

REAL ESTATE ADVISOR
JUNE 2009

ASSET-PROTECTION PLANNING

Holding on to what's yours

Given today's economic uncertainties and our litigious society, asset-protection planning has become increasingly important for real estate investors and developers and there are several options.

Insurance offers front-line protection

The first line of defense in your asset-protection strategy is having complete insurance coverage. *Property insurance* is a critical front-line protection for your assets. When determining how much coverage you need, consider the property's value and the likelihood of a liability-generating event. If you have multiple properties, consider purchasing an umbrella policy that can provide blanket insurance at a smaller cost than purchasing separate policies for each property.

Because a life-threatening accident or illness can quickly deplete assets, adequate *health insurance* is key to any asset-protection plan. Disability insurance, while frequently overlooked, can also protect your earning power in the event of extended health challenges.

Life insurance proceeds can help preserve wealth for your heirs if estate taxes are due at your death. Life insurance can also supply working capital for the continuation of your real estate investment portfolio or real estate development business, and provide wealth equalization for heirs not involved in managing your assets or business.

Retirement accounts shelter assets

With proper planning, Employee Retirement Income Security Act (ERISA) provisions can be implemented to keep creditors from delving into your retirement fund. Examples of pension plans covered by ERISA include qualified profit-sharing plans, money purchase plans, defined benefit plans, and 401(k)s.

If yours is a non-ERISA plan, creditors can access your plan assets unless a state law prevents them from doing so. IRAs, Simplified Employee Benefit Plans, and qualified plans in which only the owner (or owner's spouse) is the beneficiary are examples of non-ERISA plans. Check to see if your state provides IRAs with asset protection capabilities.

If most of your other assets are tied up in real estate, contributing to a qualified retirement plan that's invested in stocks, bonds or mutual funds can help diversify your portfolio, which may help protect your assets.

Different entities, ownership help spread the risk

Putting all your "eggs" in one entity "basket" can be risky, so consider spreading that risk by dividing the business. Separate entities might be established along functional lines. One might be a holding company for property ownership, for example, while another provides property management services, and still another serves as a consulting or real estate brokerage firm.

Some investors segregate riskier assets into separate entities. For instance, large sums of cash generated from the recent sale of a property could be held separately from a shopping mall (where you might get sued if someone slips on a sidewalk and is injured). The need to form separate entities must be balanced with the complexity of setting up the entity, the costs involved, and the burden of ongoing administration. How far you should go in segregating the assets of your business depends on the level of your litigation risk and the amount of money you could lose in a lawsuit.

Limited liability companies (LLCs) and limited partnerships (LPs) also provide valuable asset protection opportunities for real estate investors. Although LLCs and LPs are similar in some ways, they have distinct differences. In an LLC, all owners receive the benefit of liability protection from business debts and claims, and none are excluded from management functions. In an LP, on the other hand, the general partners are personally liable for business debts and limited partners are excluded from managing the business.

Trust in trusts

Certain trusts can provide another line of defense in asset protection. Although revocable grantor trusts (often referred to as “living trusts,” used to manage assets in the case of future incompetence and to avoid probate) provide no legal protection from creditors, irrevocable trusts generally offer some protection.

When a grantor places property in an irrevocable trust for the benefit of his spouse, children, grandchildren or other heirs, future creditors can reach the assets only by convincing a court that the transfer was made to intentionally “hinder, delay or defraud” current or potential creditors of the grantor, and that the grantor was insolvent as a result of the transfers to the trust. The downside of such trusts is that the grantor no longer has access to the funds in the trust.

If you need access to the trust funds, an alternative is to set up asset-protection trusts. These are normally established in offshore jurisdictions to insulate assets against creditor attack. Certain states, such as Alaska and Delaware, allow trusts that provide benefits similar to those of offshore trusts. Irrevocable trusts are also commonly used to settle or discourage litigation, as an alternative to traditional prenups, or as a means to maintain confidentiality of asset ownership.

If you don't need access to trust assets, but you do need an income stream and are charitably inclined, consider a charitable remainder trust (CRT). CRTs can protect property from creditors because, as with other irrevocable trusts, you no longer own the property. In addition, a well-planned CRT allows you to:

1. Dispose of highly appreciated assets without having to pay an immediate capital gains tax,
2. Create an income stream for yourself or your loved ones, and
3. Reduce your estate taxes.

