

Flower Residential Properties: A Real Estate Investment Trust Case Study

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This case is designed for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The subject company has been disguised and some of the information in the case has been modified to protect confidentialities and to enrich the learning experience.

Focus

The learning objective is to provide an opportunity for the student to analyze a complex set of business, tax, and financial arrangements. The case involves issues relating to real estate management, financial management, taxation, and business ethics.

Setting

A chief financial officer (CFO) of a medium-sized, publicly traded real estate investment trust (REIT) is considering the potential disposition of one of the properties in the trust's portfolio. The property was originally contributed by one of the founders of the REIT in a tax-favored way. If the property were disposed of in an outright sale, the original owner could recognize a significant taxable gain. By using a like-kind exchange, the original owner's gain could be deferred. In considering the disposition, the CFO has to understand the various business and tax issues associated with the operation of a REIT, as well as the issues that might arise based on the preferences of the original owner of the property and the perhaps competing interest of the public shareholders of the REIT.

Exhibits

An Appendix and five exhibits are included at the end of the case.

Exhibit 1: Structure of Flower Residential Properties

Exhibit 2: Flower Residential REIT Income Statement and Dividend Information

Exhibit 3: A Like-Kind Exchange Using a Qualified Intermediary

Exhibit 4: Example of Transfer of Property to a Partnership in Exchange for a Partnership Interest

Exhibit 5: Examples of Like-Kind Exchange Transactions

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Availability

This case study is available through the editor of the *Journal of Real Estate Practice and Education*.

Teaching Notes

Teaching notes are available and cover the learning objectives in detail. Specific responses to the case questions are included.

Introduction

Flower Residential Properties is a medium-sized, real estate investment trust (REIT) listed on the New York Stock Exchange. It has a substantial portfolio of high-end, residential apartment units located around the United States. It grew in size as the REIT industry has grown through the 1990s and the early part of the twenty-first century. The chief financial officer (CFO) is a professional manager with substantial experience in the real estate industry. While he serves on the board of Flower and owns stock, he is not one of the founding organizers of the business. Flower is currently considering disposing of a property that had been contributed by one of the founders. The disposition could have a substantial financial and tax impact on the founder, as well as a significant impact on the REIT itself. The CFO has been asked to make a recommendation with respect to the disposition. In preparing his recommendation, he has to take into account his role at the firm, the interests of the founding investors, the details of a complex tax and financial transaction, and his responsibilities as a CFO of a public company.

Flower Residential Properties

Flower Residential Properties Trust (Flower) is a REIT focusing on multifamily residential properties. The company develops, acquires and manages upscale apartment buildings in several regions of the U.S. All of the buildings are operated under the Flower name. Its stated mission is to "Provide an Outstanding Living Environment for Our Residents."

Flower is organized using an UPREIT structure (see below). The partnership, a limited partnership, owns the communities and Flower conducts its business through it. Flower is the sole general partner and has a 94% interest. The founding investors retain the other 6%. Flower is publicly traded on the New York Stock Exchange. The structure is summarized in Exhibit 1.

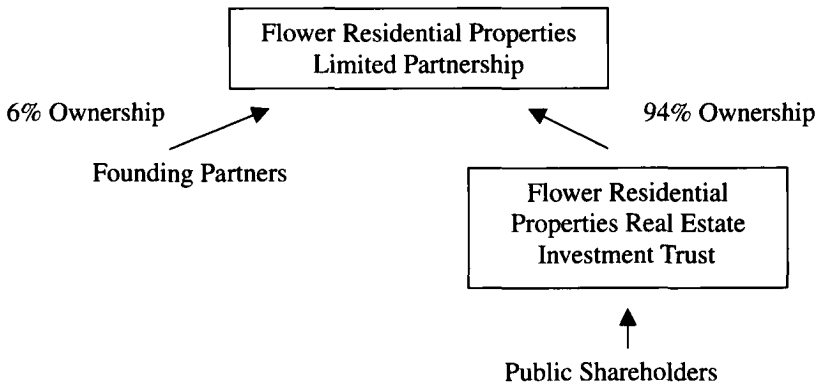
As of September 30, 2003, the Flower portfolio included 74 stabilized apartment communities containing 28,289 apartment homes and an additional 1,817 apartment homes under development or in lease-up phases in five locations.

There were three initial investors in Flower. They were each substantial real estate investors in their own right before the creation of Flower. They obtained their initial ownership interests in exchange for properties that each had owned individually or in partnership with others. None of them had disposed of any of their interests since the inception of the REIT. Each of them had substantial real estate and other investments separate from their investments in Flower.

The REIT Industry

Since 1986, the REIT structure has become the preferred structure for large public equity investment in real estate. The fact that these REITs can be publicly listed and

Exhibit 1
Structure of Flower Residential Properties



freely traded has made it possible to raise significant funds from the public and institutional investors that were not previously available for real estate investments. The fact that the REIT itself is structured as a flow-through entity for tax purposes makes REIT investments very attractive to pension funds, as well as otherwise taxable investors. The Appendix provides information on the REIT industry for those with little background in real estate.

