MARKS PANETH

ACCOUNTANTS & ADVISORS

MARKS PANETH REAL ESTATE ADVISOR DECEMBER 2013: STRATEGIES AND SOLUTIONS FOR CONTINUING TO GROW YOUR REAL ESTATE BUSINESS

TAX COURT FINDS PROPERTY OWNER WAS NOT “A REAL ESTATE PROFESSIONAL”

A property owner who qualifies as a “real estate professional” stands to reap more tax benefits than ever these days. If you satisfy the requirements, you may be able to offset some nonrental income with rental losses, as well as avoid the new 3.8% Medicare tax on net investment income.

Satisfying the requirements, though, is no small task. In *Hassanipour v. Commissioner*, the owner and manager of rental units recently learned that lesson the hard way.

Owner claims net rental losses

In 2008, the owner/manager was employed full-time as a research associate. He signed and submitted monthly timesheets to his employer, reporting a total of 1,936 hours worked. He also owned 28 rental apartment units in seven buildings in Vallejo, California, and had a 50% interest in a single-family residence in Lake Tahoe. He performed various duties in relation to the rental properties, including repairs, administrative tasks, researching landlord/tenant law and preparing tax returns.

On their joint 2008 Form 1040, the owner/manager and his wife reported combined wages of $239,037 and claimed net rental losses of $120,540. The IRS, however, disallowed the rental losses as passive activity losses and found that the couple had underpaid taxes by $38,067.

Real estate professional rules

“Passive activity” is defined as any trade or business in which the taxpayer doesn’t materially participate. “Material participation” is defined as involvement in the operations of an activity that’s regular, continuous and substantial. Rental real estate activities are generally considered passive activities regardless of whether you materially participate.

The Internal Revenue Code grants an exception from restrictions on passive activity losses for real estate professionals. If you qualify as a real estate professional and materially participate, your rental activities are treated as a trade or business, and you can offset any nonpassive income with rental losses, thereby reducing your taxes. You may also be able to sidestep the 3.8% Medicare tax on net investment income as long as you’re engaged in a trade or business with respect to the rental activities.

To qualify as a real estate professional, there are two tests that a taxpayer must meet. The first test requires that a taxpayer spend more than one-half of their total work time during the tax year on real property businesses in which the taxpayer materially participates. The second test requires that the taxpayer perform more than 750 hours of service during the year in real property trades or businesses. A real property trade or business is defined as any real property development, redevelopment, construction reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business. Time spend as an employee in real property activities is counted only if the taxpayer owns more than 5% of that business.

The property owner's claims

At trial in this case, the owner/manager argued that the hours he spent on rental activities exceeded his time spent working for his employer. He claimed that he worked 35 hours per week for the employer for a total of 1,610 hours.

To prove his hours spent on rental activities related to the Vallejo apartments, he presented estimates, summaries and a generic calendar-which wasn't dated 2008, but which he'd allegedly kept contemporaneously on dates starting on Dec. 31, 2007. The calendar showed 1,182.9 total hours working on the Vallejo apartments. He hadn't kept a contemporaneous record of time spent on the Lake Tahoe property but estimated that he spent 150 to 200 hours working on that property and more than 500 hours performing tasks not reflected on his calendar.

Court sides with IRS

Participation in an activity can be established by any reasonable means — you aren't required to keep daily time reports, logs or similar documents. A reasonable system could include appointment books, narrative summaries or calendars.

However, in this case, the U.S. Tax Court rejected the owner/manager's evidence as unreliable. For starters, his "2008" calendar was copyrighted in 2009 and appeared to be reconstructed, rather than contemporaneous. And his testimony regarding his 35 hours per week work for his employer was contradicted by his monthly timesheets. Additionally, some of the estimates he added to the hours recorded in the calendar duplicated tasks or time that was already logged in the calendar.

The court concluded that the owner/manager had failed to establish that he was a real estate professional in 2008, without needing to consider the material participation aspect. His rental activities, therefore, were passive, and he couldn't offset his rental losses against other income.

The challenge

It can be difficult to satisfy all the requirements to qualify as a real estate professional, particularly if you have another full-time job. Contemporaneous records may not be required, but they'll go a long way toward helping build your case.

A BUDDING VALUATION CONSIDERATION: EXPLORE THE WORLD OF GREEN BUILDING FEATURES

With sustainability becoming more common in both residential and commercial real estate, appraisers are increasingly asked to weigh in on buildings with green features. While green valuations haven't yet come fully into bloom, the seeds have clearly been planted for environment-related features to affect property value.

Why green matters

At this point, many valuators are reluctant to incorporate green features in their valuations. After all, most sustainable or green buildings are relatively new, so there's a lack of data on comparable sales and rates of return. But the growing demand for green properties means this can't be ignored for long.

These days, many companies and governments are requiring certain LEED or Energy Star ratings on new construction and rental property, including the federal government's General Services Administration. Energy Star–certified buildings net an average rental premium of 4% and an average sales price premium of 26%, according to one study, "Green Noise or Green Value? Measuring the Effects of Environmental Certification on Office Values."

Moreover, the University of California, Berkeley, found that, among Energy Star–certified buildings, saving $1 in energy costs is associated with gaining a 4.9% premium in market valuation. This translated into an average increase in transaction price of $13 per square foot. And the U.S. Green Building Council has estimated that 40% to 48% of new commercial construction by value will be green by 2015.

