



MP&S REAL ESTATE ADVISOR MARCH 2011: STRATEGIES AND SOLUTIONS FOR CONTINUING TO GROW YOUR REAL ESTATE BUSINESS

MARCH 2011

FINANCING YOUR NEXT PROJECT: WHY A PUBLIC REIT MAY BE THE RIGHT WAY TO GO

Traditional bank financing is scarce for some commercial real estate properties, driving some real estate professionals to pursue public real estate investment trusts (REITs) as a form of financing to repay maturing debt or to raise capital to grow their portfolios while property values are low. Is a REIT right for you?

Reap the bounty

Publicly traded REITs pool capital from many investors to purchase income-producing real estate (equity REITs), mortgage loans (mortgage REITs) or both (hybrid REITs). REITs invest in all types of properties, from office buildings to apartments to malls.

Public REITs enable small investors to participate in large real estate deals and to diversify some risk, similar to stock mutual funds. They also offer liquidity by providing an active market for trading shares.

On the flipside, REITs provide millions in cash to finance various real estate opportunities. Some REITs buy and manage specialized portfolios of properties while others lend money to developers and profit from the interest rate spread between the bank rate and the mortgage rate. Moreover, REITs tend to be conservative when taking on debt. Most charters limit leverage to 50% of the REIT's net asset value. Investments with less debt are more stable and less dependent on capital markets.

The primary appeal of REITs is their pass-through tax status. As long as REITs comply with Internal Revenue Code Sections 856–860, they are not subject to an entity-level income tax. Instead, income flows through to the shareholders' in the form of dividends.

Follow the rules

To maintain their tax-favored status, REITs must distribute at least 90% of their taxable income as dividends. Cash-poor REITs sometimes pay dividends with equity to preserve cash. IRS Revenue Procedure 2010-12 temporarily requires only 10% cash dividends (for tax years ending before December 31, 2011) , leaving some shareholders with insufficient cash to pay their flow-through tax obligations.

Other important IRS requirements include the following:

Income test. At least 75% of a REIT's annual gross income must be real-estate-related. No more than 5% of a REIT's income can be from nonqualifying sources, such as service fees or non-real-estate businesses.

The IRS allows REITs to own stock in taxable REIT subsidiaries (TRSs) to pursue other business opportunities such as providing management services for the REITs tenants. A REIT's investment in TRSs can't exceed 25% of its total assets.

Asset test. At all times, at least 75% of a REIT's assets must consist of real estate or loans secured by real property. Be aware that declines in property values have caused some REITs to inadvertently fail this test.

Additionally, the IRS requires REITs to be jointly owned by 100 or more investors and no more than 50% of the value of the outstanding shares can be owned by five or fewer investors. Furthermore, global REITs must meet the REIT tests in other jurisdictions. If the REIT doesn't meet another jurisdiction's requirements, all its income in that country will be taxable.

Get ready, get set, go public

Be sure to weigh the potential upsides of a REIT against the costs and scrutiny of going public. The process of going public starts a year (or more) before the initial public offering (IPO) date and it involves many steps.

Before making an offering, an equity REIT must unwind the disparate ownership of properties into a single entity, which often is an umbrella partnership REIT (UPREIT). Each property is transferred to the UPREIT in a separate transaction, which requires compliance with SEC regulations and consent from lenders (if applicable).

Once an IPO is complete, a REIT incurs ongoing costs, including listing fees and costs of preparing annual proxy materials and financial reports. And sponsors ultimately relinquish some control, flexibility and privacy to directors, shareholders and the SEC.

Decide for yourself

Properly structured, planned and managed REITs are a good way for you to access cash in a tight credit market. Contact your real estate and tax advisors for more detailed information on the ins and outs of financing via a public REIT.

A NEW TWIST ON SECTION 1031 EXCHANGES

Section 1031 exchanges can offer real benefits but they also come with strict rules — such as time limits for completing the exchanges. Fortunately, a new twist on Sec. 1031 exchanges (also referred to as “like-kind” exchanges) may be available to you that could essentially *double* the length of one critical time limit.

Crucial time limits

Sec. 1031 exchanges allow you to exchange business or investment property (the relinquished property) for business or investment property of a like kind (the replacement property) without recognizing any gain or loss until you sell the replacement property.

