



Real Estate Report

Winter 2011

Financing your next project

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Ask the Advisor

How can I reduce insurance premiums on my properties?

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Financing your next project

Why a public REIT may be the right way to go

Traditional bank financing is scarce for 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 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). They 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 buy and manage specialized portfolios of properties, for example. 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. By comparison, owners of individual properties typically operate at a 90:10 debt-to-equity structure. 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 needn't pay an entity-level income tax. Instead, income flows through in the form of dividends to the shareholders' personal tax returns.



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, leaving some shareholders with insufficient cash to pay their flow-through tax obligations.

Other important IRS requirements include the:

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 a non-real-estate business.

The IRS allows REITs to own stock in taxable REIT subsidiaries (TRSs) to pursue other business opportunities, such as management services

for its tenants. A REIT's investment in TRSs can't exceed 25% of its total assets.

Asset test. At least 75% of a REIT's assets must consist of real estate or loans secured by real property. 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 against the costs of going public. For example, 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 also 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 Sec. 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. This might help you take advantage of the weak commercial real estate market and obtain valuable properties at reduced prices.

Crucial time limits

Sec. 1031 exchanges are named after the Internal Revenue Code section that allows 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).

Section 1031 allows a deferred, or “forward,” exchange where you transfer relinquished property before the replacement property is acquired.

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 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.

You begin executing a *deferred* exchange by, within 45 days, identifying additional like-kind replacement properties to purchase with the remaining \$550,000 of proceeds from the relinquished New Jersey property. And 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 doable. Your tax advisor can provide additional advice and help ensure that you satisfy all of the requirements and guidelines for Sec. 1031 exchanges. ■

A star is born: Measure and manage your energy performance

Anyone who owns or manages properties knows that the associated energy costs can add up quickly. So, 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 both



individual buildings and 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.

This allows you to set goals, assess progress and identify opportunities for savings and improvements.

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

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.

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. (Click on "Buildings & Plants" / "Portfolio Manager Login" / "Learn what Portfolio Manager can do for your organization" / "Rate building energy performance" / "energy performance targets.") 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

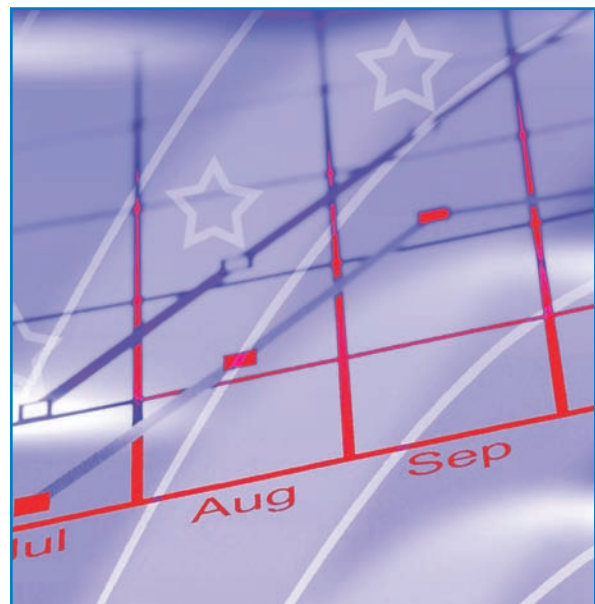
with that, you can better evaluate opportunities to invest in improvements across your portfolio. Moreover, the built-in financial tool makes it easy to compare savings across properties as well as calculate cost savings for specific projects.

You can also generate a Statement of Energy Performance for each building through Portfolio Manager. (The link is on the same page containing the "energy performance targets" link, above.) Then use the

statements to apply for the Energy Star label, satisfy Leadership in Energy and Environmental Design (LEED) certification requirements, facilitate mortgage, sale or lease transactions, 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. ■



Ask the Advisor

How can I reduce insurance premiums on my properties?

Besides going with a higher deductible, here are four strategies you can employ to help reduce your premiums and boost profits.

1. Know the property's FMV

Property value plays a key role in setting the insurance premium — the greater the value insured, the higher your premium. A property's fair market value (FMV) includes the value of the land as well as the building, but your coverage may be for only the replacement cost of the building.



Check the values assigned to the property for insurance purposes and ensure they reflect replacement costs. Obtain an updated appraisal if property values — or your tenants' business operations — have changed in recent years. Beware of insurers that automatically increase policy limits for inflation, especially in depressed markets. And, if your lenders require insurance, don't give in to pressure to overinsure at the full FMV.

