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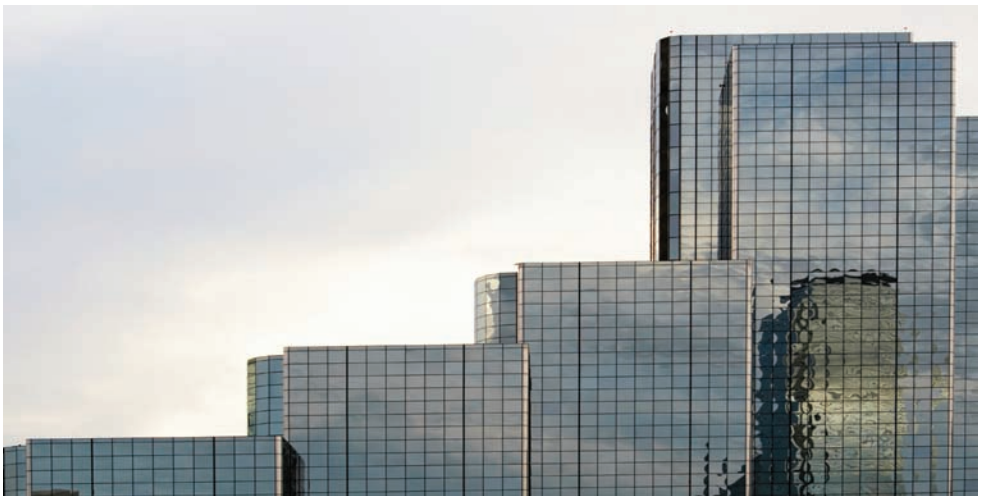
THE NEWSLETTER OF THE BDO REAL ESTATE INDUSTRY PRACTICE

REAL ESTATE MONITOR



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BDO REAL ESTATE AND HOSPITALITY SERVICES PRACTICE

BDO's Real Estate and Hospitality Services practice consists of multi-disciplined professionals, well-versed in compliance and consulting matters. Our professionals have many years of experience in financial reporting and accounting, tax and auditing issues and are continually updating their knowledge and, therefore, are in a position to give timely and accurate advice.

THE RISE OF THE NON-TRADED REITs

By Anthony LaMalfa

The past few years have seen an accelerating number of registration statements being filed for non-exchange- traded real estate investment trusts, or "non-traded REITs." Just what are non-traded REITs and how do they differ from listed REITs?

Basically, non-traded REITs are syndicated real estate investment partnerships brought to the investing public. Since shares of non-traded REITs are registered with the Securities and Exchange Commission (SEC), investors in them are not required to be "accredited investors" as defined in Rule 501 of Regulation D. Non-traded REITs are available to all investors that meet certain "suitability standards[1]," which set a lower threshold than the accredited investor standards.

Generally, a non-traded REIT is formed by a sponsor entity. The sponsor entity will provide the non-traded REIT with asset and management services over the life of the REIT. As of June 30, 2011, there were 66 non-traded REITs according to the *Blue Vault Partners Nontraded REIT Industry Review Second Quarter 2011* issued by Blue Vault Partners, LLC.

▶THE SIMILARITIES

There are many similarities between traded and non-traded REITs. They both register their shares with the SEC, they both are required to file reviewed quarterly financial statements, and both are required to file audited annual financial statements. In fact, all of the SEC reporting requirements (including proxies,

[1] Suitability standards vary by state but are generally are individuals with a net worth of $150,000 or with both a $45,000 annual income and a $45,000 net worth.

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NON-TRADED REITs

SMITH LEONARD

and Form 8-K and Form 4) are applicable to non-traded REITs in the same manner as any other SEC filer. In addition, the financial statements of non-traded REITs must follow the same accounting principles as other listed companies (currently accounting principles generally accepted in the United States, or "GAAP."

▶THE DIFFERENCES

A number of key differences separate traded from non-traded REITs and they should be considered by any potential investors. For example, non-traded REIT shares are only sold through broker/dealers and financial advisors rather than over a national exchange. At times, the broker/dealers or financial advisor may be related to the non-traded REIT's sponsor.

