MARKS PANETH
ACCOUNTANTS & ADVISORS

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

IRS FINAL REGS ON TANGIBLE PROPERTY: SAFE HARBORS OPENED AND EXPANDED

The IRS has released its final regulations on the proper tax treatment of expenditures related to tangible property, including buildings. The regs explain how property owners can distinguish between expenses (which are immediately deductible against current income) and capital expenditures (which must be recovered over time through depreciation).

The final regs, which apply to tax years beginning on or after Jan. 1, 2014, replace the temporary regs released in December 2011. The IRS retained many of the earlier regulations provisions but modified several sections and created and expanded on some notable safe harbors.

De minimis safe harbor

The final regs make a number of changes to existing rules regarding the safe harbor that allows taxpayers to avoid capitalization of certain expenditures, thereby reducing current-year taxable income. Under the temporary regs' *de minimis* safe harbor, a taxpayer that expensed the purchase price of tangible property for financial reporting purposes — in accordance with its written accounting procedures — on an applicable financial statement (generally, a certified audited financial statement) could deduct that amount for tax purposes, up to an aggregate ceiling.

The final regs eliminate the ceiling, replacing it with a new safe harbor that's determined at the invoice or item level. A taxpayer with an applicable financial statement may now apply the *de minimis* rule to deduct amounts properly expensed under written accounting procedures that apply to items that don't exceed a certain dollar amount — as long as the amount per invoice or line item doesn't exceed $5,000.

Note that this doesn't mean that a taxpayer can't have a policy that allows expensing of certain items with a cost in excess of $5,000. It just means that the safe harbor will apply only to those items that cost $5,000 or less.

The final regs also expand the *de minimis* rule to cover amounts properly expensed under written accounting procedures that apply to property with an economic useful life of 12 months or less — again, as long as the amount per invoice or item doesn't exceed $5,000. By contrast, the safe harbor in the temporary regulations applied only when the taxpayer had accounting procedures expensing amounts costing less than a certain dollar amount, not when it had accounting procedures expensing amounts paid for property with a useful life under a certain period.

The *de minimis* rule is an annual irrevocable elective safe harbor, rather than a mandatory one. If a taxpayer elects the safe harbor, however, it must apply the rule to all amounts paid in the taxable year for tangible property that meets the requirements.

Routine maintenance safe harbor

Tax regs mandate that a cost that results in an improvement to a building structure or to any of the enumerated building systems (for example, the plumbing system) be capitalized. An improvement occurs if there was a betterment, restoration or adaptation of a unit of property.

Under the final regs' routine maintenance safe harbor, an activity isn't an improvement if the taxpayer is expected to perform the improvement to keep the property in its ordinarily efficient operating condition. The activity counts as "routine" only if, at the time the property was placed in service, the taxpayer reasonably expected to perform it more than once during the property's life.

Unlike the temporary regulations, the final regs extend the safe harbor to buildings. For buildings, the taxpayer must reasonably expect to perform the activity more than once in 10 years.

The final regs modified the temporary regs to clarify that a taxpayer's expectation won't automatically be considered unreasonable simply because the taxpayer ultimately doesn't perform maintenance a second time during the relevant period. But the taxpayer would then need to substantiate that its expectation was reasonable at the time the property was placed in service. Bear in mind that costs for activities falling outside the routine maintenance safe harbor may nonetheless qualify as a deductible expense under the general rules for improvements.

Small business safe harbor

The regs create a new safe harbor for qualified small businesses — generally those with gross receipts of $10 million or less. On buildings that initially cost $1 million or less, such taxpayers can elect to deduct the lesser of $10,000 or 2% of the adjusted basis of the property for costs related to repairs, maintenance, improvements and similar activities each year.

The final regs and you

The provisions discussed here are just a small part of the extensive final regulations. The regs include rules addressing a range of other matters, such as the tests for betterment and restoration, materials and supplies, and temporary spare parts. Please contact your tax advisor to determine how the new regs affect you.

A safe harbor for taxpayers without audited financial statements

The final IRS tangible property regulations (see main article) provide some relief for taxpayers that don't have their financial statements audited — so long as they have written accounting procedures in place for expensing amounts paid for property costing less than a certain dollar amount, or for property with an economic useful life of 12 months or less.

Such taxpayers can apply the *de minimis* safe harbor if the amount paid doesn't exceed $500 per invoice or item. (This amount is subject to change by the IRS.) If the cost exceeds that threshold, however, no portion of it falls within the safe harbor. According to the IRS, the reduced threshold is necessary because of the reduced assurance that such taxpayers' accounting procedures clearly reflect income.

WHY YOU SHOULD CONSIDER THE TAX RAMIFICATIONS OF AN SMLLC

If you're a real estate investor, you've likely heard of SMLLCs, which stands for "single-member limited liability companies." An SMLLC holds properties in order to distance the investor from various liabilities. But before setting up such an entity, it's important to consider the tax ramifications.