The Nature of UPREITs

There are certain characteristics of partnerships that are more attractive than corporations or REITs for typical real estate transactions. For example, a taxpayer who transfers property to a corporation or REIT in exchange for stock in the corporation or a beneficial interest in the REIT is likely to recognize gain or loss on the transfer unless certain fairly restrictive criteria are satisfied. Those who transfer property, even property subject to liabilities, in exchange for a partnership interest, however, ordinarily would not recognize gain or loss on the transfer of that property. As a result, property holders can transfer appreciated property to a partnership in exchange for a partnership interest and defer recognition of gain on the disposition of that property.

The gain that goes unrecognized when the property is originally transferred to the partnership, however, may well be recognized when the property is disposed of by the partnership. Moreover, any portion of the gain that that was attributable to the period of time prior to the contribution would be allocated to and reportable by the taxpayer who originally contributed the property to the partnership.

To avoid this adverse tax result, some UPREITs will make an effort to dispose of the property using a like-kind exchange transaction. The benefit of this type of transaction is that a gain can be further deferred until the property acquired in the like-kind transaction is ultimately disposed of in a taxable event.

More detailed information on the nature of UPREITs is available in the Appendix.

Tom Farrell

For six years Tom Farrell has been executive vice president and CFO of Flower Residential. Prior to that, he had held significant positions at major real estate investment firms. Farrell was a CPA and has an MBA from the University of Michigan. Farrell had overseen quite a number of large acquisitions and dispositions of properties in the past. The Flower of Phoenix property, however, posed a very complex set of issues and he knew that his position on these issues would have a major impact on the ultimate decision to retain or dispose of the property. He also knew that his recommendation might or might not coincide with the preferences of the founding investors and that his career depended, in part, on how well he worked with them. Finally, he knew that, as a company officer, he had obligations to the public shareholders of the company.

Farrell's personal business history in some sense paralleled the development of the real estate industry in the U.S. over the past thirty years. After a brief stint in public accounting, he accepted a position in the financial part of a real estate development company. After several years, he moved on to become CFO of one of the largest private syndicators of real estate investments in the U.S. After that, he joined Flower when it was a private REIT as CFO and participated in the taking of Flower public through an initial public offering on the New York Stock Exchange. Over his career, Farrell moved from private real estate development through private syndications of real estate projects on to large publicly-funded real estate activities much as the industry has gone from a reliance primarily on private financing to large institutional financing.

The Flower of Phoenix

Property Description

Flower Residential was currently considering disposing of the Flower of Phoenix Apartment community. The Flower of Phoenix Apartments is a 1,180-unit apartment complex set on 92.64 acres on the north and south sides of Old Skokie Road, just off Batten Road and north of Hickory Falls Road in Gold County, Arizona. Located approximately five miles northwest of the intersection of AZ 400 and I-160, it is approximately 30 miles north of the Phoenix central business district.

The property was developed by affiliates of Flower's predecessor and was constructed in four phases beginning in 1985 and ending in 1989. The oldest 400 units were renovated in 2001. There are 18 different residential floor plans concentrated in 60 two- and three-story split, frame-constructed buildings with wooden exteriors and gable roofs. Unit amenities include patio/porches or sunrooms, washer-dryer hook-ups, wood-burning fireplaces, and vaulted ceilings. The property contained 2,064 parking spaces, two clubhouse facilities with aerobics rooms and meeting/social rooms, four swimming pools, three hot tubs, two fitness centers, two indoor

racquetball courts, five lighted tennis courts, three picnic areas with gas grills, sand and water volleyball, two basketball courts, walking and jogging trails, a car care center, and a golf putting green and driving cage.

How It Was Acquired

From inception through 1993, the land assemblage, development, and operation of the property were conducted by a group of individuals operating in the form of a limited partnership that preceded the organization of Flower Residential Properties. Their total capital expenditure with respect to the property was approximately \$52.3 million. Over the years, they incurred approximately \$18.1 million of accumulated depreciation expense, as well as substantial interest expense. In 1993, the net basis for tax purposes of the property was approximately \$34.2 million and the total debt on the property was about \$40 million. In 1993, each of the initial partners had a share of liabilities in excess of his tax basis in his share of the original limited partnership.

In 1993, the partners agreed to exchange their ownership interests in the original partnership for interests in another partnership, Flower Residential Properties Limited Partnership (the UPREIT partnership). The new partnership was the umbrella partnership created in connection with the formation of Flower Residential Properties Trust, the REIT. At the time the property was contributed to the UPREIT partnership, the property had a market value of approximately \$60 million. The UPREIT partnership assumed the contributing partners' liabilities.

By exchanging their interests in the property for interests in the UPREIT partnership, each of the partners had individually deferred any gain, which would have otherwise been recognized had the property been sold to a third party or sold to the REIT directly.

Flower Residential Properties Trust completed its initial public offering in February 1994.

Rationale for Considering Disposition

One of Flower's stated strategies is to maintain a newer, Class "A" upscale apartment portfolio. As such, the company typically seeks to sell properties that are seven to twelve years old and recycle sale proceeds into acquisitions and developments of new or newer properties.

Flower's management takes many factors into account when considering dispositions. The age of the property is one. Usually more important is the expected future operating performance and the evaluation of the individual asset relative to other currently owned assets and other alternative investment opportunities. In addition, management takes geographic diversification into account.

The Flower of Phoenix property itself was older than most of the properties in the portfolio and, if it were to be retained, would probably have to be renovated to

maintain the upscale apartment feel. While Flower usually preferred to dispose of older properties and buy newer properties, it felt that the quality of the neighborhood and the growth potential for the Phoenix metropolitan area would likely make a high-quality renovation economically viable.

