



# 2011 Year-End Real Estate Tax Planning Checklist

As the end of another year draws near, this is an important time to be thinking about year-end tax planning moves. Despite the fact that the last several years have been very bleak for the real estate industry, there are still quite a few incentives available to property owners to help lower their tax burden. Here are some items that should not be overlooked.

## Enhanced Depreciation Provisions

Generally, amounts you invest in capital assets (i.e., furniture, fixtures, equipment, property improvements, etc.) cannot be immediately expensed. Instead, the cost of these assets must be capitalized and recovered through depreciation deductions over their useful lives which are prescribed by the Internal Revenue Service ("IRS"). However, through December 31, 2011, the "bonus depreciation" rules permit property owners to take a 100 percent depreciation deduction on certain qualified property. In order to qualify for the 100 percent bonus depreciation an asset must meet all of the following criteria:

- It must be new property (as opposed to used property);
- It must be acquired and placed in service between September 9, 2010 and December 31, 2011; and
- The useful life of the asset, based on the IRS prescribed tables, must be 20 years or less.

After December 31, 2011, the 100 percent bonus depreciation provision is scheduled

to drop to 50 percent bonus depreciation for assets acquired and placed in service through December 31, 2012 and then to zero percent thereafter.

## Repairs vs. Capitalization

Property owners are always incurring costs in connection with the improvement or maintenance of their property. One of the most important determinations that must be made is whether the expenditure should be categorized as a repair or a capital improvement. For tax purposes, an expenditure that constitutes a repair is currently deductible whereas an expenditure that creates an asset with a useful life of more than one year must be capitalized and depreciated. While the determination of whether or not an expenditure is a deductible repair or a capitalizable asset is subjective, the IRS has issued guidance that can help make that determination. While most property owners would prefer to categorize costs of this nature as repairs, for 2011 the bonus depreciation rules may mitigate the negative effects of having to capitalize such costs.

## Cost Segregation Studies

Property owners are generally able to recover their real property investment costs through depreciation deductions. Under the current depreciation rules, however, it could take as long as 39 years to recover your initial investment. Depending upon your situation, a cost segregation study ("CSS") may allow you to recover your

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costs more quickly. A CSS seeks to identify components of a building which can be categorized as personal property and depreciated over shorter lives, thereby accelerating the depreciation deductions, reducing taxes, and increasing cash flow. Since special expertise is required, most property owners retain accountants and engineers to conduct the study.

### **Leases: Free Rent vs. Ownership of Improvements**

Property owners who enter into leases requiring a build-out of the occupied space have several options to consider with regards to who pays for the build-out. It is quite common to see “free rent” provisions whereby the tenants pay for the build-out in lieu of rent. In many cases, the tenant will be entitled to deduct the payments as rent expense in the period they are made and will not own the improvements. Property owners will, however, report rental income, record the improvements on their books and be entitled to the depreciation deductions as the property owner. This is one such option, and it is advisable that you have the provisions of these leases carefully reviewed in order to avoid any year-end tax surprises.

### **Dealer vs. Investor**

As a property owner, it is very important to determine whether you are a dealer or an investor. A misclassification as one or the other can have serious tax consequences. A dealer is someone who regularly sells property to customers in the ordinary

course of business. A dealer will typically look to capture short-term profits through the sale of inventory and thus pays tax at ordinary income rates. An investor typically looks to capture long-term appreciation and generally pays tax at the more favorable capital gains rates. Investors who see an opportunity to further develop a piece of property to increase the gain potential run the risk of converting their long-term capital gain into ordinary income. However, there are planning opportunities available that may preserve long-term capital-gain treatment for the pre-development appreciation inherent in the property. Because these strategies usually involve the creation of a new entity, it is of major importance to properly plan the timing of the development activities, including the subdivision of the property.

### **Real Estate Professional/Passive Activity Rules**

Individual property owners with losses stemming from rental real estate may not be getting any current tax benefit from their losses. This is because these losses are, by definition, passive and can generally only offset passive income unless the property is sold in a taxable transaction. An exception to this stringent treatment is that an individual who qualifies as a real estate professional may not be subject to the passive-loss rules. In order to qualify for this exception, you must work 750 hours in a real property trade/business and must spend more than 50 percent of the total time spent working in real property trades/businesses in which you materially

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participate. If you are only involved in rental real estate, it may be more difficult for you to meet these criteria and a special tax election may be required.

### Like Kind Exchanges

Even though real estate values are still depressed, a like-kind exchange is still one of the most powerful tools available to property owners. Gain on the sale of business or investment realty can be deferred if the proceeds from the sale are reinvested in another piece of realty and other requirements are met. There are several common traps which can create a taxable event such as not reinvesting the entire sales proceeds, not increasing your equity position, or not using a qualified intermediary to hold the proceeds at all

times until the initial sale and subsequent purchase of replacement property is completed.

These ideas should be considered as part of your overall tax planning strategy. No steps should be taken solely for tax reasons. First and foremost, any move you make should make business sense. Please feel free to contact your Wilkin & Guttenplan advisor to further discuss if any of these ideas might be appropriate for you or your business.

*Any U.S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding tax penalties that may be imposed on the taxpayer.*

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