Liability protection

SMLLCs are similar to corporations in that they limit owners' personal liability for the debts and actions of the entity. Creditors of the SMLLC generally can't go after the investor's personal assets; they can pursue only SMLLC assets.

Investors with more than one property can use multiple SMLLCs to segregate potential liability exposure for each property. SMLLCs also offer some of the benefits of partnerships, without requiring a minimum of two partners.

Avoiding double taxation

For federal income tax purposes, an SMLLC can be treated as either a corporation or a single-member disregarded entity. To be treated as a corporation, the SMLLC must file IRS Form 8832 and elect to be classified as a corporation.

Classification as a C corporation, however, often isn't desirable because it can result in double taxation. When an SMLLC is treated as a C corporation, it's taxed on the income it generates, and then the single member/owner is taxed on dividends he or she receives.

If the SMLLC elects to be treated as an *S corporation*, double taxation is avoided. In such cases, the single member/owner is subject to tax on all of the S corporation's earnings, often through a combination of salary and flow-through income. S corporations generally aren't taxed at the federal level, but state tax may be imposed.

If an SMLLC doesn't elect to be a corporation, the IRS will classify it as a disregarded entity taxed as a sole proprietorship. Single members/owners report the entity's income, gains, losses and expenses on their personal tax returns. The entity doesn't file a tax return, thus avoiding double taxation.

Partnership interest in SMLLCS

When using an SMLLC to own a partnership interest, there may be negative tax repercussions that wouldn't necessarily be the same if you owned the partnership interest as an individual. Take losses, for instance.

Real estate investors often incur losses in the early stages of a real estate development. If you've invested directly in a partnership and losses exceed the amount of equity invested, you generally can deduct — on your personal tax return — the losses up to the amount of your equity investment plus your allocable share of any partnership liabilities. The IRS also allows you additional tax basis for the share of liabilities that you'll ultimately be responsible for as a partner, regardless of whether you have adequate assets to pay those liabilities.

If you establish an SMLLC, however, allowable losses are limited to the amount for which you're personally responsible. So, unless you've personally guaranteed the SMLLC debts, you're allowed additional tax basis only for the partnership's liabilities up to the fair market value of the SMLLC's assets.

Also, losses from the partnership are deductible only up to your equity investment in the SMLLC plus the fair market value of other assets owned by the SMLLC. And keep in mind that, if you've claimed tax losses that exceed your equity investment in a partnership — and you no longer have allocable liabilities from the partnership — the contribution of the partnership interest to an SMLLC can produce a taxable *gain*.

Finally, consider the tax treatment of distributions. Normally, you can take distributions out of a partnership up to the amount of your tax basis *without* causing a taxable gain. The tax basis equals your equity investment plus allocable liabilities adjusted for earnings and losses of the partnership and prior distributions. If the partnership interest is held by an SMLLC, though, the allowable distribution may be significantly more restricted.

Ponder the issue

These are only some of the factors to consider as you ponder whether an SMLLC can help you achieve your goals. So please contact your tax advisor for more information. He or she can help you decide if SMLLCs are right for you.

KEEP YOUR EYES WIDE OPEN: DONATING HISTORIC PRESERVATION EASEMENTS

The Internal Revenue Code allows taxpayers to take a charitable deduction for the donation of historic preservation easements on property they own. But some donors may have unrealistic expectations about the amount of the deduction they'll qualify for. With the IRS aggressively challenging these donations in costly court battles, it's important to understand what it looks at when evaluating easement deductions.

Determining the deduction

The IRS defines a historic preservation easement (sometimes referred to as a façade easement) as a voluntary, legal agreement made between a real property owner (donor) and a qualified easement-holding organization (donee) to protect a historic property by restricting future changes to or development of the property in perpetuity. The qualified contribution of such an easement gives rise to a charitable deduction equal to its fair market value (FMV).

Not every preservation easement contribution, however, justifies a charitable deduction. The FMV of the underlying property must decrease after the granting of the easement. A "qualified appraisal" by an appraiser is required to substantiate the deduction. The IRS has noted that common deficiencies revealed in audits of preservation easements include noncompliance with substantiation requirements and use of improper appraisal methodologies.

Proper easement valuation

Because preservation easements typically aren't bought and sold in a market that values them directly, federal tax regulations endorse the indirect "before and after" valuation method to determine FMV. This method values the underlying property before and after the grant of the easement, with the difference representing the easement's FMV.

An appraiser should, when assessing the "before" value, consider not only the current use of the property but also the likelihood that the property, without the easement, would be developed. He or she should also take into account any effect from zoning, conservation or historic preservation laws that already restrict the property's "highest and best use." According to the IRS, an easement is likely to have no significant effect on the value of the property if the easement isn't more restrictive than local preservation laws or other restrictions that are already in place.

