MARKS PANETH

ACCOUNTANTS & ADVISORS

MARKS PANETH REAL ESTATE ADVISOR DECEMBER 2014: STRATEGIES AND SOLUTIONS FOR CONTINUING TO GROW YOUR REAL ESTATE BUSINESS

HOW A TRUST QUALIFIED FOR AN EXCEPTION TO PAL RULES

In a favorable decision for trusts that hold real estate assets, the U.S. Tax Court has held that such a trust qualified for the real estate professional exception and was therefore exempt from the limitations on passive activity losses (PALs). The court's holding also means the trust can avoid the new 3.8% net investment income tax (NIIT) that applies to passive activity income.

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 the activity that's regular, continuous and substantial. Rental real estate activities are generally considered passive regardless of whether you materially participate.

Internal Revenue Code Section 469 grants an exception from restrictions on PALs for taxpayers who are real estate professionals. If you qualify as a real estate professional *and* you materially participate, your rental activities are treated as a trade or business, and you can offset any nonpassive income with your rental losses. You may also be able to avoid the NIIT as long as you're engaged in a trade or business with respect to the rental real estate activities (that is, the rental activity isn't incidental to a nonrental trade or business).

To qualify as a real estate professional, you must satisfy two requirements: 1) More than 50% of the "personal services" you perform in trades or businesses are performed in real property trades or businesses in which you materially participate, and 2) you perform more than 750 hours of services in real property trades or businesses in which you materially participate.

The IRS challenge

In *Frank Aragona Trust v. Commissioner of Internal Revenue*, the trustee had formed a trust in 1979 with his five children as beneficiaries. The trustee died in 1981 and was succeeded as trustee by six trustees — his five kids and an independent trustee. Three of the kids worked full-time for a limited liability company (LLC), wholly owned by the trust, that managed most of the trust's rental properties and which also employed about 20 other individuals.

During 2005 and 2006, the trust reported nonpassive losses from its rental properties which it carried back as net operating losses to 2003 and 2004. The IRS determined that the trust's real estate activities were passive activities and the challenge landed in the Tax Court.

A trust as a real estate professional

The IRS contended that a trust couldn't qualify for the real estate professional exception because a trust can't perform "personal services," which regulations define as "any work performed by an individual in connection with a trade or business." The Tax Court rejected this argument. It found that, if a trust's trustees are *individuals* who work on a trade or business as part of their trustee duties, their work can be considered personal services that can satisfy the exception's requirements.

Evaluating material participation

The IRS alternatively argued that, even if some trusts can qualify for the exception, the Aragona trust didn't because it didn't materially participate in real property trades or businesses. The agency asserted that only the activities of the trustees can be considered, not those of the trust's employees. And the IRS claimed the activities of the three trustees who worked for the LLC should be deemed activities of employees and not trustees.

The Tax Court didn't decide whether the nontrustee employees' activities should be disregarded in determining if the trust materially participated in its real estate operations. But it held that the activities of the trustee employees should be considered. It also noted that trustees aren't relieved of their duties of loyalty to beneficiaries just because they conduct activities through a corporation wholly owned by the trust.

Be prepared

For technical reasons, the trust in this case wasn't required to prove that it satisfied the two-prong real estate professional test. Other trusts wishing to take advantage of the exception should be prepared to do so.

Trustees' minority interests didn't undermine material participation

Two of the trustees in *Frank Aragona Trust v. Commissioner of Internal Revenue* had minority interests in all of the entities through which the trust operated real estate holding and development projects. The trustees also had interests in some of the entities through which the trust operated its rental real estate business. The IRS argued that some of their activities in managing the jointly held entities should be attributed to their personal shares of the businesses, rather than the trust's, when determining whether the trust satisfied the material participation requirements.

But the Tax Court pointed out that the two trustees' combined ownership interest in each entity wasn't a majority interest, nor was it greater than the trust's ownership interest. Further, their interests as owners were generally compatible with the trust's goal of helping the jointly held entities succeed and the two trustees were involved in managing the day-to-day operations of the various businesses. The Tax Court, therefore, remained convinced that the trust materially participated in the real estate operations.

ORDINARY INCOME VS. CAPITAL GAIN: HOW TO TREAT REAL ESTATE SALE PROCEEDS

When the owner of real estate sells a property, he or she typically prefers that the proceeds be treated as a *capital gain* rather than ordinary income for tax purposes, thus meaning the real estate was held as investment property. But what if the owner originally purchased the property for development and subsequently treated it as investment property? In *Allen v. United States*, an owner discovered the undesirable tax consequences of his change in business plans.

Owner sells land to developer

A taxpayer purchased land in East Palo Alto in 1987. Between 1987 and 1995, the taxpayer attempted to develop the property on his own, spending money on engineering plans and taking out a second mortgage on the property. His development company created about 10 sets of plans for the property as he attempted to find a partner to develop the land.