Information on the Flower of Phoenix Property: June 2003

As a result of depreciation and improvements, the June 2003 tax basis for the property was approximately \$28 million. The best estimate of its selling price was \$80 million. The property was still subject to a liability of \$40 million. If the property were sold, it would have generated a \$52 million taxable gain.

On the other hand, it might have been possible to dispose of the property in a like-kind exchange. To do so, the firm would have had to comply with the technical tax requirements for a like-kind exchange including, presumably, finding an appropriate “qualified intermediary” and finding appropriate replacement property within the mandated time frame. While some REITs had terrible experiences with the selection of inappropriate qualified intermediaries, Flower had substantial experience with a number of able and financially viable intermediaries and did not anticipate any difficulty finding an appropriate one for this transaction.

Because of the size of Flower Residential, it was always in the market for new properties. In fact, it was in varying stages of negotiations on five or six properties that could have been viewed as replacements for the Flower of Phoenix. Each of the properties was substantially newer than the Flower of Phoenix and had comparable or better amenities. All but one of these properties would have cost more than the full value of the Flower of Phoenix so, if any one of four turned out to be the replacement property in a like-kind exchange, it was likely that the full gain on the exchange could be deferred. On the other hand, it was not clear that Flower could find an appropriate high-quality replacement property at the prices that it felt comfortable paying in the time frame that would be required if a like-kind exchange were used.

It was also not clear what the attitudes of the initial partners would be if they were presented with a firm proposal to sell the property.

Financial Issues

The Flower Board of Trustees determines the company’s dividend policy. In general, the Board seeks to maintain a consistent quarterly dividend amount per common share until such time as the (prospective) earnings of the company, in the opinion of the Board, would support increasing the dividend to a new, higher, sustainable amount.

Two other significant factors in determining the amount of the dividend are: (1) compliance with tax regulations and (2) the company’s “payout ratio.” In general, REITs are required to pay out 90% of their taxable income in order to maintain their REIT tax status. However, tax law requires payment of an excise tax if at least 100%

of taxable income is not distributed. As such, most REITs choose to target a level sufficient to pay out at least 100% of taxable income. Income statement, income tax, and dividend information about Flower Residential are included in Exhibit 2. The Appendix provides an explanation of the term Funds Flow from Operations (FFO), which is a computation of funds flow that is widely used in the REIT industry. FFO information is also provided in Exhibit 2.

The potential sale of the Flower of Phoenix is not yet included in 2003 estimated amounts. It could affect taxable income and therefore could affect the amount that

Exhibit 2
Flower Residential Real Estate Investment Trust
Income Statement and Dividend Information

	12/02	12/01	12/00	12/99
Revenue	\$118	\$122	\$127	\$129
Cost of Sales	\$14	\$13	\$13	\$13
Gross Profit	\$105	\$109	\$114	\$116
Operating Expenses				
Selling, General & Administrative	\$60	\$63	\$58	\$58
Operating Profit Before Depreciation & Amortization	\$44	\$46	\$56	\$58
Depreciation & Amortization	\$21	\$20	\$19	\$18
Operating Income after D & A	\$24	\$27	\$38	\$40
Other Income (net)	\$1	\$23	\$50	\$21
Interest Expense	\$0	\$0	\$0	\$0
Pre-Tax Income (EBT)	\$25	\$50	\$88	\$61
Net Income from Continuing Operations	\$22	\$43	\$75	\$52
Net Income from Discontinued Operations	\$18	\$3	\$2	N/A
Net Income from Total Operations	\$40	\$46	\$77	\$52
Total Net Income	\$40	\$46	\$77	\$52
Preferred Stock Dividends	(\$8.0)	(\$7.0)	(\$7.1)	(\$7.3)
Net Income available for Common Shareholders	\$32	\$39	\$69	\$44
Basic EPS from Continuing Operations	\$1.25	\$2.40	\$4.29	\$3.06
Dividends Paid/Share	\$1.92	\$1.89	\$1.86	\$1.81
Taxable Income per Share	\$0.62	\$1.15	\$1.07	\$2.14

A summary of the company's earnings, dividend and taxable per share since inception is as follows:

	1994*	1995	1995	1997	1998	1999	2000	2001	2002	2003e
FFO	\$1.73	\$1.90	\$2.01	\$2.13	\$2.34	\$2.59	\$2.75	\$2.51	\$2.35	\$2.13
Dividend	\$1.68	\$1.71	\$1.72	\$1.73	\$1.76	\$1.81	\$1.86	\$1.89	\$1.92	\$1.92
Taxable Income	\$0.62	\$0.83	\$2.01	\$1.37	\$1.80	\$2.14	\$1.07	\$1.15	\$0.62	\$0.60

* The data for 1994 is pro-forma data because the operations of the REIT initiated on February 4, 1994.

Flower has to distribute to avoid penalty taxes. Any gain on the sale would not directly affect FFO because gains are typically excluded from that computation but the proceeds of the sale could be available for dividends if the firm decided to use the proceeds that way. The projected income for 2003 and the projected FFO did include operating income from the Flower of Phoenix.

The Tax Issues

An overview of the tax treatment of REITs, umbrella partnerships, the treatment of transfers of appreciated property to an umbrella partnership, and the possibility of using like-kind exchanges for dispositions of property from an umbrella partnership is included in the Appendix.

