# NET LEASE ADVISOR

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Third Quarter 2009

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CALKAIN COMPANIES, INC.

# Q&A:

## SECTION 1033 - INVOLUNTARY CONVERSIONS

### Q&A with SmolenPlevy's Dan Ruttenberg & Matt J. Campione

Calkain asked Dan Ruttenberg and Matt Campione from SmolenPlevy in Vienna, VA to explain §1033 involuntary conversions as it applies to real estate. Founded in 1977, SmolenPlevy (smolenplevy.com) provides high quality legal representation to individuals, families and businesses. Mr. Campione served for many years as a Senior Tax Law Specialist in the National Office of the Internal Revenue Service and as a tax partner in Reznick, Fedder and Silverman (currently known as the Reznick Group) before joining SmolenPlevy in 2001. Mr. Ruttenberg joined SmolenPlevy in 1997. In addition to his law degree, Mr. Ruttenberg has a Master of Laws in Taxation and is licensed as a Certified Public Accountant.

CALKAIN: What is a §1033 Involuntary Conversion Exchange with regard to real estate?

SmolenPlevy: Internal Revenue Code Section 1033 allows taxpayers to defer the capital gains associated with real property that has been involuntarily converted when they purchase similar replacement real property. If you are familiar with a §1031 Like-Kind Exchange, it works similarly.

CALKAIN: What is considered an "involuntary conversion" for purposes of a §1033 Exchange?

SmolenPlevy: The most commonly thought of involuntary conversion is eminent domain. That is when the government takes your property for its own purposes such as building a new road. In exchange for your property, the government gives you the fair market value of your real estate and you would typically have to pay capital gains on the transaction as if you voluntarily sold it to any third party. However, an involuntary conversion also includes a sale of property under the threat of condemnation as well as the destruction of property from fire, flood, etc.

CALKAIN: Are there any restrictions on the replacement property one can buy?

SmolenPlevy: Most of the time, we are dealing with property that is condemned or sold under threat of condemnation. Such involuntarily converted real property may be replaced by real property which is "like-kind" in nature. Like-kind property is a fairly broad standard. For example, an apartment is like-kind to a farm and improved property is like-kind to raw land. However, if other property is involuntarily converted, you are subject to a stricter standard. In such a case, the replacement property must be "similar or related in service or use". For example, your house should be replaced by another house, although you could purchase raw land subject to a construction contract. This is generally not an issue as would usually replace your house with another home.

CALKAIN: Why wouldn't I just do a §1031 Like-Kind Exchange if my real estate is involuntarily converted?

SmolenPlevy: First of all, a §1031 Like-Kind Exchange only applies to property used in a trade or business or held for investment purposes. Therefore, you cannot take advantage of §1031 if your home is involuntarily converted. Second, the rules under §1033 are much more flexible than the rules under §1031. For example, the sales proceeds in a §1031 Exchange must be held by a Qualified Intermediary such as the ES Group until they are used to purchase the replacement property. However, the property owner can hold their own funds in a §1033 Involuntary Conversion Exchange. Also, when dealing with property that is used in a trade or business or held for investment

**Involuntary Conversion**

*Definition* – noun: Money or property received in compensation for a damage or loss by casualty, condemnation, or theft. Profit realized on involuntary conversion is generally tax-free if it is invested in a property similar to the damaged or lost one within a certain period.

purposes, the taxpayer has 3 years to purchase the replacement property instead of the 180 days one would have in a §1031 Like-Kind Exchange.

CALKAIN: What are the common pitfalls in this area for taxpayers subject to this provision?

SmolenPlevy: You have to be careful to preserve the identity of the party eligible for the tax free roll over of proceeds. These rules are similar to rules regarding which party is eligible for §1031 Like-Kind Exchange treatment. For example, if real property held by a partnership is taken or sold under threat of condemnation it is the partnership that must purchase the replacement property within the time period allowed. The partners cannot individually reinvest the proceeds. A recent private letter ruling, PLR 200921009, provides an interesting example of how the eligibility can be fractured through a creative use of partnership taxation rules. Similar to a §1031 Like-Kind Exchange, the taxpayer has to be careful to buy enough replacement property to avoid recognition of income. §1033 is fairly technical and has many rules. The bottom line is that this is not something someone should try without the guidance of qualified professionals. ■

Along with handling §1033 Involuntary Conversion Exchanges and other real estate matters, SmolenPlevy is a respected leader in the areas of succession planning for businesses, general corporate law, estate planning, estate administration and family law.

