

A Check-Up for Real Estate Clients

Despite the ups and downs of the real estate market, ownership of real estate has a number of unique tax aspects. Many opportunities exist that can help owners secure the highest total return from the operation and disposition of property. The following checklist provides a few items to consider:



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Cost Segregation Study

Depending on the use of the property, it may be possible to recover costs through depreciation deductions. The current depreciation rules, however, are not taxpayer friendly as it could take as long as 39 years to recover the initial investment. A cost segregation study permits the segregation of the property into components, each of which may be eligible to be depreciated over a shorter life, thereby accelerating the depreciation deductions, reducing taxes and increasing cash flow.

Leases: Free Rent/Ownership of Improvements

For leases where a build-out of the occupied space is required, it is common to see “free rent” provisions allowing the tenants to pay for the build-out in lieu of rent. The terms of these leases must be carefully reviewed. 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 as property owner. These lease provisions must be carefully considered to avoid any year-end tax surprises.

Dealer Versus Investor

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 pay tax at ordinary income rates. An investor typically looks to capture long-term appreciation and will generally pay 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. Careful planning to preserve long-term capital-gain treatment for the pre-development value of the property usually involves performing the development activity in an entity separate from that which held the property during the period of long-term appreciation.

Real Estate Professional Rules

Losses stemming from rental real estate 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 a real estate professional may not be subject to the passive-loss rules. In order to qualify for this exception, taxpayers 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 they materially participate. To meet these criteria, taxpayers may need to make an election under Internal Revenue Code §469(c)(7) to aggregate rental real estate activities so that hours spent on

separate activities can be combined to meet the material participation threshold. The Internal Revenue Service (IRS) recently issued Rev. Proc. 2011-34 which allows for late aggregation elections in certain circumstances.

Repairs Versus Capitalization

For tax purposes, an expenditure that constitutes a repair is currently deductible; an expenditure that creates an asset with a useful life of more than one year must be capitalized. The determination of whether or not an

expenditure is a deductible repair or capitalized asset is subjective based on the expected benefit of the expenditure and whether the expenditure extends the useful life of the property. The IRS has released the *Capitalization Versus Repair Audit Technique Guide* which can be found on irs.gov and contains a comprehensive analysis of the case law in this area.

Impact of Debt Guarantees

Depending upon the type of entity that holds the real estate, there may be

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a benefit to personally guaranteeing the debt. In order to deduct losses from the operation of real estate, an individual must have basis in his or her S corporation stock or partnership interest and must be at risk for that amount. A partner, guaranteeing the debt of a partnership, receives at risk basis merely for providing the guarantee and, thus, can deduct losses against the guaranteed portion of the entity's debt. Owners of S corporations,

however, are not afforded the same favorable treatment. They must actually act on the guarantee and make good on it before they receive an increase in basis allowing them to deduct losses.

Debt-Financed Distributions

Real estate owners will frequently borrow against the equity in their holdings and use the borrowed funds to distribute to the owners. When the borrower is a flow-through entity, to the extent the entity has made a debt-financed distribution, the deductibility of the interest expense associated with the distributed funds is determined at the owner level and is ultimately determined based on how the distributed funds were used by the owner. For example, if the owner used the funds for personal purposes, the interest would not be deductible, as it would be treated as personal interest.

Like-Kind Exchanges

Despite the fact that real estate values are still depressed, a like-kind exchange is still one of the most powerful tools

available to taxpayers. The basics are well understood – the gain on the sale of business or investment property can be deferred if the property is exchanged or if proceeds are reinvested and other requirements are met. There are several common traps, however, such as not reinvesting the entire sales proceeds or not using a qualified intermediary to hold the proceeds at all times, which can eliminate the benefit of the exchange.

The above list only scratches the surface of available opportunities. Effective real estate planning often involves multi-year projections, since most real estate investors focus on the total returns associated with a property and consider both the operation as well as property disposition. ■

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