The Flower of Phoenix had been contributed by an initial investor at a time when its fair value exceeded its tax basis. Because it was a contribution to the umbrella partnership, it was not a taxable disposition of the property for the contributing investor at that time. The gain that went unrecognized on the contribution of the property as well as any additional gain that accrued since the property was contributed would have to be reported by the partnership if the partnership sold the property in a taxable disposition. Moreover, the portion of the gain that accrued prior to the contribution would have to be allocated to the original contributing partner along with his proportional share of subsequent appreciation. The remaining portion of the gain would be allocated to other partners including the REIT itself. If the property were disposed of in a like-kind exchange, however, it might be possible to defer the recognition of gain on the property disposition. In fact, if a like-kind exchange were used and a taxable disposition of the replacement property was not made until after the contributing investor died, the deferred gain would never be subject to income taxation. As a result, it was reasonable to assume that the contributing investor would strongly prefer that the Flower of Phoenix either not be sold or be "sold" by means of a like-kind exchange.

The Issues and Decision Facing Tom Farrell

Farrell had been involved in the acquisition and disposition of a large number of properties over the years. He had a financial interest in the company but, since he was not one of the initial investors, he had no special interest in the Flower of Phoenix Apartments property. Three of the individuals on the senior management committee were the initial investors, who had owned an interest in the Flower of Phoenix prior to the formation of the REIT. As CFO, Farrell wanted to make sure he appropriately took into account all the factors and all the constituencies that would be affected by whatever decision was ultimately made.

Before the meeting on this property, Farrell wanted to be certain he understood:

1. What is the estimated tax consequence to the founding investors and to the REIT shareholders if the property is sold in a like-kind exchange?

2. What is the estimated tax consequence to the founding investors and to the REIT shareholders if the property is sold in a fully taxable transaction?
3. What are the financial implications for the REIT of a sale, on the one hand, or a like-kind exchange, on the other?
4. As a CFO of a public company, what other factors should he consider in making his recommendation to the Trustees?
5. What should he recommend?

Appendix

Real Estate Investment Trusts: A Background Note

History

Prior to 1986, many widely held real estate investments were structured as limited partnerships. Since a partnership was not a taxable entity, the individual partners, who reported on their own returns their share of partnership income and losses, were able to benefit directly from certain tax features of this investment structure. Many of these investments generated deductions in excess of revenues. A portion of the deductions, however, were generated by non-cash expenses such as depreciation and the underlying properties in some cases actually appreciated. As a result, if things went as planned, a limited partner could get an interest in an appreciating investment along with some deductible losses that he or she could use to offset income from other sources and, perhaps, a positive cash flow.

The 1986 income tax law changes made the limited partnership structure substantially less attractive for most real estate investments. After 1986, losses from most investment-type partnerships generally could not be used to offset income from other activities. As a result, investors no longer sought these types of investments to 'shelter' their income from other sources and the popularity of the limited partnership structure declined dramatically.

The REIT structure was introduced into the U.S. Internal Revenue Code in 1960. It was structured to permit smaller investors to acquire an interest in a real estate portfolio in a manner similar to the way a mutual fund permits smaller investors to obtain an interest in a portfolio of stocks. The investor would benefit from both the potential diversification and the professional management of the REIT. While there were a number of REITs in the 1960s and 1970s, the limited partnership was clearly the real estate investment vehicle of choice during that era. After 1986 and especially in the 1990s, the REIT became the preferred vehicle for raising capital for larger real estate investments and real estate investment portfolios.

General Requirements to Qualify for the Favored Tax Treatment of REITS

REITs are a construct of the Internal Revenue Code. The requirements that must be satisfied to obtain REIT treatment are generally in Internal Revenue Code Section 856

and the tax treatment of the qualifying entities is generally in Code Section 857. To qualify as a REIT, an entity must annually meet four tests relating to organizational structure, source of income, nature of assets, and distribution of income. The general nature of these tests follows:

Organizational Structure Requirements: The REIT generally must have 100 or more owners;¹ those owners must have transferable ownership interests;² the ownership cannot be so concentrated that a few individuals control the majority of shares;³ and one or more trustees must manage the REIT.⁴

Income Requirements: A REIT's gross income must come primarily (at least 95%) from passive sources as opposed to the operation of a business.⁵ Seventy-five percent or more of gross income generally must come from real estate related activities.⁶

Asset Requirements: Generally, more than 75% of the assets of the REIT must be invested in real estate assets (including interests in real property and interests in mortgages on real property), cash, cash items, and government securities.⁷

Distribution of Income Requirements: Generally, a REIT must distribute 90% of its taxable income to its beneficial owners each year for it to be treated as a REIT.⁸ In addition, a REIT may be subject to an excise tax on undistributed income.⁹

By meeting these requirements and electing to be treated as a REIT, the entity is entitled to a very substantial tax benefit. Unlike regular corporations, a REIT can deduct dividends paid to beneficial owners. As a result, REITs that choose to distribute all of their taxable income can operate without tax. Prior to the enactment of The Jobs and Growth Tax Reconciliation Act of 2003, taxpayers who received these dividends generally treated them in the same manner as dividends from other corporations; although, as is the case with mutual funds, a portion of the distribution might have been treated as long-term capital gain and a portion might have been a non-taxable return of capital. The 2003 tax law provided favored treatment for dividends from regular taxable corporations but, because of the dividends paid deduction allowed at the REIT level, those who receive regular dividends from REITs are generally not entitled to the new, lower tax rates on dividend income. They would, however, be entitled to favored tax rates on the portion of dividends treated as long-term capital gain.