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# 15 Year Depreciation, "I'm Lovin' It"

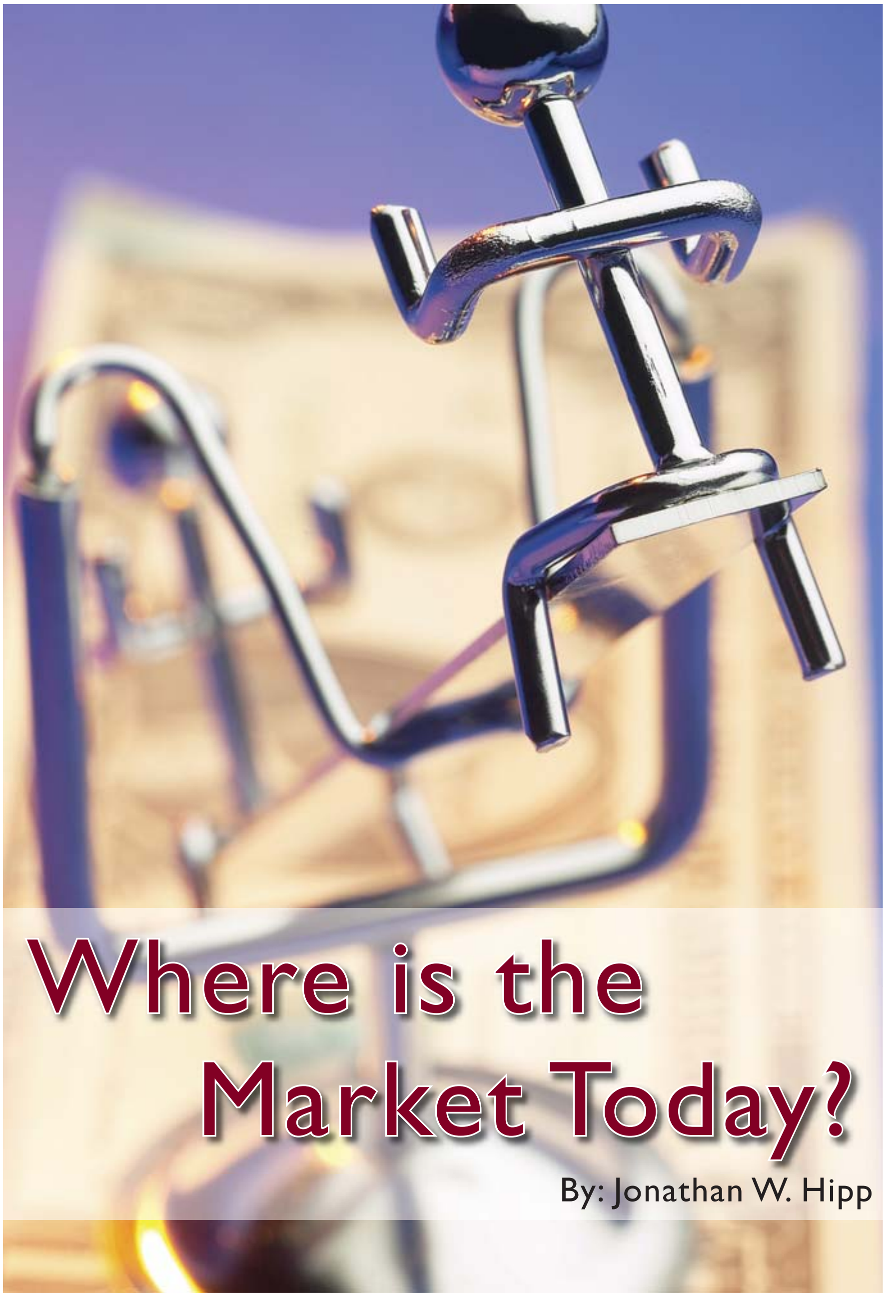
By: Winston Orzechowski

Amid the hundreds of pages contained within the Emergency Economic Stabilization Act of 2008, there potentially exists an extremely valuable tool for those interested in real estate investment. A new law enables restaurant buildings and improvements to be depreciated on a 15 year basis if they are placed in service within the calendar year of 2009 and more than 50% of their square footage is dedicated to "the preparation of, and seating for on-site consumption of, prepared meals". What does this mean for the investor? Well, restaurant real estate generally has to be depreciated on a 39 year basis, which means one could increase their depreciation tax shield by close to 40% if they act within 2009. That translates into large dollar sign increases on after tax income.