Moreover, a CRT allows you to leave a substantial gift to the charitable organization of your choice and potentially enjoy an income tax charitable deduction.

MP&S Tax Partner Michael Bekas has authored a white paper entitled "Charitable Remainder Unitrusts: A Must-Consider Wealth Maximization Vehicle for Owners of Hard Assets." This white paper explores how, when structured properly, charitable remainder unitrusts (CRUTs) can assist with wealth optimization.

The bottom line

In the words of one sage, “Wealth itself prompts claimants to pursue litigation.” It should also prompt those who hold such wealth to develop smart asset-protection strategies to help preserve it — not only in the event of litigation, but also in the case of bankruptcy, divorce or simply as a matter of quality estate planning.

Providing trust and estate services is a core competency of Marks Paneth & Shron. We serve a broad client population and often work closely with our clients' attorneys on these matters. Please feel free to contact us for additional information.

“Planning” for divorce

If you're considering marriage, also consider a prenuptial agreement. A prenup allows you to determine, when things are going well, how real estate and other assets will be divided should things not go so well later. It can also reduce the likelihood of draining bank accounts to finance expensive divorce proceedings, preserving a higher percentage of wealth for your heirs.

If divorce is imminent, talk with your financial advisor immediately, because there are certain tax ramifications attached to an upcoming split. If you and your spouse jointly own a real estate development business, for example, and expect to transfer ownership as part of a settlement, the tax man may want his share. Tax issues related to separation or divorce are complex, and any one of a number of technical missteps can trigger capital gains exposure. Even the date of separation matters when it comes to tax issues.

So, if you want to minimize what goes to Uncle Sam, get professional advice.

5 MISTAKES COMMERCIAL REAL ESTATE INVESTORS MAKE

Investors face an uphill battle today, because achieving profitability poses more of a challenge than it did in years past. You can enhance your probability of a healthy bottom line by avoiding five common mistakes, however. Let's take a look at what they are.

1. Inadequate market research

Although national real estate trends are of value, the *best* market indicators are those in your local market. Make sure you get a handle on local rental rates, occupancy levels, competitive space supply and demographic trends. Moreover, because expansions, cutbacks or relocations by major local employers can significantly affect property prices, regularly monitor local news for such developments.

2. Inaccurate financial projections

Your investing decisions are only as good as your financial projections. So it's more important than ever to look at real operating figures when purchasing an established rental property. (See “Ask the Advisor” on page 7 for more on calculating financial projections.)

3. Too much leverage

Used properly, leverage is a powerful tool for increasing your return on investment (ROI). There are high-risk behaviors, however, that you should be aware of to avoid becoming overextended. For example, basing an investment decision on appreciation assumptions is riskier than ever today. Just because a property has historically appreciated in value doesn't mean the trend will continue.

Other high-risk behaviors include getting strapped by mortgage payments that are too high to handle in a softening market, and getting lured into deals by the presence of readily available financing. Just because you can get into a property doesn't make it a bargain or a winning investment option.

4. Lack of planning

Like any major undertaking, real estate investing requires considerable planning. A good plan will outline all possible outcomes of the investment.

If your portfolio is a mix of winners and losers, review it carefully. You can improve your bottom line now by unloading properties that don't fit your larger investment goals.

5. Ignoring financial indicators

When performing due diligence on a prospective property, look for deteriorating bottom lines, as well as aggressive revenue recognition policies or deferred expenses.

Comparing the property's cash flow with its earnings statement can be revealing. If the former owner shows net income increasing while cash flow is in the red, watch out. A change in accounting methods or accountants midstream should also be a red flag, prompting you to question the reasoning behind such moves. (For more on due diligence, see "The due diligence payoff" below.)

When the numbers don't add up

Many of the mistakes that impede profitability can be avoided through prudent planning and attention to financial detail. Work closely with your CPA to avoid making any of these five mistakes.

THE DUE DILIGENCE PAYOFF

Performing due diligence ranks right up there as one of the most potentially boring — but important — tasks for real estate investors. Crossing your T's and dotting your I's could save you a lot of money, as well as entanglement in less than desirable investment properties. But what should you be looking for when you do your due diligence?

