sign the closing statement on behalf of the Exchanger. The Exchanger approves the closing statement and typically signs all other closing documents.

An Exchanger may also enter into a "Reverse Exchange", in which the replacement property is purchased prior to closing on the relinquished property.

A tax deferred exchange is also subject to 1099-S reporting and FIRPTA regulations and withholding.

There are many things an investor must consider when thinking about entering into a tax deferred exchange. Interested parties should contact a tax advisor or an attorney who specializes in tax matters, and to speak directly to a qualified exchange accommodator.

### **1099-S Reporting**

The Internal Revenue Code requires that all proceeds from the sale or exchange of a real estate transaction be reported to the IRS. All real estate transfers are subject to 1099-S reporting, including commercial properties, regardless of whether or not there is any consideration paid for the property.

All transferors (sellers) are subject to 1099-S reporting, including individuals, estates/trusts, partnerships, sole proprietorships, limited liability companies. Even foreign sellers are subject to 1099-S reporting, regardless of whether or not FIRPTA taxes are withheld and paid. Corporations are not subject to 1099-S reporting.

### **FIRPTA – Foreign Investment in Real Property Tax Act**

Section 1445 of the Internal Revenue Code requires that the transferee (buyer) must deduct and withhold a tax equal to 10% (or other amount) of the total amount realized (total sale price or consideration on the disposition of a U.S. real property interest by a foreign person (transferor/seller). Taxes and forms must be submitted to the IRS within 20 days of the transfer.

All real estate transactions/transfers, including exchanges, are subject to FIRPTA regulations; however, many commercial contracts contain provisions for the seller's cooperation with FIRPTA compliance at closing.

There are ten (10) different FIRPTA exemptions, including the Non-Foreign Certification (refer to IRS publication 515). The foreign transferor must prove to the buyer and to the settlement agent that an allowed exemption applies to the transaction.

Because the buyer is held responsible by the IRS, the buyer should be kept in the loop regarding any matters pertaining to FIRPTA and foreign sellers. Many state's (California and Hawaii) have their own FIRPTA regulations that are enacted if one or more of the properties are located within that state.

## **Property and Casualty Insurance Requirements**

Insurance coverage is required to be evidenced at closing, if there is a new lender involved in the transaction. Sometimes the lender's attorney will deal directly with the insurance company. The settlement agent will require contact information for the buyer's insurance agent prior to closing.

Depending on the type of property, and the Buyer, the method of paying insurance premiums can vary. A large client may have master policies and no premiums will be paid in escrow. A buyer may set up an installment and only a portion of the premium will be paid through escrow.

## **Proformas**

A lender or attorney may request a "proforma". What they are asking for is a sample policy and samples of the endorsements they require at closing. The title examiner will prepare the "proforma" for delivery to the parties to the transaction.

## **Endorsements**

An "endorsement" is a rider issued to a policy of title insurance that insures over a particular matter or provides additional coverage to the insured. Endorsements may be customized to meet the particular needs or concerns of the proposed insured or the nature of the property to be insured, and may be applicable to either the owner's or the lender's policy, or both.

Whenever a title company is asked to endorse around or insure over a specific matter, there may be certain conditions that must be met depending upon the subject matter of the endorsement, before the endorsement can be issued. All endorsements are subject to approval by the title underwriter.

## **Re-Insurance**

The title insurer will insure up to the total sale price or loan amount, and then employs another title insurance company to insure them. The premium paid to the re-insurance title company is deducted from the title fees; it is not an additional charge to the parties. Re-insurance is handled by the Title Department when requested by the proposed insured or is required based upon self-imposed or statutory title insurance limits.

## **Co-Insurance**

The proposed insured may only allow the title insurance company to insure up to a certain amount (i.e. not the total sale price or loan amount). The insuring company must employ another title insurance company to insure the remainder of the sale price or loan amount. When there is co-insurance, the customer is charged based upon each company's filed rates for the portion of the total liability covered by that company. The coinsurance company may be chosen by the customer.

## **UCC Search**

A Uniform Commercial Code (UCC) search is conducted through the Secretary of State for any Financing Statements that may have been filed to perfect a lien on personal property in accordance with the Uniform Commercial Code. The search is conducted on name(s) of the Debtor(s) as well as the location of the property. This search is not a part of the preliminary report or commitment provided by the title insurer, but an outside provider company that specializes in such reports. There is an additional cost for the UCC Search, which cannot be determined until after the search is completed and provided to the settlement agent.

A UCC Search through the Office of the Secretary of State is not conducted unless required under the terms of the purchase agreement or requested by one of the parties. The names to be searched must be provided to the settlement agent if any name other than the seller or buyer as it appears on the purchase agreement or preliminary report/title commitment are to be included in the search. The settlement agent needs to be

provided the names to be searched in writing by the requesting party. The cost of the final report must be paid for by either buyer or seller. If the report is produced early in the transaction processing period, it may need to be updated prior to closing, resulting in additional charges.

## **UCC Filings**

Many lenders will require a UCC-1 Financing Statement to utilize personal property as additional security for their loan. A UCC-1 Financing Statement may be recorded in the County in which the real property is located. The UCC-1 is typically recorded concurrently with and after the deed of trust or mortgage instrument or as instructed by the lender.

A UCC-1 Financing Statement should be filed with the Secretary of State in the jurisdiction of the location of the debtor. Enforcement of a debt secured with a UCC Financing Statement comes under the Uniform Commercial Code. It is actually the state filing that perfects the lien. In the case of an individual, it should be filed in the state in which they reside. In the case of a legal entity, it should be filed in the state in which the entity was organized. For example, if the debtor has its primary residence in Arizona, the UCC-1 would be filed with the Arizona Secretary of State. If the Debtor is a California Limited Liability Company, the UCC-1 would be filed with the California Secretary of State.

The Secured Party and the Debtor should determine the location of recording and or filing of the UCC statement. The completed UCC-1 Financing Statement is normally provided by the lender.

UCC-1 Financing Statements do not have to be signed by either the Debtor or Secured Party; however, they must be authorized. This means that the parties must instruct the settlement agent, in writing, to record the UCC with County Recorder and/or to file it with the Secretary of State, naming the county recorder and the state jurisdiction.

Although the UCC-1 Financing Statement does not require signatures, any attachment such as the legal description or special terms and conditions may require the signature of the Debtor.

A UCC-1 Financing Statement expires after five (5) years, unless a continuation is recorded and/or filed. It is the sole responsibility of the Secured Party to determine if a continuation is necessary and to record and/or file any continuation statement.