Below is an illustration of just how much a depreciation shield increase of close to 40% could affect one's cash flow. For purposes of the comparison, we will be using a McDonald's and a Burger King, both with solid credit ratings, placed in service in 2009 and 2007 respectively. Since the McDonald's was placed in service in 2009 it can take advantage of the accelerated depreciation schedule, unlike the Burger King.

What is evident from this example is that restaurant real estate is the place to invest in 2009. In this case we saw an after tax cash flow difference of $55,671 in favor of McDonalds for one year. If all else holds equal, over 15 years that becomes an $835,065 difference. This could make a huge difference to all who are thinking of investing in 2009 and goes to show that change on Capital Hill can turn into cash in your pockets. ■

| | BURGER KING | MCDONALD'S |
|---|---|---|
| Value (Improvements) | $4,045,250 | $4,045,250 |
| Value (Equipment) | $2,206,500 | $2,206,500 |
| Depreciation Life (Improvements) | 39 Years | 15 Years |
| Rental Income | $460,000 | $460,000 |
| Interest-1st Mortgage | $297,579 | $297,579 |
| Depreciation (Improvements) | $99,392 | $258,451 |
| Depreciation (Equipment) | $382,460 | $382,460 |
| Fees/Costs | $1,000 | $1,000 |
| Taxable Income | ($320,431) | ($479,490) |
| Tax Liability Savings (35%) | ($112,151) | ($167,821) |



# Where is the Market Today?

By: Jonathan W. Hipp

There is no doubt that we have seen drastic adjustments in the net lease market. Not only from the financial and economic perspectives, but from a psychological perspective as well. Of course there has been quantifiable increases in cap rates, interest rates and internal rates of return, but the perception of today's market is probably the most interesting intangible investment factor.

As the President and CEO of a net lease brokerage firm, we have the privilege of working with professionals from a multitude of disciplines within commercial real estate. We hear market perspective from attorneys to engineers, developers to sellers, REITs to investors and everything in between. What we are hearing is everyone wants more for less. That doesn't mean that they are getting it, but at least they are saying that they want it.

Investors want better credit, longer leases, the best real estate and an absolute triple net lease. But what they may be forgetting is that net lease investments offer something that other real estate doesn't; the opportunity to underwrite the known investment potential from day one. There is no other type of commercial real estate that will allow an investor to know exactly what their income will be from the day they buy the asset until the day they sell the asset. But the perception is that they should be getting a much better return than they are being offered. In some cases, that is highly warranted. But in others, it may not be.

We have to remember that net lease investments are still a long term income stream backed by real estate. When an investor and I discuss the current market statistics, I always remind them that yes, they will be getting a better return than what was offered in the last 3-4 years, but they may not be getting the deal of a lifetime. Net lease investments are still garnering single digit cap rates for long term, credit tenant investments. There was a day when today's investments were pricing out at 10%+ CAP rates, but not today.

