REAL ESTATE ADVISOR - JULY, 2016

NEW TAX LAW OFFERS PATH TO SAVINGS

In late December 2015, President Obama signed H.R. 2029, which includes provisions that created the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act). The wide-ranging tax law makes permanent or extends three breaks that have proven popular with many taxpayers in the real estate industry. These provisions can make it easier for taxpayers to expense or recover the costs of certain types of property related to their businesses, rather than depreciating them over lengthy recovery periods.

Sec. 179 deduction

Under Section 179 of the Internal Revenue Code (IRC), business taxpayers can immediately deduct — or "expense" — the cost of certain tangible personal property that's purchased for business use in the year of purchase (for example, computers, office furniture and office equipment) rather than recovering the costs more slowly through depreciation deductions. For 2014, businesses were allowed to deduct up to $500,000 in qualified new or used assets, subject to a dollar-for-dollar phaseout trigger when the cost of all qualifying property placed in service during the taxable year exceeded $2 million.

Before the PATH Act, the deduction and phaseout amounts for 2015 had fallen to $25,000 and $200,000, respectively. The uncertainty created by Congress's annual late-year extensions of Sec. 179 left some small businesses reluctant to invest in new equipment. But the act makes the 2014 limits permanent (with the limits indexed for inflation beginning in 2016). The provision further modifies the expensing limitation for qualified real property, such as qualified leasehold-improvement property, qualified restaurant property and qualified retail-improvement property. The act eliminates the $250,000 cap beginning in 2016.

If your business is eligible for full Sec. 179 expensing, you could obtain a greater benefit from expensing rather than from bonus depreciation because the expensing provision might let you deduct an asset's entire acquisition cost. Plus, you can use Sec. 179 expensing for both new and used property, and bonus depreciation might be subject to recapture on disposition of the asset. On the other hand, taxpayers must have net income to take advantage of Sec. 179 expensing.

Bonus depreciation

IRC Sec. 168(k) was also extended but not permanently. The provision, which allows businesses to recover the costs of depreciable property more quickly by claiming bonus first-year depreciation for qualified assets, will run through 2019, with declining benefits each year. For property placed in service during 2015, 2016 and 2017, the bonus depreciation percentage is 50%. It will fall to 40% in 2018 and 30% in 2019.

Businesses can still use Sec. 168(k) to claim unused AMT credits instead of bonus depreciation, and the amount of unused AMT credits that may be claimed increases beginning in 2016. Qualified assets include new tangible property with a recovery period of 20 years or less (such as office furniture and equipment), off-the-shelf computer software, water utility property and qualified leasehold-improvement property.

As noted above, the Sec. 179 deduction might provide a greater tax benefit than bonus depreciation if you qualify for it. But bonus depreciation may help more taxpayers than Sec. 179 expensing because it doesn't include a limit on the amount of assets purchased, require net income or phase out at any point. Of course, you must also consider any applicable state tax consequences when purchasing equipment.

15-year straight-line depreciation cost recovery period

The PATH Act makes permanent the 15-year straight-line cost recovery period for qualified leasehold improvements (alterations in a nonresidential building to suit the needs of a particular tenant), qualified restaurant property and qualified retail-improvement property. Such expenditures would otherwise be subject to the 39-year depreciation period.

Finding the best path forward

The PATH Act includes numerous other significant provisions that could affect the taxes of both businesses and individuals. Make sure you contact your tax advisor regarding these changes. He or she can help minimize your tax burden for 2015 and beyond.

Sidebar: Incentive for charitable real estate donations made permanent

The PATH Act made permanent several tax benefits related to charitable giving, including the deduction for contributions of real property for conservation purposes. To be eligible for the deduction, you must contribute a qualified real property interest, to be used only for conservation purposes, to a qualified organization. The organization must have a commitment to protect the donation's conservation purposes and the resources to enforce the restrictions.

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Qualified real property interests include your entire interest in real estate (other than a mineral interest), a remainder interest or a restriction (granted in perpetuity) on the use that may be made of real property. Your deduction is generally limited to 50% of your adjusted gross income less your deduction for all other charitable contributions. The PATH Act allows you to carry forward any contributions you can't deduct because of this limit for 15 years, up from the previous limit of five years.