Another key difference is that non-traded REITs lack the liquidity of traditional REITs since they are not traded on a national exchange. Generally, an investment in a non-traded REIT is recovered by the eventual liquidation of the entity, a process that may take longer than expected and may affect investor returns. A number of newer offerings include redemption provisions to deal with the liquidity concerns of investors, but these provisions are very limited and subject to management override.

There is also a disparity in the front-end fees between traded and non-traded REITs. Generally, in an initial public offering, a traded REIT will pay approximately 7 percent (or more) of the offering proceeds to the underwriter, with individual investors paying commissions to their brokers when they acquire shares. Conversely, front-end fees in a non-traded REIT offering can be 15 percent of the per-share price going to the sponsor. This is another area where newer offerings have taken investor concerns into account, and the fee structures of some of these deals have lower overall fees or, more likely, may have shifted some of the front-end fee load to the back-end in the form of a bigger carried interest for the sponsor.

Non-traded REITs have also increased their transparency, complementing their disclosures with benchmark information and appraisal-based valuation reports. However, some of the new found transparency has come in response to previous investor lawsuits and new Financial Industry Regulatory Authority guidance. Another promising development is that as the industry grows, the number of companies providing industry and company data is growing. Now, much more information is available to investors through reports published by companies that track the non-traded REIT industry. All of this additional information is shedding new light on the various opportunities in non-traded REITs.

▶THE DRAW

Regardless of concerns about transparency or the lack thereof, what investors want are returns, and non-traded REITs are promising them. Generally, non-traded REITs provide quarterly distributions to shareholders and a return of capital upon liquidation. Currently, quarterly distributions of non-traded REITs vary widely, from as low as zero to over 8 percent. These distributions are based on the performance of the entity, but are also significantly impacted by the stage of the entity's life. Some early distributions may be funded with new offering proceeds, which may trouble newer investors.

Through their carried interests, the sponsors share in the performance and capital appreciation of the assets with the shareholders, thereby aligning their interests. The enticement is the hope of receiving a steady income stream over the holding period and then sharing in the significant capital appreciation of the real estate at liquidation.

If the new and more transparent non-traded REITs can deliver the returns investors seek, there should be a long and prosperous future for this budding market. Investors then will be happy they gave non-traded REITs a chance.

Anthony La Malfa is a director in the Real Estate & Hospitality Services Group in BDO USA's New York office. He can be reached at (212) 885-8000.

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SMITH LEONARD

GREEN LEASING: TOP 10 TIPS

By Paul Jayson and Sally Whitney

THE GREENING OF BUILDINGS RAISES UNIQUE ISSUES BETWEEN LANDLORDS AND CURRENT AND FUTURE TENANTS. TO HELP NAVIGATE THIS NEW AND QUICKLY EVOLVING AREA, AN ARTICLE BY PAUL JAYSON AND SALLY WHITNEY DESCRIBES THE TOP 10 TIPS FOR GREEN LEASING.

Landlords and tenants are beginning to realize there are significant benefits from going green. For landlords, these include savings in operational and maintenance costs, increases in tenant retention rates and a general competitive advantage in today's challenging real estate market. For any real estate occupier, leasing space in a green building is one aspect of a comprehensive sustainability program designed to reduce energy and resource consumption, carbon emissions and waste. However, the greening of buildings raises unique issues between landlords and their current and future tenants.

1. Set the standards

In the most basic sense, a green lease is any lease to which some sustainability concepts have been added. Accordingly, in order to achieve a meaningful green lease document, there needs to be a clear understanding of the specific "green objectives." It is strongly recommended that, before commencing a green leasing initiative, both parties develop a set of the specific sustainability standards they wish to achieve. These will guide the lease negotiations, stipulating both the requirements and how they are to be implemented.

2. A balancing act

To achieve the desired sustainability goals for its property, a tenant will often want the building it occupies to meet specific standards throughout the lease term (such as the EPC rating, the availability of renewable energy, a building-wide recycling program, a green travel plan). For landlords, however, although it is critical to be specific about what sustainability standards have to be achieved, it is vital to avoid being so prescriptive that the standards become outdated or irrelevant during the lease term.

It is also essential that newly added or revised provisions relating to green issues work in harmony with the other non-green provisions, in the lease documents. These provisions must be tailored to match the specific design and operational characteristics of the particular property.