Today, we see genuine interest in the net lease investment asset class because of its passive nature and higher returns than money markets, cd's, US treasuries, and the like. So while the perception of the market is "buy now, because it may not be this good again," I offer the following advice. The net lease market will ebb and flow with the rest of the market, but stability of the assets will typically remain somewhat constant. Net leases are almost an anomaly in that respect. Perception is reality, but net lease investments are real. ■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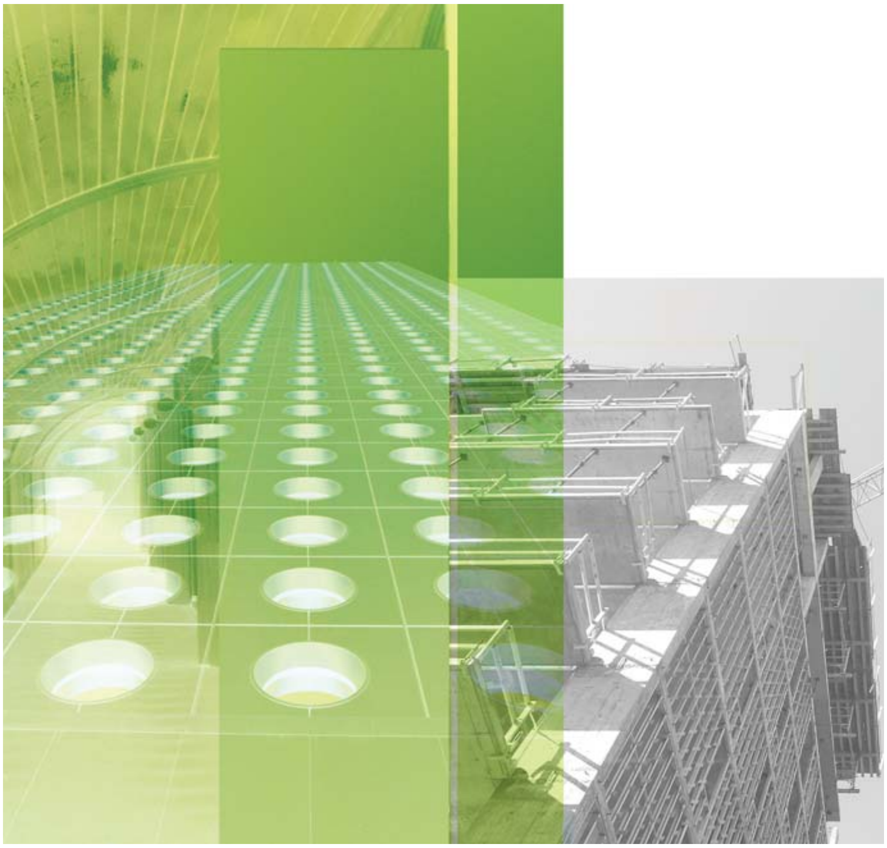
# BENEFITS OF BUILDING "GREEN"

By: Joan Pino



The much anticipated green building movement has finally reached the commercial real estate industry, where it has the potential to make the largest positive impact on the environmental health of our planet. The shift to constructing and occupying green buildings has been challenging due to the adjustment in conventional practices required by professionals in the industry coupled with widespread speculation regarding the "green cost premium." Progressive companies including Whole Foods Markets, Chipotle Mexican Grill, Best Buy, Starbucks, Walgreens, PNC Bank and Toyota, in addition to governments across the world, have tackled these initial obstacles and proved time and time again that green buildings are cost-effective investments that provide numerous advantageous benefits for all who develop, own and occupy them. While everyone stands to profit, net lease tenants have the potential to gain the most from green buildings, which provide protection from rising energy costs, boost employee productivity, drive higher sales and contribute to the overall consumer experience.

A study released by CoStar Group in March 2008 stated "non-green buildings are going to become obsolete." This statement may seem exaggerated and impracticable, yet it is an ever impending truth which the commercial real estate industry must consider. Lee Arnold, CEO of Colliers Arnold, said in a recent interview on Tampa Bay's Studio 10 daytime talk show "you will not see commercial office buildings that are competitive in the future if they are not green, it will impact their cap rates and value." Net lease tenants are becoming aware of and beginning to demand the ample tangible and intangible benefits green buildings offer. Green buildings reduce energy use by 24-50%, water use by 40%, and solid waste by 70% which all equate to decreased operating costs. Furthermore, they have been proven to be healthier and safer for occupants and enhance public image. Research has also shown a strong positive correlation between time and money spent by consumers in stores with increased levels of natural light, which is a key design element in many green buildings. All of these benefits supply developers and owners of green buildings with highly marketable assets which create a distinct competitive advantage over conventional buildings in comparable markets.