With sustainability becoming more important to tenants and buyers, it seems likely that lenders will eventually get on board also and their due diligence and underwriting may well expand to reflect the benefits and risks associated with green properties.

Valuing green

In recognition of the growing green role in residential valuations, the Appraisal Institute recently released an updated form intended to help appraisers analyze the value of energy-efficient homes. The Residential Green and Energy Efficient Addendum is an optional addition to Fannie Mae Form 1004 (which is the valuation profession's most widely used form for mortgage lending purposes).

The five-page document offers a list of factors that valuators consider when appraising residential properties with green features, including:

- Certifications by LEED or similar organizations
- Energy-efficient components (insulation, water systems, windows, lighting, appliances and HVAC)
- Energy ratings,
- Indoor air quality,
- Utility costs,
- Solar panels, and
- Federal, state and local incentives that offset costs

Geographic location is also critical. Certain markets — such as New York, Washington, D.C., Chicago, San Francisco, Seattle and Portland, Ore. — have a higher green demand. Cities like Detroit and Cleveland are less focused on sustainability, at least for now. A green property also may be more valuable in locations with higher utilities costs, including water, electricity and natural gas charges.
The methodology appraisers use to quantify the added value of sustainability varies significantly. For instance, the unique attributes of a green property might require a wider comparable radius to find similar properties. In the absence of comparables, an appraiser might add a green premium based on the replacement cost of energy-efficient items.
For commercial properties valued using the income approach, cost savings and financial incentives of being green will generate a higher net operating income. If so, the appraised value may already include a green premium implicit in the capitalization methodology. Care should be taken not to double-count the benefits.

Overcoming challenges

"Comparables" are often the basis for both residential and commercial property appraisals. While it's still difficult to find green comparables, this situation will surely change as more sustainable and retrofitted properties go on the market. In the meantime, make sure your property appraiser is up to speed on green features, technologies and practices and knows how to incorporate them in a valuation.

ASK THE ADVISOR

IS A REVERSE EXCHANGE RIGHT FOR ME?

Real estate investors interested in enjoying the tax benefits of a like-kind exchange may consider a "reverse exchange" — where the replacement property is acquired before the investor transfers the relinquished property. It is important to note that the taxpayer may not own both the relinquished and replacement properties at the same time. The IRS has issued Revenue Procedures 2000-37, which provides a "safe harbor" for reverse exchanges. Reverse exchanges come with certain advantages and disadvantages.

Reverse exchanges

There are two types of reverse exchanges, each with its own rules:

1. **Exchange-first transaction**. An exchange accommodation titleholder (EAT) purchases the relinquished property from the investor with funds borrowed from the investor, before closing on the replacement property. A qualified intermediary (QI) uses the proceeds to acquire the replacement property. The EAT holds title to the relinquished property until the investor sells it to a third party.

2. **Exchange-last transaction**. The EAT purchases the replacement property with the investor's funds. When the taxpayer has a contract to sell the relinquished property, a QI sells it to the buyer and uses the proceeds to purchase the replacement property from the EAT. At closing, the EAT receives the proceeds, which it uses to pay off the loan to the investor.
With each type of reverse exchange, closing must occur within 180 days of the EAT taking title to the relinquished property
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Pros and cons

The principal benefit of the exchange-first structure is that it eliminates the need for the EAT's participation in the financing process for the replacement property. If, however, there's existing financing secured by the relinquished property, the lender may have approval rights on the transfer to the EAT which could slow down the exchange process as well as stop it dead in its tracks if lender approval is not obtained. Another drawback is the possibility of underestimating the sales price, which could lead to taxable excess proceeds.

With an exchange-last transaction, the investor can borrow the funds it expects to get from the relinquished property and pay down the loan after the relinquished property closes but before taking title to the replacement property. This allows the investor to invest all of the exchange funds in the replacement property and defer all taxes. On the other hand, the EAT will need to sign loan documents if the investor borrows money secured by the replacement property, and the loan must be nonrecourse to the EAT. Additionally, the investor may need to personally guarantee the loan.

Get the big picture

If you're considering an EAT, weigh the cost of potential environmental factors, taxes, closing costs, and similar issues. Your financial advisor can help you decide if you should pursue a reverse exchange.

SPOTLIGHT ON MARKS PANETH

LOOK FOR THE RESULTS OF OUR THIRD GOTHAM COMMERCIAL REAL ESTATE MONITOR

The *Gotham Commercial Real Estate Monitor* from Marks Paneth LLP represents the findings of a survey of top commercial real estate professionals in the New York City Market. They include owners and managers of commercial property as well as commercial real estate brokers, agents, attorneys and accountants specializing in this sector.

We will issue the results of our Fall 2013 survey during the week of December 16. If you like to receive the survey results or participate in our next survey, please email marketing@markspaneth.com

HAPPY HOLIDAYS

The partners, principals and staff of Marks Paneth LLP extend warm wishes for a happy holiday season and all the best in the new year.

HONORS AND AWARDS

Marks Paneth was again voted a 'Top Three Best Forensic Accounting Provider' in 2013 by readers of the New York Law Journal. Ours is the only major regional firm to be ranked among the top three firms in the category of forensic accounting for four straight years.

New York Law Journal Reader Rankings

Top Three Best Forensic Accounting Provider Marks Paneth & Shron LLP 2013

FOR FURTHER INFORMATION

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