3. Certify it

Achieving independent certification is likely to add to the lease's green credentials and attract tenants seeking green leases. From a tenant's perspective, it is desirable that the building achieves BREEAM or other sustainability certification. As there are a number of ways to achieve certification, the agreement for lease or development agreement will need to specify, in detail, the standards to which the building is to be built (or refurbished). The certification process is complex and requires considerable lead time; accordingly, the agreement should establish realistic milestone dates with which the landlord or developer must comply in applying for and achieving certification.

4. Capture it

In order to measure system performance that ensures that the sustainability standards for the building or premises are being met on an ongoing basis, it may be necessary to install, maintain and operate special monitoring and data collection equipment. Smart meters

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GREEN LEASING

which allow the remote measurement of energy use on an hourly or half day basis are a good example. The allocation of both the obligation and cost of doing so is a negotiable item, but tenants will need to ensure they have access to the data either on a continuous basis or via periodic reports and in an agreed form.

5. Encouraging cooperation

Having green buildings can give a landlord a competitive advantage in the market, both in terms of the attractiveness to potential tenants as well as the possibility of cost savings (for example, through reduced energy use). Leases may, therefore, incorporate provisions requiring tenants to cooperate with the landlord's sustainability practices. Tenants should bear in mind the need to ensure that any such obligation is specifically set out in the lease or any apportionment is allocated fairly between the landlord and tenant.

6. Commit to carbon reduction

Both government regulation and private markets are creating sustainability incentives, such as carbon offset and tax credits. These can become important financial factors for any green building or lease. For example, In April 2010, the Carbon Reduction Commitment Energy Efficiency Scheme (CRC) was introduced in the UK by the Department of Energy and Climate Change, in partnership with the Scottish government, the Welsh Assembly and the Department of Environment in Northern Ireland. Landlords may seek to capture credits and incentives or seek discretion over their allocation. Tenants, on the other hand, may also wish to capture these credits and incentives to the extent they relate to their premises and have been generated by their own efforts to achieve sustainability. The CRC is likely to become a key factor to consider in green lease negotiations.

7. Sustaining sustainability

As the performance of equipment degrades over time, the landlord may take the view that he can only guarantee the high standard of performance required by typical sustainability standards either at the beginning of or during the warranty period for any new equipment. This is unlikely to be acceptable to tenants who need to achieve their own sustainability goals throughout their period of occupancy. The issue can often be resolved by permitting the landlord to include, in its annual operating expenses, the amortized cost (over its useful life) of replacing the equipment that no longer meets the higher standards, if normal maintenance and calibration of such systems cannot produce the required performance levels.

8. Check the back door

It is common for the rules and regulations that are attached to a lease to address matters including sustainability, which have been negotiated in the body of the lease. Be sure that any rules and regulations that are redundant or in conflict with the lease itself are deleted or conformed.

9. A broad approach

For landlords, updating lease documents so that they govern relationships with future tenants addresses only part of the challenge of green leasing. For years to come, most of a building's leases will consist of older, non-green lease documents,

To fully achieve green objectives, it is critical for the existing leases to be made as green as possible. Each of the existing and prior lease forms in use at a building should be examined with the goal of determining the most favorable approach to pursue:

- To the extent the existing or prior lease form does not fully accommodate the building's newly instituted green measures, an appropriate form of green lease amendment should be created so that, as and when significant changes are made to existing leases in the future (such as renewals, relocation, and expansions), such occasions can become opportunities to fully green existing leases.

- Some existing leases may be able to accommodate new green measures with very little adjustment. It is important to be advised as to what actions, if any, are appropriate for a specific lease and the pros and cons of allowing leases to remain unchanged.

For real estate occupiers, leasing space in a green building is just one aspect of a comprehensive sustainability program. For tenants keen to reduce their energy and resource consumption, carbon emissions and waste, thought needs to be given to information gathering and analysis programs and metering so that progress towards such goals can be measured.

10. An expert eye

This briefing outlines some of the more salient issues that need to be addressed in negotiating a green lease that truly meets the sustainability goals of sophisticated landlords and tenants. To successfully draft and negotiate a green lease that will achieve such goals needs forward-thinking lawyers with both an expert knowledge and hands-on experience of sustainability issues.