The U.S. Green Building Council (USGBC) formed the LEED® (Leadership in Energy and Environmental Design) Green Building Rating System with the goal of providing a comprehensive method for designing, constructing, and operating high performance,

*"The LEED® ( Leadership in Energy and Environmental Design) Green Building Rating System is the nationally accepted benchmark for the design, construction, and operation of high performance green buildings."*

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**TENANT SPOTLIGHT:**


# Buffalo Wild Wings

## Snapshot By Apeksha S. Shah

Buffalo Wild Wings, Inc., (NASDAQ: BWLD) founded in 1982 and headquartered in Minneapolis, Minnesota, is a growing owner, operator and franchisor of restaurants serving Buffalo-style chicken wings. Buffalo Wild Wings has escaped the fate of most casual dining chains during this economic downturn and its revenue has grown at least 19 percent every year for the past four years. Last year the company recorded revenues of $422 million, which Value Line forecasts to grow to $1 billion by the year 2014.

The company owns 197 stores and has 363 franchises. From the 2008 annual report, the company seeks to grow to 1,000 outlets as it expands nationally. Despite the recent economic slowdown, the company has held on to the stated aim on opening 15% more outlets in 2009 while not compromising its earnings and revenue growth goals.

Buffalo Wild Wings' management continues to target impressive double-digit earnings growth rates and has also generated returns greater than the cost of equity, hence creating value for shareholders.

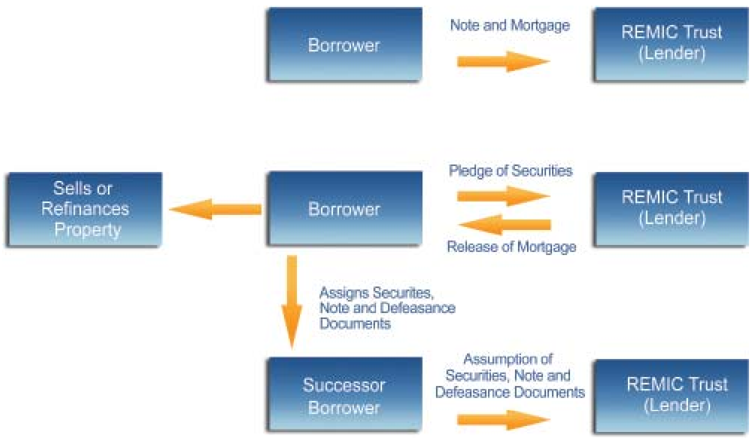
Financially, the company has generated positive cash flow from operations of $66 million, and is free of long-term debts. But it has a substantial amount of operating leases in its off balance sheet financing. The lease amount is not reflected on the company's financial statements. If the operating leases are capitalized and accounted for, it increases the liability by a significant amount. However, despite this obligation, Buffalo Wild Wings' fixed coverage (the firm can pay all fixed charges) is considerably high and the lease rent is only 6.5% of the revenues, indicating a strong investment grade level. Also, the company recorded revenues of $2 million per store last year.

Buffalo Wild Wings will open its first location outside the United States within three years and is looking for sites in Canada and Mexico, said CEO Sally Smith, according to Bloomberg News. Projecting the company's future cash flows, we can document that the company will increase its growth by capturing the US market and expanding abroad, hence will continue to create value. Also Buffalo Wild Wings retains financial flexibility (since it is an all equity company and has the capacity to take on debt) for additional acquisitions and store openings or to weather difficult periods. ■

# What Is Defeasance?

By: Chuck Spencer

Defeasance is the preferred form of call protection for fixed-rate conduit/commercial mortgage backed securities (CMBS) loans. Defeasance has become so prevalent in securitized loans that life insurance companies, HUD, and others seeking to preserve the ability to securitize their loans have incorporated defeasance into their form loan documents as well. A defeasance is basically "a substitution of collateral." It is not a simple prepayment but a financial and legal transaction that typically takes 30-45 days to complete. In the defeasance process, the borrower uses proceeds from a sale or refinance to purchase a portfolio of U.S. government securities that is sufficient to make the remaining principal and interest payments when they come due. The securities are pledged to the lender, and the lender releases the real estate from the lien of the mortgage. The promissory note, which remains outstanding, and the portfolio of securities are assigned by the borrower to a special purpose successor borrower.