Categorizing REITs by Types of Investments

As mentioned above, REITs are restricted in the types of income and assets they can have. Many REITs focus on subsets of these permissible items; that is, REITs are frequently classified into Equity REITs, Mortgage REITs, or Hybrid REITs, with Equity REITs focusing on equity investments in real property; Mortgage REITs focusing on real estate mortgages; and Hybrid REITs investing in both mortgages and real property. Equity REITs, in turn, are frequently broken into subcategories depending on whether their properties consist mostly of residential, industrial or retail properties.

UPREITs

Some REITs are initiated by "investors" who have pre-existing properties or portfolios of properties. In many cases, these investors have built-in gains on the properties they hold. If they sold the properties to a REIT, they would have to recognize those gains. If they transferred properties to the REIT in exchange for an ownership interest in the REIT, they generally would also have to recognize gain.¹⁰ To provide a tax-advantaged way for the sponsor to transfer real property to the REIT, real estate professionals created the concept of an Umbrella Partnership REIT (UPREIT).

Under this arrangement, the investors transfer their property to a newly-formed limited partnership in exchange for a limited partnership interest. This transaction would generally be tax deferred for the sponsor.¹¹ A REIT, which had raised funds from public investors, transfers all or a portion of those funds to the newly created partnership in exchange for a general partnership interest. As a result, the investors are able to defer gain on the transfer of their property and the public investors have an interest in the REIT, now called an UPREIT, which owns a portion of the partnership which, in turn, owns real property, cash, and other qualifying assets.

A U.S. partnership is not subject to federal income tax. Both the REIT and the other partners in the partnership report their share of income or loss from the partnership on their own returns each year. Most or all of the REIT's taxable income is, in turn, paid out to the REIT owners in the form of dividends that they separately report on their individual returns. The UPREIT structure, then, provides the following major tax features:

1. The investors defer recognition of gain on the transfer of their property to the partnership;
2. The income of the partnership is not subject to tax at the partnership level; and
3. Because of the UPREIT's dividend-paid deduction, the distributed income of the UPREIT is not taxed at the UPREIT level.

Agreement to Convert Ownership Units in the Umbrella Partnership for Ownership Units in the REIT

With the structure described above, the investors and the REIT end up with partnership interests in the limited partnership owning the properties. Traditionally, partnership interests are relatively more difficult to sell than interests in corporations or beneficial interests in REITs. To deal with the possible lack of liquidity of the partnership interests, the UPREIT and the umbrella partnership typically have an agreement permitting the exchange of ownership units in the partnership for ownership units in the UPREIT. Generally, each unit of the UPREIT is the economic equivalent of a unit of the umbrella partnership. For example, if the umbrella partnership had 100 units representing ownership in the partnership and the REIT owned 75% of the partnership, the REIT could have 75 UPREIT shares outstanding and the investors could have 25 units in the umbrella partnership. Each unit of the partnership owned by a sponsor

would be convertible to an equivalent UPREIT share at the election of the sponsor, typically subject to some restrictions. While the formation of the partnership would not have been taxable for the sponsor, the conversion of the ownership units of the partnership for ownership units of the UPREIT would be a taxable event for those transferring the interest in the partnership.

Subsequent Transferors of Property to the UPREIT

The UPREIT limited partnership provides a tax-advantaged vehicle for investors to transfer their properties, avoid current taxation, and diversify their risks. The sponsoring partners are not necessarily the only individuals who are able to take advantage of this structure. That is, there may be other entities who own appreciated real estate that would prefer to dispose of their real property in a tax-advantaged way if they were given the opportunity to do so.

If the UPREIT purchased the real property directly or provided UPREIT shares in exchange for the property, the transaction would virtually always be taxable to the person disposing of the property. On the other hand, if the UPREIT limited partnership accepted the property in exchange for a partnership interest, the transferor of the property would get the same tax-favored treatment that the investors received in the initial transfers to the partnership. That is, the transferors would not recognize gain; their basis in the partnership interest would be the same as their basis in the property they transferred (this ignores a complex adjustment for liabilities released and/or assumed by the transferor which, under certain circumstances, can be significant); and the partnership would have the same tax basis in the property that the transferors had before the transfer.

These subsequent transferors, then, obtain many of the tax benefits that are available to the investors. On the other hand, they frequently do not have significant influence on the ongoing operations of the REIT. Since dispositions of the transferred property by the UPREIT limited partnership could significantly affect the tax treatment of the individual partners who transferred that property to the partnership, these individuals will frequently require a "tax indemnification agreement" as a part of the agreement to transfer their property to the UPREIT limited partnership. These agreements can take many forms but they generally restrict for several years the limited partnership from taking actions with the transferred property that would adversely affect the tax treatment of the transferors. Should the limited partnership take any such actions during the prohibited period, the limited partnership may be required to pay some compensatory amount.

