

MARKS PANETH REAL ESTATE ADVISOR MAY 2014: STRATEGIES AND SOLUTIONS FOR CONTINUING TO GROW YOUR REAL ESTATE BUSINESS**NEW REGS TACKLE PROPERTY TRANSFERS FROM C CORPS TO REITS AND RICS**

Last fall, the IRS issued long-awaited final regulations providing guidance on the recognition of built-in gains when the appreciated property of a C corporation becomes the property of a real estate investment trust (REIT) or regulated investment company (RIC). Such a situation can arise when a C corp becomes a REIT or RIC or because it transfers its property to a REIT or RIC in a “conversion transaction.” The regs include two important exceptions to the general rule on gain recognition.

The general rule

Unlike C corporations, REITs and RICs usually aren’t subject to corporate income tax when they dispose of appreciated property, such as real estate. The general rule limits the ability of C corporations to avoid corporate-level taxes by converting into a REIT or RIC and having the new entity sell appreciated assets or contributing such assets to a REIT or RIC in a tax-free contribution. If a C corporation’s property becomes the property of a REIT or RIC, the REIT or RIC is subject to tax on the net built-in gain in the converted property.

The general rule, however, doesn’t apply if the C corporation transferor makes a “deemed sale election,” which accelerates the gain. Under the election, the C corporation recognizes gain and loss as if it sold the converted property to an unrelated person at fair market value. The REIT or RIC then takes a fair market value basis in the converted property.

The proposed exceptions

In April 2012, the IRS released proposed regulations with two exceptions to the general rule:

1. **Exchange exception.** A REIT or RIC isn’t subject to the built-in gains tax if the conversion transaction qualifies for nonrecognition treatment as a like-kind exchange or involuntary conversion into similar property or money, where the C corporation replaces the transferred property with other property with the same basis as the transferred property.
2. **Tax-exempt exception.** If the C corporation falls within one of eight categories of tax-exempt entities (including charitable remainder trusts), the transaction isn’t subject to the general rule if the tax-exempt entity wouldn’t be subject to tax (such as under the unrelated business income tax rules) on gain resulting from a deemed sale election if the election had been made.

The final regs retain these exceptions, with some critical clarifications in response to feedback on the proposed regulations.

The final regs' clarification of the proposed exceptions

The IRS acknowledged that the proposed regs may have been unclear about whether the tax-exempt exception applies to a transaction where some of the gain from a deemed sale election would be subject to tax if such an election were made, while some of it wouldn't be.

The final regs clarify that the general rule *doesn't* apply to a conversion transaction in which the C corporation that owned the converted property is a tax-exempt entity to the extent that gain wouldn't be subject to tax if a deemed sale election were made. In other words, if the tax-exempt entity would have been subject to the unrelated business income or similar tax on only a portion of the gain if the entity had made the election, the built-in gains tax applies only to that portion of the gain — not the entire built-in gain.

The IRS also considered a requested clarification that the exchange exception applies to certain multiparty like-kind exchanges involving intermediaries, including reverse like-kind exchanges (where the replacement property is acquired before the relinquished property is transferred). The IRS declined to change the proposed regulations. But it stated in the preamble to the final regulations that the exception operates to exclude any realized gain that isn't recognized by reason of either a like-kind exchange or an involuntary conversion regardless of the transaction's form.

More guidance

While the final regs are intended to prevent the avoidance of corporate-level taxes, the exceptions do provide some protections. Your tax advisor can help you determine the best tactics for minimizing your liability for built-in gains tax.

The rejected exception

In its recently issued final regulations (see main article), the IRS weighed inclusion of a new exception to the general rule. This exception addresses the situation where a real estate investment trust (REIT) or regulated investment company (RIC) purchases appreciated property from a C corporation for cash or other consideration equal to the property's fair market value.

A commenter on the proposed regulations asserted that, if the entity doesn't have a continuing relationship with the corporation, the entity has no way of knowing the extent to which the C corp might not recognize any gain. The commenter contended and the IRS agreed - that because the entity's basis in property purchased in an arm's-length transaction generally is its cost, the entity generally shouldn't have any built-in gain in the converted property.