For the "after" value, the appraiser should consider the amount of access the easement allows and the effect its restrictions will have on the property's value. He or she must weigh both the specific restrictions imposed by the preservation easement and the specific restrictions imposed by easements on any "comparable" properties used to reach a value.

Note that the IRS doesn't recognize any set "safe harbor percentage" (commonly believed to be 10% to 15%) by which an easement reduces the "before" value of property. The allowable deduction is determined by the facts and circumstances of each easement contribution. The IRS won't accept an appraisal to substantiate the FMV of an easement if it merely reduces the "before" value by a set percentage without explanation or reference to the property's specific attributes and the easement.

Do the math … first

Keep your eyes wide open before donating a historic preservation easement, especially if you're counting on a substantial charitable deduction. Be sure to hire a qualified appraiser, too, so you can substantiate a deduction *and* withstand IRS scrutiny.

ASK THE ADVISOR

HOW SHOULD I REPORT RENTAL INCOME?

Reporting income from rental properties may seem straightforward, but that's not always the case. The IRS' definition of rental income, for example, might be broader than property owners realize. Such misunderstandings could prove costly if uncovered by an IRS audit.

What constitutes rental income

Rental income is any payment you receive for the use or occupation of your property. In addition to normal rent payments, rental income includes:

***Advance rent*.** This is any amount you receive *before* the rental period it covers.

***Amounts paid to cancel a lease*.** If a tenant pays a fee to cancel a lease, that amount is considered rent.

***Expenses paid by a tenant*.** If a tenant pays any of your expenses (such as a bill for garbage removal although the lease doesn't require the tenant to do so), those payments are rent.

***Property or services*.** When you receive property or services as rent in lieu of money, the fair market value of the property or services is rental income. If services are provided at an agreed-upon or specified price, that price generally represents the fair market value.

Any rent described above must be included in your rental income in the year you receive it, regardless of the period covered by the rent or the method of accounting you use.

What about security deposits?

A security deposit shouldn't be included in your income if you might have to return it at the end of the lease. If you keep some of the deposit because the tenant breaches the lease, you must include that amount in your income in the year that the breach occurs.

If you keep all or part of a security deposit because a tenant damaged your property and you must make repairs, you only need to include the amount you retain to cover those repairs if your regular accounting practice is to deduct the cost of repairs as expenses. Otherwise, you *aren't* required to include any amount of the security deposit that reimburses those expenses, such as the case when you capitalize those expenditures as improvements.

If the lease requires that the tenant pay the last month's rent at inception or you use the security deposit as the tenant's final month of rent, you must include the security deposit as income when you *receive* it — as opposed to when you *apply* it to the last month's rent. This amount is considered advance rent.

The bottom line

As you can see, there are many twists and turns on when to report rental income for tax purposes. That's why it's important to work with your tax advisor. He or she can help you ensure you're reporting rental income properly and avoid interest and penalties for underreporting.

SPOTLIGHT ON MARKS PANETH

Don't Miss Out: Take Our Survey

How much of an influence do you think the tech sector will have on commercial leasing in New York City? Do you think the current data on commercial property vacancy rates in Manhattan is accurate?

Join your colleagues and counterparts and take our survey, the *Gotham Commercial Real Estate Monitor*, which tracks the concerns, opinions, outlook and forecasts of New York's commercial real estate executives and decisions makers – like you. This week, we are sending out our Summer 2014 survey, a short, confidential poll that takes about 5 minutes to complete online. You can wait for your email or take it *right now* . . . just click on the link below:

TAKE OUR GOTHAM SURVEY NOW!

As usual, we expect the results to be frank, insightful and sometimes counterintuitive. And we'll share those findings with you as we continue to monitor attitudes and perceptions for you and the rest of the industry. So don't miss out! Take our survey and let us know what you think.

Marks Paneth Names New Partner

We are pleased to announce that Michael W. Hurwitz, CPA, MST, has been promoted to Partner in the Real Estate Group. He joined the firm last year as an Executive Consultant. He has more than 25 years of experience and is very knowledgeable about real estate tax matters. He has worked for both public and private real estate investment trusts (REITs). He is an adjunct professor at New York University's Schack Institute of Real Estate, where he teaches partnership taxation and other related real estate tax topics. He is an active participant in NAREIT.

Marks Paneth Partner Elected to Board of EPC of New York City

Laura E. LaForgia, CPA, MST, a Partner in the firm's Tax Practice, has been elected to a three-year term on the Board of Directors of the Estate Planning Council (EPC) of New York City. She will be a Director of Accounting. The EPC is an interdisciplinary organization for professionals involved in estate planning.

FOR FURTHER INFORMATION

If you have any questions, please contact William Jennings**,** Partner-in-Charge of the Real Estate Group at 212.503.8958 or wjennings@markspaneth.com or any of the other partners in the Marks Paneth Real Estate Group:

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Additional information about the Marks Paneth Real Estate Group can be found at www.markspaneth.com**.**

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