Review the books

Start with a review of accounting records for the property under consideration. Examine the income and expense statements for at least the previous 24 months, watching for income, rental rates or expenses that seem unusually high or low. Review documentation of rental deposits and check out signed rental agreements, documentation of problem tenants, and an aged schedule of rent and/or accounts receivable.

Consider the contracts

Some properties are locked into service contracts for literally years to come. Avoid surprises by checking out agreements during your due diligence, ascertaining if contracts are transferable or if any penalties for termination apply. Inquire about contracts involving property management services and maintenance services. Make sure you review the leases for the same types of concerns on commercial properties. You'll want to know how long each tenant is committed for, and whether the terms of those leases are in your favor as the future owner.

Inspect the property

A physical inspection of both the property's interior and exterior should be on your due diligence checklist. Look for obvious water damage and deterioration inside and out. Note any needed repairs, and arrange for professional inspections to ensure the mechanical and structural aspects of the building are sound and meet current code.

If you're planning any renovations, make sure the renovations won't make the property subject to changes in code requirements based on the property being "grandfathered" under older code restrictions. This could prove expensive in many ways, including having to abide by requirements to increase parking availability and/or significantly modify internal systems.

Check with local authorities

You can learn a lot about zoning, permit or encroachment issues simply by calling or visiting the municipalities with jurisdiction over a property. Read the local zoning ordinance (including the fine print about minimum frontage requirements, signage and other issues), and review the zoning map. Also, be sure you have the most recent ordinances, and check your county's property records for recent sales of comparable properties during the past six months. Environmental hazards and fire code violations, together with the owner's response, should also be reviewed.

You'll also want to examine any deeds, liens, restrictive covenants, easements and subdivision plans related to the property in question. These can usually be found at the local county courthouse. If you're considering an expansion or adaptive reuse and have questions about whether a property can be appropriately serviced by public water and sewer, gas or electric, consult local authorities. Your community's department of public works can provide you with direct information on the capacity of local systems to support your project.

Make sure the locality can support the additional usage before you get deeply into the project financially. (Just because the building is there doesn't necessarily mean the community is prepared to serve the needs you have in mind for its next or extended use.)

You'll also want to look at market information. Hire a qualified market study provider to get an idea of the property's long-term viability. This is particularly important if the property has commercial leases that are set to expire in 12 to 36 months for a large portion of the property.

For residential real estate, understanding the market volatility is a must. You can get some basic data at your local courthouse. Information about proposed highways and other facilities can also be obtained through federal, state or local authorities. Also check the U.S. Census Bureau, U.S. Department of Labor, U.S. Department of Agriculture and FEMA for important information about natural resources; housing shortages; proposed roads; transportation facilities; utilities; local manufacturers, hospitals and schools; soil surveys; and floodplain mapping. This last is very important, as it's difficult to secure debt on properties that lie within floodplains, unless your property includes architectural details that are specifically modified for these concerns and you're working with lenders who understand these issues.

Due diligence does matter

The due diligence process is critical to any successful real estate transaction, because it helps ensure that you, as the buyer, get the most for your money and are protected against unexpected "revelations" after the documents are signed. A thorough review of financial and other property details before inking your name on the dotted line is the best insurance against unwanted surprises.

ASK THE ADVISOR

How can I develop an accurate cash flow projection?

Realistic cash flow projections are crucial to wise investment decisions and intelligent property management. Savvy real estate investors run cash flow projections on every property they intend to buy, to help determine the before-tax viability of an investment.

Fortunately, even if you do not have a large office staff, with a little research and some simple calculations, you can develop a cash flow projection on your next purchase.

Estimating gross operating income

The first step in developing a cash flow projection is to estimate gross operating income by subtracting projected vacancy and credit losses from the gross potential income. If historical data is available for your property, base your estimates of gross potential income, vacancy and credit losses on two or three years' data. (Gross potential income equals the total annual income that would be realized if the property were fully occupied and all rents were collected.)

If vacancy seems to be on the rise, factor that in as well. Vacancy rates for comparable properties can also be valuable in this calculation, though challenging to come by because most landlords don't advertise those numbers. An Internet search for "apartment vacancy rates," however, can yield a great deal of data. Make sure you narrow the search by adding your city, state or county to the search string. It's important to use relevant vacancy data when developing your calculations.

Calculating net operating income

Once you've calculated the gross operating income of the property, you're ready to project net operating income.

