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ACCOUNTANTS & ADVISORS

MARKS PANETH REAL ESTATE ADVISOR MAY 2015:

EXPLORING IRA INVESTMENTS IN COMMERCIAL REAL ESTATE

Investors have used self-directed IRAs to invest in residential real estate for some time now. But savvy investors can also direct those funds toward commercial real estate, which typically provides higher returns and attractive tax benefits. Before you rush into such an investment, though, you need to familiarize yourself with several critical considerations.

Recognizing the differences

A real estate purchase made through an IRA has some important differences from a regular real estate transaction — particularly the role of taxes. An IRA is a separate legal and financial entity, segregated from your personal finances. As such, it will have its own titling on legal documents related to the investments, and all paperwork generally must be executed in conjunction with the account custodian who's the signer for the account.

Note that an IRA *can* use a limited liability company (LLC) to own commercial real estate, but it isn't required to do so. Investors generally use LLCs to obtain protection from personal liability — protection that's already provided by the IRA's status as a separate legal entity. Of course, you may have other reasons for establishing an LLC, such as checkbook control.

Targeting the advantages

Purchasing commercial real estate through your IRA can provide a number of benefits, including significant tax advantages. Although you can't claim depreciation on your personal tax return (because the IRA owns the property), any profits from the investment also are removed from your personal tax equation.

In addition, asset growth in IRAs is tax-deferred, so rent payments and proceeds from the sale accumulate with no capital gains tax. In the case of Roth IRAs, which are funded with after-tax money, investments are tax-free at distribution. Investments in traditional IRAs, funded with pretax dollars, are taxed at distribution. Roth IRAs also aren't subject to minimum distribution requirements, and their structure usually exempts the account from income taxes.

Beyond the tax implications, investing in real estate allows you to diversify your IRA holdings. Doing so also gives you the comfort of holding a tangible asset, as opposed to stocks or mutual funds.

Managing the risks

Naturally, IRAs aren't without their risks. For example, they aren't particularly liquid — especially in a down market. If you require cash to make a distribution, you could run into difficulties. The IRA will also need to have some liquidity, so it can pay any expenses related to the property, such as taxes or improvements.

And don't forget about the issue of property management. Unless you're willing to handle those responsibilities yourself, you'll need to hire a property manager — which is another expense the IRA will need to cover.

Further, if you need financing in order to buy the commercial real estate, you could end up generating unrelated business taxable income on the portion of income allocable to the financing. That income is *not* shielded by the IRA's tax-exempt status.

It's important, too, to realize some of the restrictions on real estate owned by an IRA. The property, for instance, can't be used by the accountholder or any "disqualified parties," including your business or family members.

Picking the properties

If you decide to pursue IRA investments in commercial real estate, look for a property that will appreciate while providing sufficient cash flow to pay for its related expenses. Ideally, the property will already have a financially reliable long-term tenant subject to a triple net lease. Your financial advisor can help you understand the pros and cons of owning commercial real estate in an IRA.

IT ALL ADDS UP- PARTNER PROFILE:

Abe Schlisselfeld, CPA, EA

With 20 years of experience serving the real estate industry, Abe Schlisselfeld, CPA, EA, advises commercial and residential real estate clients, property management firms and REITs on all facets of accounting and tax issues. A member of the National Association of Real Estate Investment Trusts (NAREIT), Abe is well-versed in the latest trends and issues affecting the industry. He also has deep knowledge of multistate taxation. Other areas of specialty include tax planning for high-net-worth individuals and business-entity structuring.

Abe has authored numerous articles, most recently an article offering guidance for lawyers with investor clients who may be tiptoeing or plunging into the booming commercial market in New York. In addition to his professional activities and family responsibilities, Abe is a passionate NY Yankees fan.

TENANTS IN TROUBLE

As a commercial real estate owner, you know how important it is to retain your tenants. But Mother Nature, as well as other forces in the world, can make even the most solvent tenant unable to fulfill the terms of its lease.

A natural disaster, such as the landslides that have plagued the western states or the hurricanes that have ravaged the eastern and southern coasts, could inflict massive damage on a company's facilities. Or civil unrest, such as a terrorist attack or violent protests, could leave a business owner with nothing very quickly.

In such cases, business interruption (BI) insurance can help mitigate your losses. Here's how it works.

Compensation for lost income

BI insurance compensates a company for income lost when it must suspend normal operations because of physical damage to its property or a civil order requiring the business to close. Property insurance covers only physical damage to your property. But BI insurance is typically an add-on policy that provides money to pay salaries, benefits and extra expenses incurred (over and above those normally incurred) to mitigate its insured loss.

BI policies generally limit the period of recovery. This "period of restoration" generally runs from the date of suspension of operations to the date of completion of repairs or the date the property is returned to the same operating condition that existed before the disaster. Policy terms vary greatly. For instance, a policy may prescribe:

- A specific period of recovery,
- A maximum period of coverage, or
- A maximum recovery per month.

