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REAL ESTATE ADVISOR JULY 2011: NONCORPORATE BUSINESS STRUCTURES CAN PROVIDE EASE AND FLEXIBILITY

MAINTENANCE VERSUS CAPITAL IMPROVEMENT: THE DIFFERENCE CAN MEAN MORE MONEY IN YOUR POCKET

Property owners often wrestle with how to classify their repair and upkeep costs — are they routine maintenance costs, which are immediately deductible against current income? Or are they capital expenditures that must be recovered over time through depreciation?

Fortunately, proposed IRS regulations help clarify how such costs should be treated for tax purposes. Although not final as of this writing, the proposed regulations provide useful guidance based largely on previous guidance and rulings from the IRS and the courts.

The tax impact

Most taxpayers will pay less tax by classifying an expenditure as maintenance and taking a current deduction, rather than by capitalizing the expense and recovering it by way of depreciation.

On the other hand, capital improvements add to basis of a property, thereby reducing capital gains when you sell the property. However, a large one-time maintenance expense lowers the profit reported by an income-producing property which could potentially make it harder to refinance.

Capitalize versus Expense - A 3-part test

The proposed regs provide some rules on how to determine whether an amount paid for an “improvement” must be capitalized under Internal Revenue Code (IRC) Section 263(a). Generally, the regulations require a taxpayer to capitalize amounts that result in a 1) betterment, 2) a restoration, or 3) a new or different use of a unit of property.

A cost results in a *betterment* if it:

- Remediates a material defect that existed before the property’s acquisition or arose during the property’s production,
- Causes a material addition to the property, or
- Causes a material increase in the property’s capacity, productivity, efficiency, strength, quality or output.

To illustrate, suppose a storm damages a building’s roof. The IRS would likely allow you to deduct the cost of replacing a few shingles as maintenance expense. But if you upgrade to a new maintenance-free asphalt roof, it would qualify as a betterment, requiring you to capitalize it and depreciate it over 39 years (commercial) or 27.5 years (residential).

A cost results in a *restoration* if it:

- Replaces a property component and the taxpayer either has properly deducted a loss for it or has taken into account its adjusted basis in realizing a gain or loss from the component's sale or exchange;

- Is for the repair of property damage for which the taxpayer has taken a basis adjustment as a result of or relating to a casualty loss:

- Returns the property to its ordinarily efficient operating condition if the property had deteriorated to a state of disrepair and was no longer functional for its intended use;

- Results in rebuilding the property to a like-new condition after the end of its economic useful life; or

- Replaces a major component or a substantial structural part of the property.

A cost results in a *new or different use* if the adaptation isn't consistent with the taxpayer's intended ordinary use of the property at the time the taxpayer started using it. For example, suppose a taxpayer has owned a manufacturing facility since the early 1970s, using it for manufacturing. If the taxpayer decides to convert the facility to a showroom, the costs incurred are paid to adapt the building to a new or different use, so they must be capitalized.

Deciphering the Regulations

If you're uncertain about asset classifications, your MP&S advisor can help you find your way through the regs in order to help you maximize current year deductions. He or she can review your capitalization decisions to determine whether any of the capitalized expenditures can be reclassified as deductible maintenance expenses.

Treatment of property acquisition costs

IRS proposed regulations provide that "inherently facilitative" transaction costs must be capitalized. Acquirers should be aware of these costs, which can be substantial. These costs include:

- Securing an appraisal or determining the property's value or price;

- Negotiating terms of the acquisition;

- Obtaining tax advice;

- Application fees, bidding costs and similar expenses;

- Preparing and reviewing documents that facilitate the acquisition of the property;

- Evaluating the property's title;

- Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;

- Conveying property between the parties, including sales and transfer taxes and title registration;

- Finders' fees or brokers' commissions;

- Architectural, geological, engineering, environmental or inspection services pertaining to particular properties; and

- Services provided by a qualified intermediary or other facilitator of a like-kind exchange.

The regulations do, however, provide an exception for costs relating to activities such as marketing studies that are performed to determine whether to acquire real property and which real property to acquire. These costs can be deducted as period costs.

NONCORPORATE BUSINESS STRUCTURES CAN PROVIDE EASE AND FLEXIBILITY

Choosing the right business structure for a real estate venture requires serious thought. A corporation is one possible structure, but let's take a closer look at noncorporate options which generally offer more flexibility.

Enjoy simplicity, flexibility with a partnership

One reason partnerships are popular choices for real estate ventures is that they're easy to set up. It's a matter of obtaining a business license and giving notice of your partnership's name under your state's assumed-name statute.