While these types of transfers can have substantial tax benefits, the ultimate attractiveness is at least partially dependent on the market value of the beneficial interests in the REIT. That is, since the ownership interests in the umbrella partnership are generally transferable to ownership interests in the REIT, their values are tied together. If the REIT shares are selling at or above the underlying value of the assets of the REIT, then the partnership can offer a partnership interest equal to the fair value of the property it is seeking to acquire without diluting the value of the already-

existing partnership and REIT interests. If, however, the REIT interests are selling at a discount when compared to the underlying fair value of the partnership's assets, it is impossible for the partnership to offer fair value for the target property without diluting the interests of the current owners of the UPREIT and the umbrella partnership. While logic might suggest that the value of the beneficial interests in the REIT should be tied to the underlying value of the REIT's assets, it is frequently the case that the value of the traded stock does not correspond to a proportionate share of the REIT assets.

Dispositions of Property from the Umbrella Partnership

Special Treatment of Appreciation that Occurred Prior to the Contribution of the Property to the Partnership. As mentioned above, the income or loss of the partnership is reported to the individual partners. While the rules of partnership taxation are extremely flexible, they generally require that the partnership gain attributable to pre-contribution appreciation on contributed property must be allocated to the partner who contributed that property.¹² As a result, the partner or partners who benefited from the appreciation of the property prior to its contribution to the partnership are allocated all of the gain attributable to that pre-contribution appreciation if the property is disposed of in a taxable event.

This special allocation of taxable income would apply even though the actual distribution of cash from the limited partnership to the limited partners and from the UPREIT to the beneficial owners of the REIT would be in proportion to their ownership interests. It is conceivable, then, that a partner who contributed appreciated real property to the partnership would have to report taxable income from the partnership that exceeded his or her cash distribution if that property were sold in a taxable transaction. Given the possibility of substantial gain being recognized on the transfer of property from the UPREIT, if the property is to be disposed of, there is a substantial incentive to try to dispose of it in a manner that preserves the deferral of recognition of gain.

Disposing of Property Using a Like-Kind Exchange

By deferring taxable income at the partnership level, the partners (i.e., the investors, the subsequent contributors of property to the partnership, and the UPREIT itself) could prevent taxable income from the partnership from being allocated to them at the time of a property disposition. The like-kind exchange feature of the income tax law generally permits a taxpayer to defer the recognition of gain or loss on the disposition of property when that property is exchanged for property of "like-kind." See examples in Exhibit 5. While certain properties, such as inventory property, are specifically ineligible for like-kind exchange treatment, the like-kind exchange rules are relatively flexible. That is, the like-kind exchange rules would apply to almost any real property held for productive use or investment that is exchanged for any other real property held for a similar purpose. Similarly, any personal¹³ property held for productive use or investment can be exchanged for almost any other personal

property. Generally, however, exchanges of real property for personal property and vice versa are not eligible.

By arranging to dispose of property using the like-kind exchange technique as opposed to engaging in an outright sale, then, the partnership could defer the recognition of taxable income. On the other hand, it clearly would be impractical for a REIT to limit itself only to potential buyers who were willing to engage in a trade as opposed to an outright purchase. In the late 1970s, there was an important court decision dealing with like-kind exchanges that created the possibility of using a like-kind exchange even when the potential purchaser wanted to pay cash rather than provide similar property in an exchange.¹⁴ In that case, a taxpayer received like-kind exchange treatment when he traded property for a contractual right to receive like-kind property or cash at some point in the future. Since that decision was handed down in 1979, the Internal Revenue Code has been amended to set specific ground rules for transactions that would be eligible for like-kind exchange treatment even though the purchaser of the property would not be providing similar property in an exchange. Under these provisions, a taxpayer is eligible for like-kind exchange treatment if he or she disposes of property and replaces that property with like-kind property that is (1) identified within 45 days of the disposition and (2) that is received usually within 180 days of the disposition.¹⁵

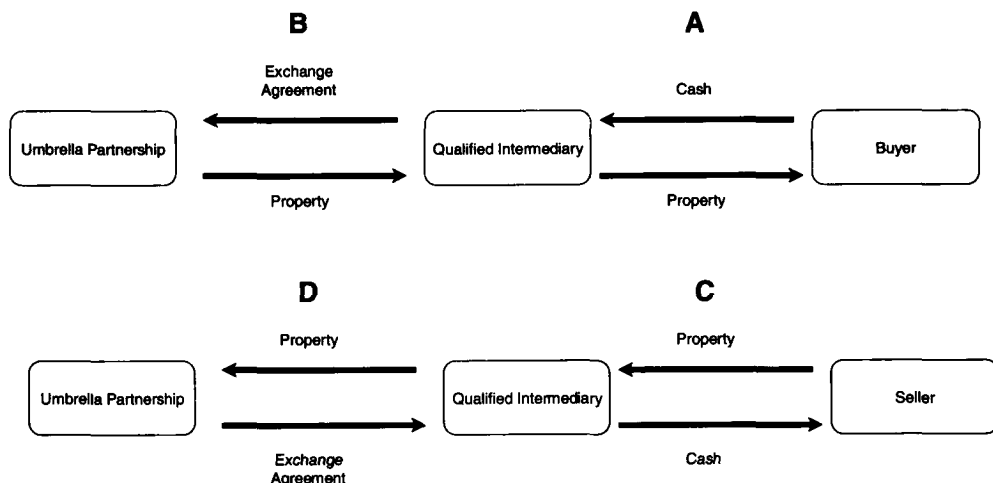
As a practical matter, to affect these types of exchanges, a third party "qualified intermediary" has to be employed. The qualified intermediary is an entity that "enters into a written agreement with the taxpayer (the 'exchange agreement') and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property [to a buyer], acquires the replacement property, and transfers the replacement property to the taxpayer."¹⁶