HOW TO USE LESS-THAN-PERFECT COMPS TO ESTIMATE VALUE

In today's volatile real estate market, it can be difficult to obtain a meaningful estimate of what a parcel of commercial real estate is currently worth. In many areas, such as Alaska, West Virginia, North Dakota and Wyoming, the market is in an official recession, while the markets in Louisiana, New Mexico and Oklahoma are at risk. Such information is essential to help you make strategic decisions about buying, selling, financing, developing and improving properties.

Relying on comparables

Appraisers often use the sales comparison approach to reach a market value for a subject property, because it's intuitive and objective. It assumes that the subject property will sell for a comparable price (or price per square foot) as similar properties (known as "comps"). When valuing a property under the sales comparison approach, appraisers must consider all relevant transactions in the area and then determine which should be used in the analysis to produce a credible value. The best comps are those most similar to the subject property in terms of land use (type of property), timing, location and size.

Ideally, each comp also was sold under the same conditions as the subject property currently is. For example, the buyer and seller should have been typically motivated (that is, not under any compulsion), and the marketing effort and exposure time should have been typical for that property type in that market.

Dealing with distressed sales

When the search for comps includes foreclosures and short sales, appraisers need to consider whether these "distressed" sales are still relevant in today's market. In some circumstances, the answer may be "yes." But using them usually requires extra legwork, especially if local market conditions are now more favorable than when the distressed sales occurred.

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It's true that the differences between the conditions of sale and those of the subject property can make a distressed sale transaction unsuitable as a comp, but certain adjustments can be made to account for some deficiencies. An adjustment might be made, for example, if the transaction involved sales concessions, or the transaction involved atypical motivations (for example, the seller might be highly motivated in a short sale), or the property's physical condition was poor.

Note that physical condition and the conditions of sale are distinct factors that must be considered separately. In other words, an appraiser shouldn't assume that a property sold under foreclosure conditions was in inferior condition. Using distressed comps may require greater investigation and analysis than relying on comps that occurred under more comparable market conditions.

Expanding the search

At times, an appraiser might be confronted with a market experiencing limited sales activity of any kind, distressed or otherwise. In such situations, the appraiser will need to modify his or her selection criteria when searching for comps. For example, the appraiser might expand the geographic area (and make appropriate adjustments for location) or rely on less recent sales (with appropriate adjustments for market conditions).

Adjustments can be supported using paired sales, market participant surveys, analysis of rent or net income differentials, and cost analysis.

Counting on qualified appraisers

It's critical to ensure your valuations are built on solid ground. But you can't do it alone. A qualified real estate appraiser who has been through multiple cycles knows how to deal with comparable sales and use them to arrive at a meaningful estimate of value.

WHAT MAKES A PROPERTY SALE A "DEALER" SALE FOR TAX PURPOSES?

If the IRS classifies a sale of real property as a "dealer" sale — meaning the property was held for sale to customers in the ordinary course of a trade or business — the tax ramifications can be dramatic. How, you might ask? The gain on the sale will be treated as ordinary income, rather than capital gain. The U.S. Tax Court recently shed some light on how it determines whether property is held primarily for sale to customers in the ordinary course of business.

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IRS challenges characterization of gain

A California couple conducted real estate business through several entities. These included Fargo Industries Corporation (FIC), a C corporation wholly owned by the husband, and Girard Development (Girard), a partnership in which the couple were the majority partners. In 1988, FIC acquired a leasehold in some property, with plans to develop a 72-unit apartment complex and retail space. It collected rent from some tenants in a building on the property, and some of the couple's rental companies also used the building for their operations.

In 1991, FIC transferred the leasehold to Girard, which entered various agreements for the development and management of the property. Several hurdles arose, however, including a major decline in the local real estate market. Development was suspended, but Girard continued to seek financing to develop the property.

Girard bought the property in 1997, and, through 2001, the property was developed for residential use. The extent of physical improvements was limited to minor repairs. In 2001, Girard received an unsolicited offer to purchase the property for $14.5 million, plus a share of the home sales profits. Under the plan, the husband would develop the property and Girard would share in the resulting profits from home sales.