Partnerships are also popular because of their flexibility. Partners typically draw up a customized partnership agreement spelling out pertinent details such as goals, management practices, capital investments, individual partner responsibilities, income distribution, dispute resolution and buyouts. Partnership agreements should be in writing and reviewed by an attorney.

Although a general partnership provides simplicity and management flexibility, it generally doesn't protect partners from personal liability for the actions and debts of the company — or the other actions of partners — key considerations in today's real estate climate.

For tax purposes, this structure is a "pass-through entity" whereby the owners report their share of the income or losses on their personal income tax returns, regardless of whether cash distributions are made.

Curb personal liability with an LLC

Another popular entity choice for real estate ventures is the limited liability company (LLC). This option offers the flexibility of a partnership and the liability protection of a corporation.

Like corporation owners, generally LLC owners aren't generally personally liable for company debts or liabilities, unless they "misuse" the corporation through fraud or other illegal activity.

So, creditors normally can't go after the LLC owners' personal 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 must file articles of organization with the state and pay the applicable fee. LLC owners must elect officers to run the company and they're subject to state regulations on how they keep records of major decisions.

Like a partnership, an LLC may elect to be treated as a flow-through entity with all federal tax paid at the individual member level. Individual cities and states have their own unique regulations as to the taxation of LLC's. In New York State, for instance, LLC's are subject to annual filing fees based on gross receipts. In New York City, LLC's as well as other unincorporated businesses, are subject to income taxes at the entity level.

Limited partnership options

Still another popular structure is the limited partnership. It affords personal liability protection to limited partners who provide financing but don't want to take an active role in operating the business. Running the business is left to general partners who assume the personal liability in the partnership. All federal tax is paid at the individual partner level, although limited partnerships may pay state and local taxes in some jurisdictions.

It’s usually easier to attract investors to a limited partnership rather than a general partnership and the limited partnership 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 filing fees.

You also may have heard about limited liability partnerships (LLPs). These structures operate much like a limited partnership but allow all partners to be active in running the business, facing legal 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.

The LLP is also a pass-through entity, therefore, federal income taxes are paid at the individual partner level. Owners of LLPs can also split proceeds however they wish. Some states recognize LLPs but limit the use to professional firms. Consult an attorney to see if LLPs make sense for real estate companies in your state.

Get it right

Although noncorporate structures offer many benefits, a corporate structure may be a better choice in some situations. So be sure to consider all of your options.

No matter which type of business structure you choose, you must address certain items when you draw up the governing agreement. Carefully consider the purpose and goals of the venture, and the overall investment needed. Working with your advisors can help ensure your venture starts off on the right foot.

TAX COURT FINDS STREET LIGHTS QUALIFY FOR 7-YEAR DEPRECIATION

The U.S. Tax Court recently ruled against the IRS in a dispute over the proper period of depreciation for street lights. The IRS had claimed that street lights were subject to a 20-year period, but the court held that they’re subject to a period of only seven years. As a result of this ruling, owners of property with a significant number of street lights, such as shopping centers and office complexes, could recover the costs of the lights much more quickly.

How are recovery periods determined?

Under the Modified Accelerated Cost Recovery System (MACRS), taxpayers recover the cost of property, including real property and improvements, by taking annual depreciation deductions over the specified life of the property. The IRS has established numerous asset classifications, with a specified period of depreciation for each class.

The Electric Utility Transmission and Distribution Plant class, for example, has a 20-year depreciation period. Property that doesn’t fall in any of the classes is considered part of the “residual class,” which is subject to a seven-year period.

What were the court’s findings?

In 1997, an electric utility company (PPL Corporation) reclassified its street lights, removing them from the Electric Utility Transmission and Distribution Plant class and classifying them as part of the residual class. PPL then claimed a catch-up depreciation adjustment of about $18,600 on its 1997 income tax return. The IRS disallowed the adjustment, asserting that the lights were subject to the 20-year depreciation period.

It was left to the Tax Court to determine the appropriate asset class — and therefore depreciation period — for street lights. The court began by considering whether the lights were “distribution property,” as the IRS contended. It noted that the tax regulations dictate that property be included in the asset class for the activity in which the property is “primarily used.”

The court found that street lights are primarily used to make light, not to distribute electricity. In fact, it emphasized that "*no one* uses street light assets in the distribution of electricity for sale." This suggests that the court's conclusion that street lights aren't properly classified as distribution property applies to both utilities and nonutilities.