A typical transaction using a qualified intermediary might take the following form described in Exhibit 3:

1. The seller, in this case the umbrella partnership, places property up for sale;
2. Once the umbrella partnership finds a buyer, the seller arranges for the buyer to pay the "qualified intermediary" for the property (Point A);
3. The umbrella partnership transfers the property to the intermediary in exchange for an "exchange agreement" (Point B);
4. The buyer receives title to the property;
5. The umbrella partnership identifies up to three properties as potential replacement properties within 45 days of the transfer of his property;
6. The intermediary acquires one of the three identified replacement properties (Point C); and
7. The umbrella partnership acquires the replacement property from the intermediary under the terms of the exchange contract within 180 days of the original transfer of property (Point D).

Under this arrangement, then, even though the buyer pays cash for the property (to the qualified intermediary), the umbrella partnership is able to benefit from like-kind

Exhibit 3
A Like-Kind Exchange Using a Qualified Intermediary



exchange treatment because the seller effectively engages in a like-kind exchange with the qualified intermediary.

The Qualified Intermediary

The income tax regulations, with some exceptions, require that the qualified intermediary be independent of the taxpayer transferring the property. In addition, the intermediary must comply with certain formalities so that the transferor of the property is never directly or indirectly in receipt of the proceeds of the sale. An intermediary's failure to comply with the requirements imposed under Section 1031 or, alternatively, the business failure of the intermediary could have disastrous tax and non-tax consequences on the parties to the like-kind exchange transaction. As a result, the selection of a competent, solvent, and independent qualified intermediary can be quite an important part of the overall transaction.

Special Issues Associated with Liabilities

It is not uncommon for one side or the other in a like-kind exchange to receive some cash in the transaction because the values of the exchanged properties are unlikely to be exactly equal. Generally, the receipt of some cash does not cause the like-kind rules to be inapplicable. On the other hand, to the extent a person does receive cash in the like-kind exchange, he or she would ordinarily have taxable gain to the extent of the cash received or the economic gain, whichever is less. The law treats the release of liabilities as equivalent to the receipt of cash presumably because being relieved of a liability is similar to receiving cash and paying off a liability. For purposes of determining "release of liabilities," liabilities on property disposed of are generally netted against liabilities of property acquired.

Exhibit 4

Example of Transfer of Property to a Partnership in Exchange for a Partnership Interest

Assumptions:

REIT contributes \$100 in cash to the partnership in exchange for a 50% ownership interest.

A Sponsor contributes property with a fair market value of \$100 but a tax basis in the hands of the Sponsor of \$60 in exchange for a 50% ownership interest.

The property is subsequently sold by the partnership for \$110.

Result:

The REIT and the Sponsor would have equal capital and profits interest in the partnership.

The REIT would not recognize gain or loss and would have a tax basis of \$100 in the partnership interest.

The Sponsor would not recognize gain or loss and would have a tax basis of \$60 in his or her partnership interest.

The partnership would have no gain or loss and would have cash of \$100 and property with a tax basis of \$60.

If the partnership later sold the property for \$110, the partnership would recognize \$50 in taxable gain.

Since the partnership is not a taxable entity, any income, deduction, gain, loss or credit at the partnership level would be reported on the tax returns of the partners, the Sponsor, and the REIT.

The portion of the gain realized prior to the partnership contribution, \$40, would ordinarily be reported by the Sponsor.

Gain in excess of the pre-contribution appreciation (\$10) would be reported by the Sponsor and the REIT according to their profit sharing ratio (\$5 each).

The sponsor would have to report \$45 gain and the REIT would have to report \$5 gain.

After the sale the partnership would have \$210 and each partner would have a half interest in those assets.

A taxpayer who is attempting to avoid taxable gain on a like-kind exchange, therefore, has to be careful to avoid an unintentional reduction of liabilities. Since liabilities taken on are offset against liabilities relieved for purposes of determining taxable gain, some taxpayers anxious to avoid the recognition of gain will take steps to make certain that any property acquired will be subject to a liability at least as great as any liability released in the exchange.

The Interests of the Public Investors in the REIT

Members of the public who choose to invest in REITs probably do so:

- To obtain a high dividend yield;
 - To invest indirectly in a diversified real estate portfolio;
 - To add diversification to their current investment portfolio;
 - To maintain the liquidity that comes with publicly traded securities; and
 - To benefit from possible capital appreciation.
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Exhibit 5

Examples of Like-Kind Exchange Transactions

1. Basic Exchange

Tax Basis of Transferor's Property	50
Liability on Transferor's Property	0
Fair Market Value of Received Property	100
Liability on Received Property	0

Computations of Gain or Loss

Amount Realized	100
Basis of Property Transferred	50
Gain "Realized" (Computed Gain not Necessarily Subject to Tax)	50

Tax Result

Gain "Recognized" (Gain Included in Taxable Income)	0
Basis of Acquired Property for Purposes of Computing Future Gain, Loss or (in the case of depreciable property) Depreciation	50

2. Exchange with Liability Assumed by the Transferor of the Property

Tax Basis of Transferor's Property	50
Liability on Transferor's Property	0
Fair Market Value of Received Property	100
Liability on Received Property	20