Begin by estimating the property's operating expenses (such as insurance, janitorial, maintenance, professional fees, taxes and utilities). Again, you'll need to rely on historical or comparable data, taking into consideration any specific repair or other needs the property may have. Then subtotal the operating expenses and subtract them from gross operating income to arrive at net operating income.

Determining cash flow before taxes

Finish by adding back any loan proceeds (cash that came into the investment from borrowed money) into the equation. For example, if you made capital improvements but took out a loan to fund them, add the amount of the loan back in. If any interest is earned by property investments, you'll also need to add that back in. The net result of this entire equation is cash flow before taxes for the property.

Cash flow matters

While accrual income statements are extremely important in monitoring overall profitability of investments, cash flow projections monitor the lifeblood of a venture. No matter how "pretty" the income statement looks, cash is still king. In today's cash-tight economy, accurate cash flow projections should be an integral tool in the arsenal of successful investors.

Cash flow before taxes:	
	Gross potential income
-	Credit and vacancy losses
	Gross operating income
	Gross operating income
-	Operating expenses
	Net operating income
	Net operating income
-	Debt service
-	Cash paid for capital improvements
+	Loan proceeds
+	Interest earned on property-related investments
	Cash flow before taxes

JUNE 30 DEADLINE FOR COMPLETION OF 2008 FOREIGN BANK AND FINANCIAL ACCOUNTS REPORT

Certain US persons may be required to file a Report of Foreign Bank and Financial Accounts (FBAR), Form TD F 90-22.1. This report must be filed each year whenever a US person has a financial interest in or signature authority or other authority over any financial accounts (including bank, securities or other types of financial accounts) in a foreign country. An FBAR is required when the aggregate value of these financial accounts exceeds \$10,000 at any time during the calendar year.

The FBAR is an information return with distinct filing requirements separate from those of individual, corporate or partnership returns. Requests for an extension of time to file an FBAR are not granted. ***This means that FBARs for calendar year 2008 must be filed on or before June 30, 2009.***

Additional information about FBAR can be found on the IRS website or by contacting David Gannaway in our firm's Litigation and Corporate Financial Advisory Services Group.

MP&S OFFERS HUMAN RESOURCE CONSULTING SERVICES

In times of economic uncertainty, many organizations are finding that they need to scale down their workforce and redesign the responsibilities of their current jobs. While the economic climate is creating many challenges, it also is presenting opportunities to evaluate current positions, reorganize tasks and recruit candidates with superior skills, knowledge and abilities.

The experienced HR Consulting specialists at Marks Paneth & Shron can help guide you through the process of examining staffing needs, conducting job analyses, developing and revising job descriptions, workflows and selecting the best candidate for your business needs.

Additionally, we can work with you to establish and implement job-related processes and procedures such as compensation, workforce development, recruiting, performance appraisal benefits and perquisite planning.

Additional information about our firm's Human Resource Consulting services can be found by contacting Eric Marks, Principal-in-Charge, Human Resource Consulting.

SPOTLIGHT ON MP&S

MP&S Assembles Team Offering Services for US Taxpayers Disclosing Foreign Accounts

Marks Paneth & Shron has assembled a team dedicated to offering services for US taxpayers disclosing foreign accounts at UBS AG and other foreign banks. The **MP&S Foreign Disclosure team** will support taxpayers and their attorneys by preparing amended returns, arranging for installment agreements and representing taxpayers before the IRS and other tax authorities and providing due diligence, forensic accounting and fraud investigation services.

Former Assistant Special Agent in Charge of IRS Criminal Investigation Joins MP&S as a Director

David Gannaway, a 20-year veteran of the IRS where he was an assistant special agent in charge of the Criminal Investigation Division's New York Field Office, has joined the MP&S Litigation and Corporate Financial Advisory Services Group as a director. Mr. Gannaway will play a key role in complex white collar fraud investigations and in the firm's newly expanded foreign disclosure services.

FOR FURTHER INFORMATION

If you have any questions, please contact **Harry Moehringer, Partner-in-Charge** of the Real Estate Services Group at 212.503.8904 or hmoehringer@markspaneth.com or any of the other partners in the MP&S Real Estate Services Group:

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Additional information on the Marks Paneth & Shron Real Estate Services Group can be found at **www.markspaneth.com**.