The provision also allows a deferred, or “forward,” exchange where you transfer relinquished property before the replacement property is acquired. In such cases, you must identify the replacement property within 45 days of when the relinquished property is transferred. Then you must acquire the replacement property within 180 days of the transfer or by the due date of your tax return (including extensions) for the year in which the relinquished property is transferred, if sooner (the exchange period).

The same time limits apply to “reverse” exchanges. In a reverse exchange, the replacement property is acquired first and “parked” with an exchange accommodation titleholder (the accommodator) *before* you transfer the property you're relinquishing.

The twist

In a memo from the Office of Chief Counsel (Memo No. 200836024), the IRS considered a scenario in which a taxpayer structured two separate exchanges. In the first, a reverse exchange, the replacement property was acquired and parked with the accommodator, and the taxpayer identified the relinquished property in a timely manner (within 45 days).

The relinquished property had a much higher value than the replacement property, so the taxpayer planned to engage in a second exchange — a deferred exchange — to defer the gain that remained after the relinquished property was exchanged for the replacement property.

A qualified intermediary (QI) was retained to execute the transfers of the properties in both exchanges. The QI followed all guidelines to ensure the taxpayer wasn't in constructive receipt of any of the exchange funds during the two 180-day exchange periods.

The IRS memo concluded that as long as the various 1031 guidelines are followed, the same relinquished property can be used in both forward and reverse exchanges, even though allowing this structure could result in up to 360 days between the day on which replacement property is parked at the beginning of the reverse exchange and the day the deferred exchange is completed.

It's important to note that a memo from the Office of Chief Counsel is specific to the particular facts that it addresses and has no precedential value. That said, it does provide a guideline for how to structure such a transaction.

How it could work for you

Imagine you decide to take advantage of plunging property values on the West Coast and purchase a property in California for \$450,000 in January 2011. You park it with an accommodator so you can determine which property you'd like to sell in order to reap the benefits of a *reverse* exchange.

Within 45 days, you identify a property in New Jersey. In July 2011 — within 180 days of parking the California “replacement” property — you sell the New Jersey “relinquished” property for \$1 million, completing the reverse exchange.

Within 45 days, you begin executing a *deferred* exchange by identifying additional like-kind replacement properties to purchase with the remaining \$550,000 of proceeds from the relinquished New Jersey property. Under the conclusion outlined in the Office of Chief Counsel memo, you have 180 days from the close on the New Jersey property to close on one or more identified replacement properties.

So, you don't have to close on those properties and complete the deferred exchange until January 2012 — nearly a year after you purchased the California property.

Daunting, but doable

Although the above scenario might sound a bit daunting, a 360-day forward and reverse exchange combination is definitely attainable. Your tax advisor can provide additional advice and help ensure that you satisfy all of the requirements and guidelines for Sec. 1031 exchanges.

EPA OFFERS ONLINE TOOL TO MEASURE AND MANAGE ENERGY PERFORMANCE

If you own or manage properties, clearly you are feeling the pinch associated with rising energy costs. How can you get a handle on your energy-related data and use it to reduce your costs?

“Portfolio Manager,” a free, online, interactive energy management tool from the Environmental Protection Agency (EPA), can help you manage water and energy consumption, benchmark energy performance, set investment priorities and earn EPA recognition that can increase the value of your properties.

Managing consumption

With Portfolio Manager, you can track and evaluate the energy and water consumption for your individual buildings and as well as your entire portfolio of properties. More specifically, the tool lets you:

- Track multiple energy and water meters for each building,
- Customize meter names and key information,
- Benchmark properties according to past performance,
- Monitor energy and water costs,
- Estimate your buildings' carbon footprints — or greenhouse gas emissions — for regulatory compliance,
- Share building data, and
- Enter operating characteristics for each space-use category within a building.

Benchmarking results

Portfolio Manager also allows you to compare various buildings' energy performance ratings with similar properties across the country. A building's peer group is determined based on data gathered in the Commercial Buildings Energy Consumption Survey (CBECS).

The Department of Energy's Energy Information Administration conducts the survey every four years, collecting information on building characteristics and energy use from buildings nationwide. A building's peer group will comprise those buildings in the survey with similar building and operating characteristics.

The rating system takes into account the effect of weather variations and changes in key physical and operating characteristics in each building. A rating of 50 indicates that a building performs better than 50% of all similar buildings nationwide. Buildings with ratings of 75 or more might qualify for the EPA's "Energy Star" label, given in recognition of superior energy performance.