Computations of Gain or Loss

Amount Realized	Property Received	100
Basis of Property Transferred		50
	Liability Assumed	20
Gain "Realized" (Computed Gain not Necessarily Subject to Tax)		30

Tax Result

Gain "Recognized" (Gain Included in Taxable Income)	0
Basis of Acquired Property for Purposes of Computing Future Gain, Loss or (in the case of depreciable property) Depreciation	70

3. Exchange with Liability Released

Tax Basis of Transferor's Property	50
Liability on Transferor's Property	20
Fair Market Value of Received Property	100
Liability on Received Property	0

Exhibit 5 (continued)
Examples of Like-Kind Exchange Transactions

Computations of Gain or Loss

Amount Realized	Property	100
	Liability Released	20
Basis of Property Transferred		50
Gain "Realized" (Computed Gain not Necessarily Subject to Tax)		70

Tax Result

Gain "Recognized" (Gain Included in Taxable Income)	20
Basis of Acquired Property for Purposes of Computing Future Gain, Loss or (in the case of depreciable property) Depreciation	50

Note that, in each case, the taxpayer's basis in the acquired property is less than the apparent fair market value of the property. The difference would be recognized if the property were sold in a taxable transaction. The portion of the "gain realized" that was not "recognized" is, in effect, deferred until a later taxable transaction. If the property is depreciable, the gain may be indirectly recognized through lower depreciation deductions than would have been allowed if the property had been acquired in a fully taxable exchange. These mechanics that result in the subsequent recognition of gain or income explain why the like-kind exchange rules are viewed as tax deferral rather than tax elimination provisions.

An interesting aspect of the market for REIT securities is that, perhaps unlike many other corporations, there are established techniques for valuing the underlying assets of the REIT. That is, for equity REITs, there may be established standards of cost per square foot of space that can provide insight into the appropriate value of the REIT's underlying assets and, in turn, the beneficial interest in the REIT. Similarly, for mortgage REITs, there are techniques of valuing cash flows. In this sense, it is arguable that investors in REITs might be able to obtain better insight into the value of their underlying investments than investors in some other securities.

The National Association of Real Estate Investment Trusts (NAREIT) is a professional association of REITs. Its website¹⁷ provides a substantial amount of information about many of the 180 or so REITs that are traded on national securities exchanges. That information includes dividend and price history of the individual REITs that are members of NAREIT.

NAREIT has promulgated a measure of the financial performance of REITs that is different from the traditional measures of Generally Accepted Accounting Principles and different from the measures used to evaluate companies in other industries. NAREIT encourages the use of a measure called "Funds from Operations," or FFO. They define FFO to be:

... net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from sales of property, plus

depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures will be calculated to reflect funds from operations on the same basis.¹⁸

The organization argues that, because of the unique types of property that comprise the major portion of REIT assets, this measure is a more appropriate measure of REIT performance than traditional net income as defined under Generally Accepted Accounting Principles. Unfortunately, when FFO is actually reported by REITs, the amount reported does not appear to be defined consistently from REIT to REIT.

The Financing of Real Estate Investment Trusts

Because of their unique tax features, REITs have a special problem in financing their operations. That is, they are required by law to distribute a high proportion of taxable income in order to retain their tax free treatment at the entity level. As a result, unlike regular corporations, they generally cannot rely on retained earnings as a significant source of funds for operations. They tend to rely more heavily on funds provided by investors, contributions of property by investors and, in some cases, co-venture arrangements with other entities that are not subject to the same restrictions regarding the distribution of income.

Endnotes

1. Internal Revenue Code Section 856(a)(5).
2. Internal Revenue Code Section 856(a)(2).
3. Internal Revenue Code Section 856(a)(6).
4. Internal Revenue Code Section 856(a)(1).
5. Internal Revenue Code Section 856(c)(2).
6. Internal Revenue Code Section 856(c)(3).
7. Internal Revenue Code Section 856(c)(4).
8. Internal Revenue Code Section 857(a).
9. Internal Revenue Code Section 4981.
10. For purposes of this transfer, the tax law would treat the REIT as a regular corporation. Frequently, transfers to corporations in exchange for an ownership interest are tax free under Internal Revenue Code Section 351. Section 351(e)(1), however, indicates that the non-recognition rules of Section 351 do not apply to transfers to investment companies. The Income Tax Regulations, which are authoritative interpretations of the law issued by the Department of the Treasury, indicate at Reg. Sec. 1.351-1(C)(1)(ii) that REITs are "investment companies" for this purpose.
11. Even though these transfers to partnerships are governed by the same investment company rules that govern transfers to corporations, a partnership would only be considered an investment company under certain restrictive circumstances. Therefore, the investors could benefit from the general non-recognition rules that apply to transfers of property to partnerships in exchange for an ownership interest in the partnership.
12. This is the general rule of IRC Section 704(c) explained by Reg. Sec. 1.704-3(b).

13. The word "personal" in this context does not mean property held for personal use. Instead, it means property other than real property. That is, for this purpose, real property is generally considered to be land and assets permanently affixed to the land. Personal property encompasses all other property.
 14. *Starker, T.J. v. U.S.*, (1979, CA9).
 15. Code Section 1031(a)(3).
 16. Reg. Section 1.1031(k)-1(g)(4)(iii)(B).
 17. <http://www.nareit.com/>.
 18. *White Paper on Funds from Operations*, The National Association of Real Estate Investment Trusts, April, 2002, 2.
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