The IRS alternatively argued that street lights should be treated as part of the Land Improvements class and be subject to its 15-year recovery period. The class generally includes sidewalks, roads, canals, waterways, drainage facilities, nonmunicipal sewers, wharves and docks, bridges, fences, landscaping, shrubbery, and radio and television transmitting towers.

The court applied the so-called *Whiteco* factors to determine whether street lights qualify as land improvements. As the court noted, the primary focus of the factors is the permanence of the depreciable property and the damage caused to it upon removal. The court found that street lights — even those bolted to a concrete foundation — aren't affixed to anything in an inherently permanent way and that removal of the lights doesn't damage them. Thus, they weren't land improvements.

Does this mean a brighter future for your properties?

The Tax Court concluded that street lights fall within the residual class and are subject to a seven-year depreciation period. But this case has broader application, beyond street lights. As the IRS continues its initiative against faster property depreciation rates, this case underscores the importance of applying common sense and revisiting the plain language of the law when battling the IRS.

Contact your CPA to determine if *any* of your assets could be reassigned to classes with shorter recovery periods, and, if so, how to make the necessary accounting changes.

STATE AND LOCAL TAX UPDATE: CONNECTICUT

The following recent tax law changes may be of interest to you if you live, work or own a business in the state of Connecticut.

PERSONAL INCOME TAX

The Governor signed Legislation effective July 1, 2011, that allows the Commissioner of the Department of Economic and Community Development (DECD) to create an incentive program designed to keep certain college students in Connecticut after graduation. Under the program the Department of Revenue Services (DRS) segregates eligible graduates' income tax payments, upon their request, into a Connecticut first-time homebuyers account for up to 10 years after graduation (i.e., for taxable years beginning on or after 1/1/14). The annual maximum tax payments that may be segregated is $2,500. Participants can withdraw the segregated amounts to buy a first-time home in Connecticut within 10 years after they graduate.

The program is open to graduates of (1) public colleges/universities in Connecticut who are in-State students and pay the in-State tuition rate and
(2) Regional vocational-technical schools. They must have graduated from either type of school on or after 1/1/14.

CORPORATION INCOME TAX

The Governor has signed Legislation expanding certain corporation business tax credits as follows.

Enterprise Zone (EZ) Credits

Effective 7/1/11, certain manufacturers in an EZ will now qualify for all the EZ benefits if (1) they create or retain jobs, export most of their products and services out of state, encourage innovation or add value to products and services, or (2) they are businesses within an "economic cluster" designated by the DECD

or (3) they are establishments, auxiliaries or operating units of either as defined under the North American Industrial Classification (NAIC). Also, businesses that provide "business support services" to the above types of companies in an EZ will qualify for the EZ credits and benefits. These services include, for example, day care, job training, and transportation to name a few. Finally, commercial businesses located in sections of Plainville will also qualify for the EZ credits and benefits.

Manufacturing Investment Accounts (MIA)

Effective for tax years beginning on or after 1/1/11, small manufacturers with 50 or less employees can defer corporation business taxes on the money they save in an MIA for training, developing and expanding their work force or purchasing machinery, equipment or facilities. The MIA must be established in a Connecticut bank and the MIA will be kept open for 5 years after which time, the money will be returned to the business. The manufacturer may deposit up to the lesser of $50,000 annually or 100% of its domestic gross receipts on a tax deferred basis for 5 years. Such deposits are deductible against the business's corporate business taxes. Upon the withdrawal of the deposits during the 5 years, corporate business tax will be due at a 3.5% rate. If withdrawn after 5 years from the MIA inception, the regular 7.5% tax rate (plus 10% surcharge) will apply.

Neighborhood Assistance Act (NAA) Credits

Effective 10/1/11, a credit will be available to businesses paying the corporate business tax or flow-through entities paying the $250 business entity tax. When the business makes an investment of $250 or more in a state or city-approved community program, it receives an NAA credit, dollar for dollar, against its business corporation tax up to an annual limit of $150,000.

ASK THE ADVISOR

Should I use a Family Limited Partnership to transfer real estate to my heirs?

Recent tax law changes have prompted many owners to reassess their plans for transferring real estate and other assets to their heirs. One vehicle worth considering is the family limited partnership (FLP). It can help you limit gift and estate taxes related to asset transfers, while still retaining some control over the property.

Tax advantages

After you establish an FLP, you transfer assets to it and grant limited partnership interests to family members. As the general partner, you can hold as little as 1% of the FLP units and still control how FLP assets are managed.