2. Purchase insurance on the entire portfolio

If you own properties in multiple locations, you may be able to lower premiums by purchasing a blanket policy for the entire portfolio, because you don't have to buy coverage on the total value of all the properties. Consider an owner with a \$500 million portfolio, including properties across the country. The highest-valued property in any single geographic location doesn't exceed \$30 million. The probable maximum loss at any one time is small in terms of the portfolio's total value because a single occurrence (such as a hurricane) isn't going to hit every property.

So the owner could buy one policy with a lower coverage limit than the entire portfolio value. Lower limits mean lower premiums, so buying a single policy with, say, a \$200 million limit will cost less than individual policies on the \$500 million of property.

3. Time the market

Premiums can swing dramatically, so monitor the insurance market closely. For example, you might find savings by switching to an insurer that's aggressively pricing policies before its year end to meet its premium quotas.

If you're already a customer of such an insurer, consider canceling and rewriting the existing policies. And shop around every couple of years for quotes from different brokers in the regions where you invest.

4. Proceed with caution

Be cautious when seeking premium savings. A lower premium isn't the only important factor when determining whether a policy represents a good deal. You need to weigh other factors that could affect the ultimate cost, including coinsurance, payout provisions and customer loyalty incentives.

Finally, never underinsure your properties. If you do, insurance proceeds may not fully cover a loss.



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RELATED-PARTY EXCHANGE NOT ENTITLED TO NON RECOGNITION TREATMENT —

The Eleventh Circuit in *Ocmulgee Fields Inc.* 106 AFTR 2d 2010-5820, 2010-2 USTC ¶5065 (CA-11,2010) held that Section 1023(f)(4) disallowed non-recognition treatment for the taxpayer's property exchange because it was part of a series of transactions structured to avoid the related party rules of Section 1031(f).

FREEZE PARTNERSHIPS —

A freeze partnership is an LLC that has two classes of membership interests—preferred and common, similar to preferred and common stock. The preferred members are entitled to fixed and certain cumulative (i.e., a priority distribution in a fixed amount upon liquidation), similar to that of preferred stock. Both are determined by appraisal and are based on the value of the assets that the preferred interest holder contributed to the entity. The common members receive annual distributions and liquidating distributions only if there are funds remaining after the preferred members are paid their pre-determined amounts. Thus, any appreciation in both the cash flow and the liquidation of the entity after the date of formation will inure solely to the common interest holder.

Did You Know ... The longest town name in the world has 167 letters.

Some Of The Other Services We Offer: • Estate Planning • Litigation Support • Business Valuations • Non-Profit • Audit

CANCELLATION OF INDEBTEDNESS (COD) INCOME — PASSIVE?

More frequently during the last two years, taxpayers have been receiving income from forgiveness of debt (COD). COD income is treated as revenue and taxed at ordinary tax rates. Taxpayers may use several methods of excluding COD income from tax or deferring the recognition of this gain. These exclusions are listed in IRC section 108. In certain circumstances though, income must be recognized and a deferral is not allowed. When this occurs, it is essential that the taxpayer address the nature of the income to be reported.

In Revenue Ruling 92-92, the Internal Revenue Service held that the taxpayer has to look to the source of the income to determine if the income is passive or ordinary income. The facts of the ruling were that the proceeds of the loan in question could be traced 60% to a passive activity and 40% to other activities. The IRS found that the passive income portion could be used to offset other passive losses or carryovers.

Another aspect of COD income should be considered. Income arising from loan proceeds used to purchase investments may be considered investment income. This type of income can be used in the calculation of deductible investment interest expense. Thus, this type of income may allow an increased investment interest deduction to offset the reported gain.

In some circumstances, COD income may arise from a partnership activity. The taxpayer is allowed to look through the partnership to determine the nature of the debt forgiven. This may be challenging as generally there will not be sufficient information to determine the type of activity that gave rise to the income. Communication with the partnership may be required to record the income properly.

In summary, if you receive COD income first check the exclusions or deferrals allowed by law. Once those steps have been taken and there is still taxable income, consider the nature of the income to determine if other offsets are available to minimize the taxable impact. If you find that you require assistance with this process, please do not hesitate to contact us.

We would welcome the opportunity to help you meet your business and personal financial goals.

Please call us at 650-365-4646 (Silicon Valley) or 415-392-2123 (San Francisco) and let us know how we can be of assistance.