

## **Real Estate Advisor October 2008**

### **ENDING 2008 ON A HIGH NOTE ... And starting next year in a better tax position**

If you want to do a better job of tax planning but you typically don't focus on taxes until the April 15 frenzy, you're not alone. As 2008 comes to a close, there are some tax strategies you can implement now that may make your life much calmer come tax time.

#### **Section 179 to the rescue**

To encourage business investment, the tax code provides opportunities for businesses to deduct the cost of depreciable assets more quickly or even "expense" them (that is, deduct the full cost in the year they're purchased). One such tax provision is Internal Revenue Code Section 179. Under Sec. 179, up to \$250,000 in qualifying assets that are placed in service in calendar year 2008 or the business's fiscal year that begins in 2008 can be deducted *immediately*.

If you spend more than \$800,000 in 2008, the amount you can expense is phased out on a dollar-for-dollar basis. So, you won't be able to expense anything under Sec. 179 if your total investments for the year are \$1,050,000 or more.

If you're thinking that these numbers are higher than normal, you're right. Congress increased them to help stimulate the U.S. economy, and it's possible that these amounts could go back down next year. So if you haven't already spent at least \$250,000 this year on such assets but you've been planning to make some purchases in the next few months, consider doing so before year end.

#### **Appreciating MACRS depreciation**

The Modified Accelerated Cost Recovery System (MACRS) divides business assets into classes and specifies shorter time periods over which they can be depreciated. For example:

- Business equipment over 3, 5 or 7 years,
- Land improvements over 15 years,
- Residential rental property over 27.5 years, and
- Nonresidential rental property over 39 years.

Most of these assets have useful lives that extend well beyond their MACRS recovery periods. Moreover, the Economic Stimulus Act of 2008 provides 50% bonus depreciation for certain MACRS property purchased and placed in service in 2008.

Qualifying property includes water utility property, off-the-shelf computer software and certain leasehold improvements, as well as tangible property that has a recovery period of 20 years or less. And, for passenger automobiles that are eligible property under the 50% bonus depreciation rules, the first-year limit on depreciation is increased by \$8,000.

#### **Timing gains and losses**

Typically, it's best to pay taxes later rather than sooner, so techniques such as deferring taxable income to next year and accelerating deductions to this year may be beneficial.

Try to put off sales of property that will result in taxable income until after the first of the year. If you can't defer the whole sale, consider structuring it as an installment sale to minimize taxable gains. Another longer-term strategy that can help you defer income or gain is a like-kind exchange (also known as a Section 1031 exchange).

If you have an asset that has been declining in value, realizing losses on a sale could be a good strategy to offset taxable gains. If you can sell these holdings, you may be able to greatly reduce your tax burden. Also pay as many business expenses as you can before year end as well.

### **Maximizing tax credits**

Make sure you understand which tax credits are available to you and take advantage of them before year end. Remember: Most tax credits reduce your business's tax liability dollar-for-dollar. One such federal credit you could consider is the Work Opportunity. Plus, you may be eligible for certain state and local tax credits. Work with your CPA to see what's available in your area.

### **Using personal tax strategies**

There are also some tax-saving strategies that will help lower your *personal* tax bill:

**Fully fund your retirement accounts.** You may be able to make *pretax* contributions of up to \$15,500 (\$20,500 if you're age 50 or older) to your 401(k) and *tax-deductible* contributions up to \$5,000 (\$6,000 if you're 50 or older) to your traditional IRA and enjoy *tax-deferred* growth. Of course, if you like the idea of *tax-free* growth, contribute to a Roth IRA or Roth 401(k). The contribution limits are the same as those of their non-Roth versions. However, your eligibility to deduct contributions to a traditional IRA or make contributions to a Roth IRA may be reduced or eliminated based on your income and other factors.

**Make a charitable donation.** Donations to qualified charities are generally fully deductible. But talk with your tax advisor if you'd like to make a large donation, because they're typically more complex.

**Employ your children.** If you own a business, you can hire your children and deduct their pay. Keep in mind, though, your children must perform actual work for wages and be paid in line with what you'd pay nonfamily employees.

### **The time to act is now**

By now you've hopefully latched onto some ideas for saving tax dollars. So stop procrastinating. You still have time to make a difference on your 2008 taxes.

## **BUILD A BETTER FOUNDATION**

### **Business structures for real estate ventures**

Combining resources to invest in real estate or develop projects can have some obvious benefits — such as pooling financial strengths and experience. The question is how best to structure such joint ventures. Let's look at some of the options.

#### **Keeping it simple**

A partnership is the simplest option to set up, because you don't have to file any special forms or pay fees to get established. For tax purposes, this structure is a "pass-through entity," meaning owners report their share of the income or losses on their personal income tax returns.

You also don't have to follow any set operating rules. Instead, partners draw up their own agreement spelling out pertinent details such as goals, capital investments, management practices, individual partner responsibilities and income distribution. All partnership agreements should be in writing and reviewed by an attorney.