The IRS found a new exception unnecessary. It explained that, if the REIT or RIC subsequently sold the property at a gain during the recognition period, the entity should be able to otherwise establish that the gain recognized isn't built-in gain.

TIPS FOR TURNING A PROFIT ON YOUR PROPERTIES

The U.S. real estate market has seen many ups and downs over the years. If you own property in the commercial market, you know how devastating it can be when values decline. But there are ways you can help ensure your properties turn a profit.

Reduce expenses

The value of commercial real estate often is a function of the property's net operating income (NOI). NOI equals gross rental income less vacancy and operating expenses. One way to maximize NOI is to reduce expenses.

Commercial properties are often ripe with costs that could easily be reduced with a little vigilance. You might, for example, adjust energy-related expenditures, such as your automated energy management system. Don't just set the start and stop times and forget about it. Rather, adjust the settings to take advantage of downtimes such as weekends and holidays.

A surprising amount of energy is consumed overnight, when buildings are essentially unoccupied. Train your cleaning staff to turn off lights when they finish a room, or install sensors that will automatically turn them off. Copiers, printers and other office equipment should also be turned off at night. And building fans and motors probably don't need to run nonstop around the clock.

Implementing environmentally friendly practices may improve tenant satisfaction, while simultaneously boosting property value.

Speaking of tenants, when is the last time you examined your properties' monthly utility and water bills to ensure that you're charging your tenants properly for their consumption? Be sure to watch for unusual spikes in usage and pass-through any costs that you can, including for survey electric. Also ensure that you gross-up variable costs to the extent that leases allow.

It can also pay to revisit your service contracts. Do your windows really need to be washed so often? Do driveways need to be blacktopped so frequently? Rebidding or renegotiating contracts may lead to cost savings, particularly if you take advantage of economies of scale by hiring the same contractor to service multiple properties.

Also reconsider your internal maintenance. Do you take a preventive approach to maintenance that abides by a time-based schedule? You might fare better by adopting a predictive approach that relies on statistics and past experience to determine the optimal intervals for servicing equipment.

Although interest is not customarily part of the NOI equation, it can be a significant expense, depending on a property's debt load. Rates are currently low and banks may be willing to negotiate if you're creditworthy.

Operate in tip-top shape

Another way to boost your NOI is to decrease vacancy. Careful management can result in lower carrying costs and quicker leasing. Consider visiting all your properties regularly to check for any problems that might delay leasing — such as a leaky roof or malfunctioning security system. Keep the premises clean and free of trash and pests. Ensure that maintenance continues on the roof, HVAC system, elevator and similar components so that they're in working order for new tenants.

Keep in mind that, while it's important to confirm that these systems are fully functioning, they don't need to operate 24/7. As with occupied space, adjust the startup and shutdown mechanisms to reduce energy costs.

Keep tenants happy

It's much more economical to hold on to existing tenants than to land new ones. Retaining tenants requires keeping them happy.

Regular communication is critical. Answer your phone and respond to e-mails promptly. Give tenants both your office and cell phone numbers. Also consider conducting annual tenant surveys to determine whether they're satisfied and if they see areas that could be improved. At the very least, a survey shows that you value the tenants' opinions.

Your employees will probably constitute the front line of tenant relations. So, develop an incentive structure that encourages them to provide outstanding service. And then reward and recognize those who go the extra mile.

Finally, remember that janitorial and HVAC issues usually top the list of tenant complaints. By keeping a close eye on these services, you can preempt many problems.

Make it pay off

It *is* possible to turn around declining property values. But it's important that you be proactive with your properties by staying atop needed maintenance and reining in your expenses.

HOW TO PROTECT YOUR LLC INVESTMENTS

Real estate owners and developers often form limited liability companies (LLCs) to hold title to property because LLCs limit personal liability: only the LLC members' assets are generally at risk. While LLC's do offer protection from personal liability for the debts and liabilities of the entity itself, some exceptions exist that could drain an owner's or developer's personal finances.

Environmental liability

Environmental liability is a common concern when purchasing property and use of an LLC to make the purchase doesn't make that concern moot. The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) imposes strict, joint and several liabilities — no showing of negligence or intent is required — for cleanup costs on past and present owners and operators of facilities where hazardous materials have been released. An LLC member who had the authority to control the operations or decisions involving the disposal of hazardous substances could be held liable for cleanup.