Paul Jayson is a partner in the London office of DLA Piper and Sally Whitney is an associate with the firm.

HORSE BREEDING: EXPENSES NOT DEDUCTIBLE

By Robert Klein

The U.S. Tax Court ruled that the petitioner was not entitled to deduct various expenses incurred in connection with horse breeding activities even though he acted in good faith, took reasonable efforts to assess his proper tax liability and relied upon his tax advisor. Accordingly, he was not liable under Code Section 6662(a) for penalties. *Van Wickler v. C.I.R., T.C. Memo. 2011-196, T.C.M. (RIA) P 2011-196 (2011)*.

▶BACKGROUND

Van Wickler, having earned a fortune in stock options, sought income-generating opportunities. He was introduced to Classic Star, a company that marketed horse-breeding activities to high-net-worth individuals. Classic Star told Van Wickler of its history of producing profitable horses and the belief that the government encouraged this type of investment because it generated revenue for the government. Van Wickler engaged a CPA to review the Classic Star materials and information, and in addition spoke to another CPA recommended by the company. Van Wickler believed he could make a profit by investing in a mare lease program with Classic Star. Over a period of three years, Van Wickler invested large sums of money in mare lease programs after being advised by the firm that they believed the program, although high-risk, could produce high returns and, if not, deductions for losses could withstand IRS scrutiny.

Van Wickler created Bent Rock Farms LLC to invest in Classic Star. While Van Wickler believed the Classic Star horses were thoroughbreds, in fact most were not. As a result, he incurred very high losses that he deducted on his federal income tax returns over a two-year period. He then received a notice of deficiency that disallowed all horse breeding activity expenses. Van Wickler appealed to the U.S. Tax Court.

▶NO EXPENSES DEDUCTIBLE

The IRS contended that Van Wickler was not entitled to deduct the horse breeding expense because he was not in the business and the amounts were unreasonable. Additionally the IRS had determined that Van Wickler was liable for accuracy-related penalties based on negligence or a substantial understatement of income tax. Negligence includes any failure to make a reasonable attempt to comply with the law or maintain adequate books and records. Although Van Wickler substantially understated his income tax, § 6664(c)(1) provides no penalty shall be imposed if there was reasonable cause for the underpayment and the taxpayer acted in good faith.

Reliance on professional advice qualifies as reasonable cause if the reliance was reasonable and the taxpayer acted in good faith. Here, Van Wickler recognized his unfamiliarity with tax law and aspects of the mare lease program. He reviewed the materials given him by Classic Star, including tax opinions, and spoke with a tax professional about the program and the tax returns at issue. He lacked knowledge of tax law and sought advice from a party who was duped by Classic Star's materials and representatives. The court concluded that Van Wickler acted in good faith and took reasonable efforts to assess his proper tax liability and reasonably relied upon the expertise of another. Accordingly, he was not liable for § 6662(a), accuracy-related penalties.

By Robert Klein, CPA, tax partner in the Woodbridge, N.J. office of BDO USA. He can be reached at 732-750-0900.

LEASES: DAMAGE AND DESTRUCTION CLAUSE

By David Tevlin

VIOLENT STORMS, FLOODS, AND TORNADOES IN RECENT MONTHS CAUSED WIDESPREAD DAMAGE AND DESTRUCTION TO BUILDINGS AROUND THE NATION.

It is likely that many lessees read – perhaps for the first time – the damage-and-destruction (D&D) clause in their leases. Because it is not a "money" clause and deals with a contingency that is often not anticipated, the D&D clause simply may be copied from a standard form (or more likely) be part of the lessor's printed form. This could turn out to be a serious mistake if the clause fails to reflect the particular circumstances of the parties.

The function of the D&D clause is to allocate the burden of loss in a manner acceptable to both parties. It is true that insurance coverage is available for all or most types of catastrophes, but even here the D&D clause plays an important role in determining which party will be responsible for obtaining and paying for the insurance. Furthermore, insurance often is an incomplete remedy, and each party must weigh the risks it assumes in the event damage or destruction does occur.