For gift tax purposes, the value of the limited partnership interests transferred are discounted to reflect the lack of control those interests have over the FLP and the lack of a market for them. Together, these discounts can be high, depending on factors such as asset liquidity, dividend-paying history and transfer restrictions.

The reduced value of the FLP interests means you can transfer more of your estate while minimizing the tax bite. Upon death, your taxable estate will be reduced because it will include only the value of your general partnership interest, not the value of the FLP’s underlying assets.

Potential pitfalls

The IRS frequently challenges FLPs. Internal Revenue Code Section 2036(a) has been the IRS’ most successful line of attack. It states that a taxable estate should include the *undiscounted* value of all property that the deceased transferred during his/her life while still retaining:

- The possession or enjoyment of, or the right to income from, the property, or

- The right, either alone or in conjunction with any person, to designate the persons who will possess or enjoy the property or the income generated by the property.

Most of the FLP's that fail do so because of bad facts. The FLP must be set up correctly and the terms of the partnership agreement must be followed by the general partner or managing member of the LLC.

Withstanding attack

Court decisions provide numerous insights on how best to structure and operate an FLP to withstand an IRS attack. Work with your tax advisor to determine if an FLP is right for you.

NYC GREENER, GREATER BUILDINGS PLAN

The August 1 deadline for owners of all buildings of more than 50,000 gross square feet to comply with New York City's Greener, Greater Buildings Plan will be here soon. The next step may be to conduct an energy audit.

In today's competitive environment, an energy-efficient building is more attractive for both commercial and individual renters and purchasers. Achieving the ENERGY STAR status puts you in a select group of nationally recognized buildings. Just as people look for the ENERGY STAR label when they purchase appliances, so too is this rating important to keep your building competitive in the marketplace.

The real estate advisors at MP&S can help you in taking advantage of green incentives, tax deductions and tax credits. We can also perform cost-benefit analyses on any potential savings from energy improvements to your buildings.

SPOTLIGHT ON MP&S

MP&S Is Pleased to Welcome These Outstanding Professionals to the Firm

SALT PARTNER

Steven P. Bryde, JD, has joined MP&S as a principal in our tax practice. Steven is a state and local taxation (SALT) specialist with approximately 25 years of public accounting experience in both global and regional firms. He has also worked in industry as a tax attorney for a global energy company.

Steven is admitted to practice before the New York State Supreme Court, the Federal District Court (Southern and Eastern Districts) and the US Tax Court.

LITIGATION AND CORPORATE FINANCIAL ADVISORY SERVICES PARTNER

Eric Kreuter, Ph.D., CPA, CFE, has joined the firm's Litigation and Corporate Financial Advisory Services Group. He specializes in litigation and forensic services including commercial damages and fraud investigations.

He has worked in professional services firms since 1983 and also served as a founding shareholder. He has testified in state courts and the US Bankruptcy Court as well as arbitrations and depositions.

CHIEF FINANCIAL OFFICER

Brian L. Fox, CPA, has been named as the firm's chief financial officer. He joins our strong financial team.

Brian was previously the CFO at an environmental engineering and commercial construction services firm based in Hartford. He also worked in public accounting in a global firm and holds a Master's degree from Harvard University.

GAAP AND GAAS SPECIALIST

Yasmine Misuraca, CPA CFE, is a Director in the firm's Litigation and Corporate Financial Advisory Services Group with more than 15 years of accounting experience in both public and private industry accounting, securities litigation and litigation consulting and forensic accounting services.

She has an in-depth knowledge of both US Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS). She has worked with the SEC on large, high-profile cases. She has also worked with major law firms and corporate counsel in assisting testifying experts and in all aspect of their cases.

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:

- Timothy Andrews
  tandrews@markspaneth.com
- Vincent Barra
  vbarra@markspaneth.com
- Arthur Cannata
  acannata@markspaneth.com
- Bradley Eckstein
  beckstein@markspaneth.com
- Robert Feldman
  rfeldman@markspaneth.com
- William Jennings
  wjennings@markspaneth.com
- Kurt Kiess
  kkiess@markspaneth.com
- Susan Nadler
  snadler@markspaneth.com
- Abe Schlisselfeld
  aschlisselfeld@markspaneth.com
- Steve Schochet
  sschochet@markspaneth.com
- Michael Saul
  msaul@markspaneth.com
- Michael Siino
  msiino@markspaneth.com
- Howard Warshaw
  hwarshaw@markspaneth.com

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

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