Commercial buildings eligible to receive a rating via Portfolio Manager include financial institutions, hotels, medical offices, office buildings, retail stores, supermarkets and warehouses.

Even if you own a building that's ineligible for a rating, you can evaluate its energy performance using the EPA's reference list of energy performance targets, available on the Portfolio Manager web page at [energystar.gov](http://www.energystar.gov):

http://www.energystar.gov/ia/business/tools_resources/new_bldg_design/2003_CBECSPerformanceTargetsTable.pdf

The targets are based on the average energy use for various types of buildings, as derived from the CBECS, but they aren't adjusted for climate or activities that may affect energy use.

Setting priorities and earning EPA recognition

Portfolio Manager allows you to consider the relative costs associated with a given level of performance, your cumulative investments in upgrades and your annual energy costs. Armed with this information, you can better evaluate opportunities to invest in improvements across your portfolio. Moreover, the built-in financial tool makes it easy to compare savings across properties as well as calculate cost savings for specific projects.

You can also generate a Statement of Energy Performance for each building through Portfolio Manager:

http://www.energystar.gov/ia/business/evaluate_performance/SEP_10.pdf

Then use the statements to apply for the Energy Star label, satisfy Leadership in Energy and Environmental Design (LEED) certification requirements and otherwise document your buildings' energy performance.

Management matters

While many aspects of today's tough real estate climate are beyond your control, energy performance isn't one of them. Working with a CPA who understands how to compare utility costs, you can use Portfolio Manager to better track and manage your energy performance and costs.

EPA extends benchmarking to data centers

This past summer, the EPA expanded its Portfolio Manager (see main article) to rate the energy performance of data centers — that is, spaces housing high density computing equipment such as server racks. Data center energy performance is based largely on Power Usage Effectiveness (PUE). A data center's PUE equals its total energy use (including all cooling, lighting and support infrastructure) divided by the energy consumption attributable solely to IT equipment. The PUE generally ranges from 1.25 to 3.0, with lower values correlated with greater efficiency.

In addition to PUE, the EPA also factors in energy output from a data center's Uninterruptable Power Supply systems. Data centers that fall in the 75th percentile (or higher) are eligible to apply for the Energy Star label.

SPOTLIGHT ON MP&S

WHAT SMART MONEY WILL DO IN 2011

Marks Paneth & Shron has released thoughts on smart money moves for the new year. Plan to expect less; save more and retire later, says Tax partner Alan Dlugash. Learn what higher taxes, a reduction in social security and Medicare benefits and low interest rates mean for your long-term strategy.

MP&S WELCOMES NEW TAX PARTNER

John Evans, a tax specialist with more than 30 years of experience on issues affecting closely held businesses and their owners, has joined the firm as a partner in the Tax practice. In addition to working with closely held businesses, he has experience with work related to taking public companies private.

EMPOWERING INTELLECTUAL PROPERTY

Intellectual property (IP) is an untapped frontier in value creation. The problem is the basic tendency regarding IP, including patents, as the single, proprietary, closely guarded holding of the patent developer. As Steven Henning and Glenn Sacks discuss in their article, that tendency is fundamental to the patent system — indeed, to all property rights, because at the root, we are talking about patent ownership.

IDENTIFYING AND CORRECTING POTENTIAL DISPARITIES IN EMPLOYEE SELECTIONS BEFORE THEY HAPPEN

Employers define human resources policies and practices and make employment decisions that, while based on legitimate business decisions, may have a disparate effect on different groups of employees. In her article in the *Employee Relations Law Journal*, Josefina Tranfa-Abboud offers a hypothetical example of selections for a proposed reduction in force (RIF) that illustrates how an evaluation can reveal a

disparate impact of a protected class group. Unveiling potential disparities before the implementation of the proposed RIF allows management to revise the goals, objectives, and the planning of the selections for termination, correcting a potential disparate effect of protected class groups, and minimizing the likelihood of legal disputes.

FOR FURTHER INFORMATION

If you have any questions, please contact **Harry Moehringer**, Partner-in-Charge of the **Real Estate Services Group** at 212.503.8904 or hmoehringer@markspaneth.com or any of the other partners in the MP&S Real Estate Services Group:

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