Although a general partnership provides tremendous management flexibility, it doesn't protect partners from personal liability for the actions and debts of the company. This should be a key consideration in the often-risky realm of real estate and development.

#### **Limiting your liability**

Several types of business structures do afford personal liability protection without the restrictions of a full-fledged corporation. The following are also considered pass-through entities, so all tax is paid at the individual partner level:

**Limited liability company (LLC).** An LLC is a hybrid business structure offering the flexibility of a partnership and the liability protection of a corporation. Like corporation owners, LLC owners aren't personally liable for any of the company's debts or liabilities. Creditors, therefore, can't go after the owners' assets. Unlike a corporation, however, an LLC isn't required to allocate profits and losses in proportion to ownership interests.

To set up an LLC, you'll need to file articles of organization with the state and pay a fee that may range from \$40 to \$800, depending on the state. LLC owners are required to elect officers to run the company, and they're subject to state regulations on how they keep records of major decisions.

The LLC is a popular business structure with small businesses because it allows for management flexibility and offers full personal liability protection. It's a structure recognized in all 50 states, with one caveat: In California, contractors can't operate as an LLC.

**Limited partnership.** This structure affords personal liability protection for those partners who provide financing to a venture but don't take an active role in operating the business. Running the business is left to general partners who assume the personal liability in the partnership. Limited partners assume no personal liability but receive a share of the profits for their involvement.

Having a limited partnership makes it easier to attract investors, and the structure is often used to acquire and hold real estate. As with an LLC, creating a limited partnership requires filing documentation with the state and paying state fees, which may vary from state to state.

**Limited liability partnership (LLP).** An LLP operates much like a limited partnership but it allows partners to be active in running the business, facing liability for only their own negligence or for that of employees directly under their supervision. LLP partners aren't subject to liability for actions by employees who aren't under their direct supervision or by other partners. However, they are liable for partnership debts that don't necessarily involve their own negligence.

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Owners of LLPs can also split proceeds however they wish. So the benefits of an LLP are limited personal liability protection and more management flexibility.

### **Work with a pro**

Choosing which business structure will work best for your next venture depends on the owners involved and how active they want to be in the business. Your tax and legal advisors can help you weigh the merits of each structure, complete required paperwork and draw up the partnership agreements.

### **10 ISSUES TO CONSIDER**

Whichever type of partnership you choose, there are basic items you should address when drawing up your governing agreement. Here are some of the key issues to consider when forging your partnership:

1. Purpose and goals of the partnership,
2. Investment needed,
3. Breakdown of capital investment by each member,
4. How the proceeds will be split,
5. Legal ownership entity (LLP, limited partnership, general partnership),
6. Management strategy,
7. How and when decisions will be made,
8. How expenses will be covered,
9. Books and record-keeping procedures, and
10. How disputes will be handled.

## LANDING A LAND LOAN

In the current skittish lending climate, obtaining a loan to invest in land can be a challenge. Far fewer lenders are willing to finance land purchases because of the inherent risk of funding a non-income-producing asset. And those that do fund land deals generally apply more stringent lending standards than on other types of property. If you're looking to buy some land, here are some insights into what lenders are looking for.

### The challenge of raw land

The requirements and prospects for landing a land loan depend on the type of property you're investing in. If you want to purchase *raw land* — land without services, such as sewer, water, access roads or power in place — and have no immediate plans to develop it into an income-producing asset, it may be difficult to find willing lenders.

Lenders value land based on its development potential. Prior to development, land holdings are financial liabilities because owners still must pay property taxes and sometimes provide maintenance. What's more, investors can't depreciate land on their taxes. Developing the services to make raw land ready for development can cost tens of thousands of dollars.

Lenders who consider such deals often require a hefty down payment of 50% or more and charge higher interest rates. You may have more luck with a local lender who knows the area. But be prepared to tell the story of the property and why you want to invest in it. You can also pursue seller financing or use home equity loan funds, depending on the size of the purchase.

Whatever type of loan you end up with, you'll need to provide the lender with a detailed budget plan, past financial statements and tax returns. In fact, your credit history and financial statements will be particularly important to land lenders, who have learned that borrowers are more inclined to walk away from relatively low-cost, undeveloped land than from more costly, developed property.

### Exit ahead

Lenders tend to be more amenable to financing *vacant land* — property with development services in place — when there is a proposed development accompanying the request. When deciding whether to offer you financing, they'll consider whether the property is zoned for the use intended, the attitude of the community toward potential development, the site's location and the demographics of the area in which it's located.

Most lenders will want you to have a plan to develop the site, or an "exit strategy," because, once you get a mortgage on the proposed structure, the land loan will be paid off.