The sale was completed in 2002, and Girard reported a capital gain of $628,222 on it. The IRS audited the tax return and found that the partnership had realized ordinary income in the amount of almost $7.5 million. The couple and Girard ended up in Tax Court.

Court rules for the IRS

Girard conceded that the property was originally acquired for development but contended that it held the property primarily to allow the market to recover from the recession. The property, it was argued, should therefore be viewed as an investment.

The Tax Court had previously identified nine factors for evaluating whether property was held primarily for sale to customers in the ordinary course of business. Although four of the factors in this case favored the taxpayers, the court focused largely on a different factor — the purpose for which the property was held at the time of sale.

It noted that Girard had purchased the property and held it primarily to develop and sell later to customers. This intent, the court said, was never abandoned and remained the primary motive for holding the property. In addition, Girard incurred significant development expenses and stood to share in the profits from development of the property after the sale. The court ruled for the IRS.

Proceed with caution

This case is a valuable reminder that the collection of rent over a lengthy holding period that ends in a single sale isn't enough to guarantee that a property sale will enjoy capital gains treatment. The seller's intent at the time of the sale could overshadow such factors weighing in its favor.

THE REAL ESTATE PROFESSIONAL EXCEPTION

Why qualifying for it can be a bit testy

The passive activity loss rules are often a major roadblock for taxpayers involved in rental activities. One recent case, however, demonstrates how work done as an employee can help qualify a taxpayer for the benefits of the real estate professional exception.

Exception explained

Rental real estate activities are generally considered passive, so rental losses can offset only passive income. Internal Revenue Code Section 469, however, grants an exception for a taxpayer who is a real estate professional and materially participates in the activity. To qualify as a real estate professional, you must satisfy these 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.

Personal services performed as an employee can count as real property trade or business hours only if the employee owns more than 5% of the employer. This hurdle often trips up taxpayers who own a portion of a project and receive a salary from an employer in which he or she isn't an owner.

Exception applied

The taxpayer in this case worked full-time for Lindsey Management Co., Inc., (LMC) as its president for 15 years. He later went to half-time status before retiring. From the beginning of his employment with LMC, he acquired minority ownership interests in more than 100 entities that owned or operated rental properties and adjoining golf courses managed by the company.

On his 2009 and 2010 tax returns, the taxpayer reported all income and losses resulting from his ownership interests as nonpassive. The IRS reclassified the income and losses as passive, however, which caused the taxpayer to owe additional taxes because he couldn't use the losses to offset nonpassive income.

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In court, the taxpayer argued that he was a real estate professional. But the IRS asserted that his hours worked as an LMC employee shouldn't be treated as having been performed in a real property trade or business, because he didn't own more than 5% of the company.

The court, however, ruled that the taxpayer owned 10% of LMC from the time he began working there, as evidenced by a stock certificate. It dismissed the IRS's argument that the taxpayer didn't own stock because he didn't make a capital contribution for his shares, noting that capital contribution is only one avenue of acquiring ownership.

Be prepared

The IRS may very well challenge your use of rental losses in order to offset nonpassive income. So, if you want to take advantage of the real estate professional exception to withstand such challenge, take the time to carefully track your hours spent on rental activities, whether as an employee or not.

PARTNER PROFILE

Mendy Schmookler, CPA

Mendy Schmookler is a Partner with the firm's Real Estate Group. He has more than 15 years' experience serving the real estate industry and provides his commercial and residential clients with a wide-range of tax and consulting services. His background includes multi-state corporate and partnership tax returns, as well as preparing certiorari filings and operating escalations. With his finger on the pulse of the marketplace, Mendy brings value to his clients with a proactive approach and understanding of their issues and goals.

He has also planned, coordinated and conducted audits of nonprofit organizations including voluntary health and welfare organizations and religious organizations.

In addition to his professional activities and family responsibilities, Mendy is a long suffering, yet optimistic Mets fan. He resides with his family in Brooklyn, New York.

LEVERAGE OUR EXPERTISE

Marks Paneth LLP has served the real estate industry for more than 100 years. We assist many of the industry's premier commercial and residential real estate owners, developers, builders, REITs (real estate investment trusts) and property managers. With more than 100 professionals, including 16 partners, who focus on the real estate industry, we bring deep expertise to every engagement.

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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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