DRAFTING THE CLAUSE

A D&D clause always should be included in a lease. In drafting the clause, the parties should be sure to coordinate it with related lease clauses—notably, the insurance clause and the repair/maintenance clause. As a general rule, the insurance clause should track the D&D clause. For example, after the clause allocates the repair or restoration obligations between lessor and lessee, the insurance provisions should require each party to carry sufficient insurance to perform its obligations. Similarly, if the D&D clause entitles the lessee to rent abatement in the event of damage or destruction, the lessor should obtain rent insurance (possibly requiring the lessee pay for the insurance as additional rent). On the other hand, if the lessee is not entitled to rent abatement, it is the lessee that should carry the insurance. With regard to the repair/maintenance clause, the parties usually do not intend that it be applicable when damage or destruction occurs because in that event, the provisions of the D&D clause are applicable. If this indeed is the intention of the parties, it should be specified.

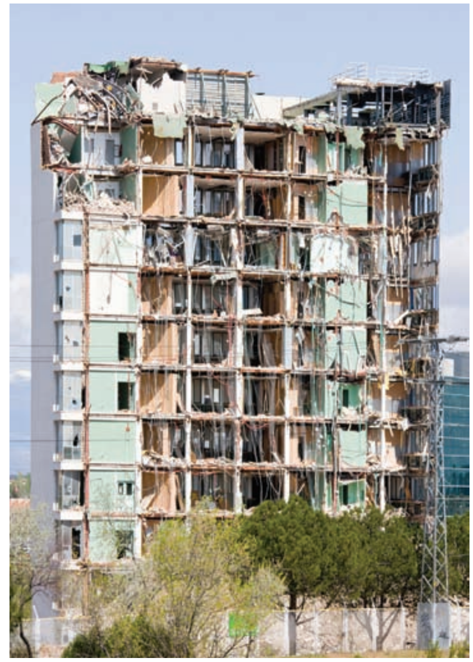
The four major issues to be decided when parties are negotiating the D&D clause are:

- The definition of "damage and destruction"
- Obligation to restore
- Abatement of rent
- Lease termination

DEFINITION OF DAMAGE AND DESTRUCTION

Most leases make no attempt to define the term "damage and destruction," except to the extent of saying "by fire or other casualty" or "by fire, explosion, earthquake, windstorm, flood, casualty, or other cause." Until recent years, such a general definition was sufficient since damage and destruction were always thought of in terms of physical damage. With the advent of environmental concerns, however, it is not always clear whether environmental contamination fails within the term damage and destruction. For example, in New York City, a building became unusable because a utility's steam pipe exploded and spewed asbestos throughout the building. A more subtle example of contamination is that involving indoor air quality that may make it difficult if not impossible to occupy the building.

Because of the difficulty of adequately defining the various causes that may trigger the provisions of the D&D clause, a better approach is to indicate when the clause becomes operative in terms of the consequences to the lessee. Examples of such language include:



- "When lessee cannot conduct normal business at the leased premises"
- "There is a material interference with the lessee's business operation in the leased premises"
- "When the building is rendered unfit for use or occupancy"
- "When the premises are rendered substantially or wholly un-tenantable"

All of these phrases establish a standard that, while not self-evident, is capable of being determined by an impartial outsider, such as a mutually agreed-on building engineer.

By David Tevlin, managing director, Corporate Real Estate Services practice, New York office of BDO USA. He can be reached at 212-885-8457.

SMITH LEONARD

FAIR HOUSING: DISPARATE IMPACT CASE REINSTATED

By Alvin L. Arnold

A decade-long battle over the redevelopment of a low income neighborhood in Mt. Holly, N.J. will continue now that the Third Circuit Court of Appeals has reversed a dismissal on summary judgment of the residents' Fair Housing Act lawsuit: *Mt. Holly Gardens Citizens in Action, Inc. v. Township of Mt. Holly, 2011 WL 4035780 (3d. Cir. 2011)*.

▶REDEVELOPMENT PLAN

Mt. Holly township has adopted and begun implementation of a plan for the redevelopment of the Mt. Holly Gardens neighborhood, a 30-acre area of 329 homes, most of which are (or were) brick townhouses. According to the 2000 census, the neighborhood was 46 percent African-American, 29 percent Hispanic, and 20 percent non-Hispanic Whites. Almost all of the residents were classified as "low income," and most were "very low" or "extremely low" income.