Personal guarantees and contracts

LLC members who personally guarantee the company's debts or obligations will be held liable for their nonpayment or breach. This is a true risk when entering into contracts or financing agreements before the LLC legally comes into existence because the other party insists on some guarantee.

To minimize the risk of personal liability, always act in the name of the LLC. When you sign contracts, for example, do so solely as an agent of the LLC, making sure to identify the LLC as the principal in the document. Similarly, make sure that the LLC's other agents and employees act as representatives of the entity and not of you personally. For

extra protection, members might consider adding a personal umbrella policy to the LLC's traditional business insurance coverage.

Certain loan defaults may also create personal liability. Carefully review all loan documents to make sure you completely understand the consequences of all potential covenant violations.

Wrongful acts

An LLC won't protect a member from liability for his or her own negligent or otherwise wrongful acts that cause injury to another, such as assault or fraud. That could include negligent hiring or supervision of employees if an employee causes some type of injury and the member hired the employee in his or her own name, rather than in the name of the LLC.

Also note that, if an LLC member commits a wrongful act that causes injury while acting as an agent or employee of the LLC, it's not just the member's personal assets that could be targeted by the injured victim. The victim could also go after the assets of the LLC under a theory of vicarious liability (also known as "respondeat superior liability") for its agent's acts.

A pierced veil

On rare occasions, a court will "pierce the corporate veil" to impose liability for an LLC's debts and obligations on its members. This typically occurs when closely held and small businesses fail to observe corporate formalities such as holding regular board meetings, keeping minutes, adopting bylaws and ensuring company finances are separate from those of members. It could also happen if the LLC engaged in reckless conduct or fraud or was inadequately capitalized from the beginning. In all of these circumstances, a court might conclude that the LLC is merely a sham to shield its members from liability.

Protect yourself

LLCs come with their benefits, but they don't provide a total defense for members' personal assets. The rules governing LLCs vary from state to state. Consult with your attorney and financial expert to devise asset protection strategies for your individual needs.

SPOTLIGHT ON MARKS PANETH

Marks Paneth: A Commitment to Social Responsibility

At Marks Paneth, integrity, caring, leadership and teamwork are part of our core values. We are committed to social responsibility and to having a positive impact on the communities in which we live, work and do business as well as on our profession. The firm and our professionals are actively involved in a wide range of programs and charitable organizations. Our partners and principals serve on the boards of more than 50 nonprofit organizations. We also have one of the region's leading Nonprofit and Government Services practices.

The firm was recently honored for our community involvement and as part of that tribute, [a short video](#) was created. We encourage you to watch it to learn more about who we are.

Global Tax Insights

Morison International (MI), the global association of leading independent accounting and consulting firms of which Marks Paneth is a member, has published the latest issue of *Global Tax Insights*. It is made up of contributions from MI member firms and includes country focus articles, technical updates and international tax cases. If you have questions or would like more information about anything you read in this publication, please contact [James M. Robbins](#), Tax Principal, at 212.503.8971 or jrobbins@markspaneth.com.

Marks Paneth to Sponsor NYU International Hospitality Industry Investment Conference in June

Marks Paneth will again be a sponsor of the [NYU International Hospitality Industry Investment Conference](#) taking place at the Marriott Marquis Hotel in New York City June 1-3. [Larry Cohen](#), Hospitality Group Leader, will be participating in a panel on “The Hospitality Marketplace: Those ‘In The Know’ Share Insider Perspectives on the Latest Transactions” on Tuesday, June 3, 11:45 a.m. to 12:45 p.m. in the O'Neill Room on the 4th floor.

Further, Larry has just written an article entitled [“Do's and Don'ts for Buyers and Sellers in a Red Hot Hotel Real Estate Market \(Pigs Get Slaughtered\),”](#) which examines the risks and advantages of a hot market and what you should be mindful of when participating. For more information, please contact Larry at 212.503.8855 or lcohen@markspaneth.com.

FOR FURTHER INFORMATION

If you have any questions, please contact [William Jennings](#), Partner-in-Charge of the [Real Estate Group](#) at 212.503.8958 or wjennings@markspaneth.com or any of the other partners in the Marks Paneth Real Estate Group:

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