The price of a defeasance is comprised of two components; the securities cost and transaction fees. The securities cost is a function of the spread between the loan coupon and the yield on the securities on the date the securities are purchased. A defeasance premium occurs when the loan coupon is higher than the average yield on the securities and a defeasance discount occurs when the loan coupon is lower than the average yield on the securities. To get an initial estimate use an online defeasance calculator (www.defeasewithease.com). To get the most accurate estimate, the first step is to gather your loan documentation and submit it to a defeasance consultant for help in estimating defeasance costs well before your anticipated sale or refinance. The consultant will be able to review your documents for any cost savings, such as types of securities and prepayment dates. ■

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sustainable buildings. LEED awards one of four levels of certification upon completion (certified, silver, gold or platinum) to recognize a building's degree of achievement and performance in sustainable site development, water savings, energy efficiency, materials selection and indoor environmental quality. The cost of LEED certification is different for every project because it is determined based on a variety of factors, such as size and type of building, level of certification, the credits selected to complete, and USGBC membership. This cost is a contributor to the green cost premium and adds on average $2,000 to the total cost of a building (other soft costs such as the time it takes to complete required documentation are not included in this figure). In an attempt to further encourage the development of green buildings, USGBC made LEED free for projects that receive the highest level of certification, platinum. Although LEED certification isn't necessary to construct a green building, it supplies third party verification that a building is maximizing operational efficiency while minimizing environmental impact, which may be important to perspective tenants. Other organizations with similar goals have formed, such as the Florida Green Building Coalition's (FGBC) Green Commercial Building Standard and the EPA's ENERGY STAR® label for commercial buildings. These organizations provide lower cost, or in ENERGY STAR's case no cost, alternatives to LEED certification. In the U.S. it may soon be government mandated, as a result of proposed legislation HR 2454 (The American Clean Energy and Security Act of 2009), for new construction and renovation projects of commercial buildings to meet stringent national energy efficiency standards which exceed the existing energy code (ASHRAE 90.1) by 30% immediately and 50% by 2015. Although the real estate industry could directly benefit from a few provisions in the proposed legislation, there has been extensive criticism pertaining to the potential cost, complexity and aggressiveness that would be required. The bill passed in the U.S. House of Representatives on June 26th, 2009 and is expected to reach the senate by mid-September.

Despite the current market, the overall green building movement has maintained constant growth. Greenbuild, the world's largest conference and expo dedicated to green building, had more than 28,000 attendees in 2008, which is an increase of 25% from Greenbuild 2007. The sustained growth in this sector may be baffling to those who believe in sticking to what they know during hard economic times; however, departure from conventional buildings may be exactly what is needed to boost businesses bottom lines and protect them from future volatility of the market. Several state and municipal governments currently have incentive programs in place to encourage private development of green buildings including bonus density, net metering, grants, expedited permitting, reduced rate loans, fee reductions/waivers, and tax deductions/credits. These programs will presumably be phased out as green buildings are government mandated and become the standard. Companies that recognize a small upfront outlay in "green" is a smart, profitable investment and adopt green buildings sooner rather than later will benefit from all angles. Whether it's increased return on investment, improved occupant heath, or a reduced impact on the environment, everyone has something to gain from the transformation of commercial real estate into a sustainable industry. ■

# Calkain's Shane Scanlon Class of '09 Featured in University of Tampa Spring 2009 Alumni Journal

When Shane Scanlon '09 walked into an internship fair in 2007, he had no idea he was taking the first step toward professional employment. It was there that he first got in touch with representatives from Calkain Companies in Tampa and landed an internship as a research assistant the following spring.

Today Scanlon is still going strong with Calkain, employed part time as a research assistant, a job that gives this business management major hands-on knowledge of the real estate industry.

"Calkain allows a great deal of decision-making to be done on your own compared to simply making the decisions for you," Scanlon said. "(It) allowed me to learn in a more active way." As an intern, Scanlon worked directly with everyone in the company from the CEO and vice president to the individual brokers. His chief duties introduced him to the basics of the company's investments, properties, and market information and different types of contract agreements. As an employee, his duties have expanded and he now plays a bigger role in managing the company's transactions.

"My knowledge of this industry entering into the internship was very limited, and Calkain has expanded upon that knowledge greatly," Scanlon said. "(The internship) also unlocked an opportunity for me to stay with the firm." ■

## GET INVOLVED!

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