In 1999, he sold the property to a developer for a lump sum amount and future contingent payments based on a percentage of profits from the future sale of developed units. The taxpayer's development company did some of the engineering work on the property until the developer changed the project's direction and hired another engineer.

In 2004, the taxpayer received a final installment payment of $63,662 and reported the money as long-term capital gain. The IRS challenged the tax treatment of the payment, asserting that the land was "held primarily for sale to customers in the ordinary course of business."

Sale proceeds were ordinary income

The U.S. District Court for the Northern District of California sided with the IRS, finding that the taxpayer was a real estate *dealer* subject to ordinary income tax rates, rather than an *investor* subject to capital gains rates — even though he'd sold only a single piece of property. It reached this conclusion after weighing several factors that courts commonly consider to determine whether a property has been held as inventory or a capital asset:

1. The nature of the property's acquisition,

2. The frequency and continuity of sales over an extended period,
3. The nature and extent of the taxpayer's business,
4. The taxpayer's activities regarding the property, and
5. The extent and substantiality of the transactions.

According to the court, while some attention is paid to the reason for the property's purchase, particular weight is given to the purpose for which it was held.

The court concluded that the first and fourth factors were determinative in this case. As to the first, the taxpayer testified that his intent to develop the property had changed to an intent to sell it because he lacked the requisite expertise to develop the land. The court acknowledged that a purchaser's intent toward property can change over time. But it wasn't convinced that the taxpayer's intent had changed, because he provided no evidence explaining how, when or why his goals for the property had changed.

The court also found that the fourth factor favored the IRS position. The taxpayer engaged in significant development activity for the property, creating multiple development plans and seeking partners until shortly before the sale. Further, some of his debts to former partners were paid out of the sale proceeds.

Protect yourself

Sometimes a downturn in the market or other circumstances will lead you to change your plans for property from development to investment. If you hope to take advantage of this change from a tax perspective, you'll need clear evidence of how, when and why your intent changed.

ASK THE ADVISOR: IS A BRIDGE LOAN RIGHT FOR ME?

As the real estate market rebounds, bridge loans can provide an interim financing option for investors and developers until they're able to secure long-term financing. While such loans provide several benefits, they also come with some disadvantages worth weighing before jumping into the loan.

Advantages of bridge loans

Bridge loans are particularly attractive these days for investors in underperforming multifamily properties. Traditional lenders prefer more stabilized properties, thus making it difficult to obtain financing to increase occupancy, make improvements or retain smarter management. A bridge loan running from 12 to 24 months can give investors the opportunity to address the issues necessary to stabilize a property to the satisfaction of traditional lenders.

Bridge loans are also appealing because of the borrower's ability to choose repayment options. A borrower can opt to repay the loan before or after long-term financing is found. If the borrower takes the former option, it can improve its credit rating by making the payments on time, thereby improving its odds of qualifying for long-term loans with favorable terms. If the bridge loan is to be paid off after long-term financing is secured, part of that financing can be applied to repay the loan.

Such loans typically require less income documentation than conventional loans and tend to close quickly. They also can be nonrecourse; to protect the borrower's other assets.

The disadvantages

Not surprisingly, bridge loans feature higher interest rates, fees and penalties, and generally require a large balloon payment. Closing costs are usually high and can't be recovered if you find long-term financing sooner than expected. Bridge loans also require a high loan-to-value ratio.

Proceed with caution

Only savvy, well-capitalized borrowers should consider bridge loans. The loans are especially appropriate for newer, large multifamily properties (at least 100 units) in stable or improving markets with solid and expanding employment bases.

For the right kind of borrower and right kind of project, a bridge loan could be just the ticket. Your financial advisor can help you determine if such financing is worth pursuing.

SPOTLIGHT ON MARKS PANETH

HOW'S MAYOR DE BLASIO TREATING THE COMMERCIAL PROPERTY INDUSTRY?

Not well, say real estate executives. More than two-thirds think he's only doing a "fair" or "poor" job and fewer than one in five (17%) think he's done either an "excellent" or "good" job at supporting commercial property owners' interests. But they are optimistic (72%) about the de Blasio administration's plans to revitalize Midtown East. Read these and other findings from our latest *Gotham Commercial Real Estate Monitor* survey of real estate professionals in New York.

MARKS PANETH TO SPONSOR 4TH REAL ESTATE WEEKLY WOMEN'S FORUM ON FEBRUARY 25TH

Marks Paneth will be a sponsor of the 4th Real Estate Weekly Women's Forum, which will be held at the Wyndham New Yorker Hotel on February 25th. Please click here for more information about the expo and to register.

FOR FURTHER INFORMATION

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