The neighborhood had significant problems that warranted a redevelopment plan. It was crowded, which led to over paving and drainage problems. Some owners were absentee landlords, and many properties had fallen into disrepair, while others were boarded up. These conditions facilitated crime – although comprising less than 2 percent of the township's land area and 10 percent of its population, Mt. Holly Gardens suffered from 28 percent of the town's crime in 1999. In 2000, a study commissioned by the township concluded that the area "offered a significant opportunity for redevelopment" due to blight, excess land coverage, poor land use and high crime rates.

Over the following years, the township created a number of redevelopment plans, the key element of which was the demolition of most of the existing homes in the neighborhood and their replacement with new housing, the vast majority of which would be market-rate. Many residents opposed the plans, believing they would be unable to find affordable replacement housing in the town. The township had offered qualified homeowners $15,000 in cash plus a $20,000 interest-free loan to help them purchase new properties; tenants were offered up to $7,500 in relocation assistance, but opponents believed these amounts inadequate.

The township began acquiring and demolishing housing units and, by 2008, it had demolished 75 units and purchased another 148 which were left vacant, rendering the neighborhood essentially uninhabitable. By 2011, only 70 homes remained in private hands, and most of the remaining units had been demolished.

▶FAIR HOUSING CLAIMS

In 2003, a community group filed suit against Mt. Holly in New Jersey court, but the suit was ultimately dismissed with a finding the discrimination claims were not ripe because the plan had not yet been implemented. In 2008, they filed suit in federal court, raising the discrimination claims again, this time under the Fair Housing Act, and seeking an injunction against the redevelopment as well as damages and compensation. The district court granted summary judgment to the township, holding that there was no *prima facie* case of discrimination and that, even if such a case had been made, the plaintiffs had failed to show that there was a less discriminatory alternative.

▶DISPARATE IMPACT CLAIM

The Third Circuit reversed and remanded, stating that the trial court had failed to give the plaintiffs the benefit of reasonable inferences and had misapplied the test for disparate impact.

A claim for disparate impact under the FHA proceeds in a series of shifting burdens. First, the plaintiff must make out a *prima facie* case, showing that the challenged acts have a racially discriminatory effect – that is, they disproportionately burden a protected class. If that is shown, the defendant must then show that its actions have a legitimate, nondiscriminatory purpose and that there is "no alternative course of action that

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FAIR HOUSING

would enable that interest to be served with less discriminatory impact." Finally, if the defendant can make this showing, the plaintiff can still prevail if it can show that there is such an alternative course of action.

The appellate court held that it had been an error to dismiss the case because, when viewed in the light most favorable to the plaintiffs, the evidence was sufficient to establish a *prima facie* case. The evidence showed that 22 percent of African-American households and 32 percent of Hispanic households in the town would be affected, compared with 2.7 percent of White households. Moreover, only one in five minority households in the county could afford market-rate replacement housing, compared with four out of five White households. The district court had failed to give adequate weight to this evidence in light of the stage of the proceedings, which called for all reasonable inferences to be made against the granting of summary judgment.

Moreover, the court held that the district court had applied a legally incorrect test by looking at discriminatory treatment rather than discriminatory effect. That is, the trial court essentially held that because minorities in the neighborhood were treated the same as the White residents, there was no discrimination. This was an error because it ignored the fact that the challenged plans affected a disproportionate number of minorities. The township argued that such a test would make it nearly impossible to redevelop minority neighborhoods, a claim that the court rejected. The FHA permits such plans, but requires that the township examine whether redevelopment can be achieved with less of a discriminatory impact.

Whether such an alternative exists, the court held, is "similar to the test of whether the defendant has demonstrated that a requested accommodation [for a disabled person] is 'unreasonable.'" This requires a showing that the alternative would "impose an undue hardship under the circumstances of this specific case." As this could not be resolved without an evaluation of conflicting evidence, summary judgment was inappropriate.

By Alvin L. Arnold, editor, Real Estate Monitor, New York office of BDO USA. He can be reached at 212-885-8235.

CONTACT:

ALVIN ARNOLD
Editor, *Real Estate Monitor*
212-885-8235
aarnold@bdo.com

www.bdo.com