You also can obtain extended coverage for the period between the completion of repairs and your return to normal occupancy. The policy should clearly define "suspension of operations." Without a clear definition, the insurer might attempt to deny coverage if you don't suffer a complete shutdown. Moreover, the insurer will cover only losses that are directly attributable to the damage, as opposed to, for example, those partly due to a slow rental market.

Evidence of losses

BI insurance aims to make commercial property owners "whole" after a disaster has caused a temporary shutdown. Policies compensate for lost rental income and costs incurred (net of operating cost savings). Some policies also reimburse for extra expenses that are incurred because of property damage.

Historic profit and loss statements, tax returns and rent rolls are used to calculate lost profits. But insurers also will factor in macroeconomic, industry and local market trends that may have lowered rental income — even if the disaster hadn't occurred. Because indemnity will be based on your property's financial records, make sure your records are updated and in a safe location.

To make a compensable claim, you must *promptly* present evidence of lost rental income. You won't be able to recover on properties that weren't generating rental income at the time of the damage. Remember, too, that insurers have taken a beating in recent years, and claims examiners are scrutinizing paperwork harder than ever. Many commercial property owners hire CPA firms to help support their lost profits calculations and clarify BI provisions.

Best move ever

It's impossible to know when a disaster will strike your property and effect one or more of your tenants. If your real estate firm doesn't yet have BI insurance, perhaps it's time to buy a policy. Doing so just might turn out to be the best move you'll ever make.

SPRING 2015 GOTHAM COMMERCIAL REAL ESTATE MONITOR

Are New York City commercial property values plateauing? Yes, and perhaps reaching the top of the roller coaster, say 54% of New York real estate executives. A quarter, 22%, think that commercial property values in the city will begin to decline while only 37% believe values will continue to rise, according to the results from the Spring 2015 Gotham Commercial Real Estate Monitor survey from Marks Paneth, the research sponsor.

The vast majority of commercial real estate execs (84%) execs also say that the proliferation of investments in Manhattan residential property by foreign oligarchs distorts the borough's market value. Yet most executives (57%) agreed that current international crises benefit the New York commercial property market.

107 professionals, including owners and managers of commercial property, commercial real estate brokers and agents, and attorneys, accountants and other professionals specializing in the sector, participated in the survey which was conducted from February 25 to March 31, 2015, by Michaels Opinion Research.

Read the full *Gotham Commercial Real Estate Monitor* survey report here.

SHOULD I IMPROVE ENERGY EFFICIENCY IN MY INDUSTRIAL PROPERTIES?

Energy costs associated with industrial properties — such as warehouse, distribution or storage facilities — can add up fast, making a significant dent in your bottom line. According to the Building Owners and Managers Association (BOMA), energy accounts for about 15% of operating costs for the industrial property sector, with an average cost of $0.68 per square foot. So, many industrial property owners are taking a new look at energy efficiency measures.

Bundle of benefits

Improved energy efficiency comes with a bundle of benefits. In addition to the obvious environmental positives, it can slash operating costs, extend the life of building systems and boost asset values by maximizing performance. Certain energy improvements may also produce significant tax breaks.

Enhanced energy efficiency can also make an industrial property more attractive. Properties with improved lighting, upgraded HVAC systems and similar improvements tend to draw new tenants and encourage existing ones to renew their leases.

Improvement measures

According to BOMA, the top five measures for improving industrial property energy efficiency are:

1. Upgrading parking lot and exterior lighting to highly efficient fixtures,
2. Installing occupancy sensors and lighting controls,
3. Reviewing temperature setpoints and making seasonal adjustments,
4. Installing dock shields or dock shelters to reduce outside air infiltration, and
5. Using high-efficient motors for material-handling conveyors and installing controls to run only when needed.

BOMA also recommends the Environmental Protection Agency's (EPA's) ENERGY STAR Portfolio Manager®. This interactive management tool can help you manage water and energy consumption, benchmark your energy performance rating against similar companies, and earn EPA recognition. An energy performance rating of 50 indicates that a property performs better than 50% of all similar buildings nationwide, and buildings with ratings of 75 or more can qualify for the ENERGY STAR label for superior energy performance.

Portfolio Manager can also help you set investment priorities. For example, it allows you to evaluate the relative costs associated with a given level of performance, your cumulative investments in upgrades and your annual energy costs. A built-in financial tool makes it easy to compare savings across all of the properties in your portfolio and calculate cost savings for particular projects, too.

Within your grasp

When it comes to the value of industrial property in today's market, many aspects are beyond your control. Energy performance, however, is firmly within your grasp. Taking steps to improve that performance can produce benefits now and for many years down the road.