You're apt to find that lenders are much more willing to step up to the plate if you're buying land with a specific development plan in place, depending, of course, on the merits of the plan and the track record of the developer. This type of funding — called an acquisition and development (A&D) loan — incorporates the price of the land, along with its development and delivery-to-market costs. Lenders also like the fact that your development plan establishes the market value of the site, rather than forcing them to rely on a speculative appraisal.

If the development plan passes muster, the down payment on an A&D loan will likely range from 25% to 30% of the project costs.

### A good time to buy

While financing land investments can be difficult, this could be a good time to consider such purchases because land prices for residential development have been declining. And, as the saying goes, "they aren't making land anymore."

## **BUILDING PROJECTS GO HIGH-TECH WITH BIM**

At last — there's a high-tech tool that's making it easier to design and manage construction projects. It's called building information modeling (BIM), and it uses digital information to create accurate project models and refine construction schedules.

The BIM concept — a method for organizing, storing and maintaining information about the physical characteristics of a building — has been around for several decades. But, with a growing tide of BIM software products filling the market, it's been gaining acceptance by more and more architects and developers in recent years.

Traditionally, information on a building's design has been stored in a number of places and variety of formats, from drawings and digital CAD files to design specification and maintenance records. BIM technology lets developers consolidate that data in a single digital repository, with components that can be changed and evaluated. The Construction Management Association of America (CMAA) defines BIM as “the production and coordinated use of a collection of digital information about a building project.”

One of the benefits of using BIM is that electronic collections of 3D models, project costs and construction schedules can be viewed simultaneously by everyone involved in the project. The technology allows a designer to electronically navigate components within a model to, for instance, relocate a wall or pipe or spot a design problem before construction starts. BIM can also be used to perform energy, lighting or acoustical analyses, get feedback, and make improvements while still in the design stage of a project.

Proponents claim that it allows better communication among architects, engineers and others, saving time and decreasing costly construction errors.

Just five years ago, only 3% of building owners were using BIM, according to a 2007 survey by the CMAA. But approximately 35% of the survey's participants have been using BIM technology for at least a year. More are likely to join these ranks: In May 2007, the National Institute of Building Sciences created a universal BIM format that can be read and understood by many different software programs. Maybe it's time you checked out this new wave of construction technology.

## **ASK THE ADVISOR**

### **What are REOs and what can they do for me?**

Some investors are finding a gold mine in real estate owned (REO) properties — foreclosed properties that banks fail to auction off. Because banks are quite motivated to sell these properties, they can make good investment opportunities. However, you'll need to do your homework to make such investments pay off.

### **A liability for lenders**

Auctions of foreclosed property are often unsuccessful. So, if a bank fails to attract a bid high enough to cover costs owed to the lender on repossessed real estate, the property becomes an REO property. Because having REOs on their books is a liability for lenders, they'll often sell them at below market value. But don't expect a bank to accept an unrealistically low offer — lenders are still looking to offset their costs.

You can track down REO properties via the Internet, where there are a number of services that provide updated lists for a fee. Or you can go to lenders directly. Many list REO properties and contact information on their Web sites. Because practices vary, contact the lender to find out what they may require to purchase an REO property. Some banks also list REOs with real estate agents.

### **Do your homework**

As you would with any other real estate prospect, conduct the necessary due diligence. Researching the market value of similar properties in the area and inspecting the premises is just the beginning. Ask the selling agent or bank if you can look at any property inspection reports.

Banks often want to sell REOs “as is,” so get estimates on the cost of any needed repairs and incorporate those costs into your offering price.

Be prepared for the negotiating process with the lender to take some time. For one thing, it will likely be reviewed by more parties than a traditional purchase offer. Although banks are often eager to unload REOs, they’ll strive to get the best price — be prepared to negotiate through several counteroffers. If your offer is rejected, wait a month or so and try again. If the property hasn’t moved by then, the lender may be more motivated to deal.

### **Advantages may outweigh the cost**

Despite the work involved, you may find the advantages to buying REOs enticing. For example:

- Such properties are often sold below market value.
- Lenders often offer favorable terms, such as low down payments or low interest rates.
- Lenders typically offer clear title — free of property liens — on REOs.

Moreover, because REO homes are already vacant, you won’t have to deal with the difficulty of ousting previous owners.

### **REO: The way to go?**

Be aware that not all REOs are good deals. You’ll need to spend time sifting out the more distressing “distressed” properties to find solid prospects. But, with the number of REOs rising in today’s market, putting in the effort to size up this investment option could be well worth your time.

## **FOR FURTHER INFORMATION**

If you have any questions, please contact **Harry Moehringer, CPA, Partner-in-Charge** of the Marks Paneth & Shron LLP Real Estate Services Group at 212-503-8904 or [hmoehringer@markspaneth.com](mailto:hmoehringer@markspaneth.com).

In addition, information on the Marks Paneth & Shron Real Estate practice can be found at [www.markspaneth.com](http://www.markspaneth.com).

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