TAX COURT CONSIDERS HOUSE FLIPPER'S EXPENSE DEDUCTIONS

With many real estate markets on the rebound, real estate investors are resuming house-flipping strategies to reap profits by, among other benefits, deducting large amounts of related expenses. But those expenses are deductible only if incurred in connection with a "trade or business." And, as the taxpayer in the recent case of *Ohana v. Commissioner* learned the hard way, a trade or business requires more than just vague intentions to sell at some point.

Flipper claims expenses

In 2005 and 2006, the taxpayer bought houses in Saratoga and Palo Alto, California. He initially lived in the Saratoga house and rented the Palo Alto house.

During that time, he worked full-time in an executive position requiring long hours and extensive travel. Nonetheless, the taxpayer claimed to run a real estate business in which he planned to make money by flipping houses: that is, buying a house with the intent to fix it up and sell it at a profit. To avoid the risk of a down market, his strategy was to move into the house and live in it until the market was more favorable.

The taxpayer bought the Palo Alto house with the intent of tearing it down and building a new one. On the record deed, he checked a box indicating he intended to eventually make the house his primary residence; he also obtained a residential mortgage for the construction. In late 2009, he moved into the new Palo Alto house and rented out the now-renovated Saratoga house.

The taxpayer claimed more than $280,000 in nonrental expenses in the years 2007 to 2009. The IRS filed notices of deficiency disallowing all of the claimed nonrental expenses, and he appealed.

Tax Court weighs in

The U.S. Tax Court weighed whether the taxpayer's activities amounted to being in a trade or business. To be engaged in a trade or business, a taxpayer must be involved in the activity in question with continuity and regularity for the purpose of garnering income or making a profit.

Although the taxpayer in this case was heavily involved in his real estate projects, he wasn't continuously or regularly involved in the business of buying and selling real estate. As the court noted, he didn't sell or buy a single property during the relevant period.

The Tax Court also found that the taxpayer's primary purpose in engaging in the real estate activity — which revolved around properties that either were or became his homes — wasn't for profit. It first considered the Saratoga house, observing that — though the taxpayer had begun to rent it out in 2009 — he'd never tried to sell it. The court added that the taxpayer had failed to record any of his expenses for the home, so the deductions would have been denied for lack of substantiation.

As to the Palo Alto house, the taxpayer argued that the expenses incurred in building the new home weren't personal because he intended to make a profit on its eventual sale. But, the court noted, referencing a prior case, if hoping to eventually sell a house at a profit was sufficient to establish a profit-making intent, "rare indeed would be the homeowner who purchased a home several years ago who couldn't make the same claim."

Regardless, the facts showed that the taxpayer had always intended to make the new Palo Alto home his personal residence. When he bought the property, he told third parties it was to be his primary residence. He enrolled his children in the Palo Alto school system for the 2008 and 2009 years. And, his loans were the type one would obtain for a primary residence.

The court also pointed to "minor personal touches" that made the home less marketable for sale and more useful for the taxpayer. These included a custom-built door with a peephole low enough for the 5-foot, 4-inch taxpayer to see out of it.

Look before you flip

House flipping may seem like an easy path to great profits, but that's not always the case. Work with your tax advisor to ensure you can defend any deductions you take against IRS scrutiny.*

* Ohana v. Commissioner, Nos. 16014-11, 25896-11, May 8, 2014 (U.S. Tax Court)

TAXPAYER'S USE OF TAX PREPARER DIDN'T PREEMPT PENALTIES

In *Ohana v. Commissioner*, the U.S. Tax Court upheld the underpayment penalties assessed against the taxpayer. (See main article.) A substantial underpayment exists if the understatement exceeds the greater of 10% of the amount of tax required to be shown on the tax return or $5,000. An additional issue in the case was whether the taxpayer had a reasonable-cause-and-good-faith defense.

Among other things, the court considered whether he'd actually relied in good faith on his tax preparer's judgment — and concluded that he hadn't. The Tax Court noted the general rule that a taxpayer can't avoid his or her duty to file accurate returns by placing responsibility on an agent such as a tax preparer.

Moreover, taxpayers have a duty to read their returns to ensure that all income items are included. Given this particular taxpayer's unusually focused attention to detail in other areas of his life, the court didn't find him credible when he said he'd never once looked at his tax returns or checked his accounting records against his returns.

LEVERAGE OUR EXPERTISE

Marks Paneth LLP has served the real estate industry for more than 100 years. We assist many of the industry's premier commercial and residential real estate owners, developers, builders, REITs (real estate investment trusts) and property managers. With more than 100 professionals, including 15 partners and principals, who focus on the real estate industry, we bring deep expertise to every engagement.

For further information

If you have any questions, please contact William Jennings, Principal-in-Charge of the Real Estate Group, at 212.503.8958 or wjennings@markspaneth.com or any of the other partners in the Marks Paneth Real Estate Group.

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