Real Estate *advisor*

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The difference can mean more money in your pocket

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Ask the Advisor

Should I use an FLP to transfer real estate to my heirs?

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Maintenance vs. capital improvement

The difference can mean more money in your pocket

Property owners often wrestle with how to classify their repair and upkeep costs — are they routine maintenance costs, which are immediately deductible against current income? Or are they capital expenditures that must be recovered over time through depreciation?

Fortunately, proposed IRS regulations help clarify how such costs should be treated for tax purposes. Although not final as of this writing, they provide useful guidance because they're based largely on previous guidance and rulings from the IRS and the courts.

The tax impact

Most taxpayers will pay less tax by classifying an expenditure as maintenance and taking a current deduction, rather than by capitalizing the expense and recovering it by way of depreciation.

On the other hand, capital improvements add to your basis in a property, thereby reducing capital gains when you sell it. And a large one-time maintenance expense lowers the profits reported by an income-producing property in the current year, making it appear less profitable and, therefore, harder to refinance.

A 3-part test

The proposed regs provide some rules on how to determine whether an amount paid for an "improvement" must be capitalized under Internal Revenue Code (IRC) Section 263(a). Generally, they require a taxpayer to capitalize amounts that result in a 1) betterment, 2) a restoration, or 3) a new or different use of a unit of property.

A cost results in a *betterment* if it:

- Remediates a material defect that existed before the property's acquisition or arose during the property's production,
- Causes a material addition to the property, or
- Causes a material increase in the property's capacity, productivity, efficiency, strength, quality or output.

To illustrate, suppose a storm damages your building's wooden roof. The IRS would likely allow you to deduct the cost of replacing a few shingles

as maintenance expense. But if you upgrade to a new maintenance-free asphalt roof, it would qualify as a betterment, requiring you to capitalize it over 39 years.

A cost results in a *restoration* if it:

- Replaces a property component and the taxpayer either has properly deducted a loss for it or has taken into account its adjusted basis in realizing a gain or loss from the component's sale or exchange,
- Is for the repair of property damage for which the taxpayer has taken a basis adjustment as a result of or relating to a casualty loss,
- Returns the property to its ordinarily efficient operating condition if the property had deteriorated to a state of disrepair and was no longer functional for its intended use,
- Results in rebuilding the property to a like-new condition after the end of its economic useful life, or
- Replaces a major component or a substantial structural part of the property.

Treatment of property acquisition costs

IRS-proposed regulations (see main article) provide that "inherently facilitative" transaction costs must be capitalized. Acquirers should be aware that these costs (which can be thousands of dollars) often are inadvertently expensed by property owners, leading to surprise postacquisition IRS deficiencies and fines. These costs include:

- Securing an appraisal or determining the property's value or price,
- Negotiating terms of the acquisition,
- Obtaining tax advice,
- Application fees, bidding costs and similar expenses,
- Preparing and reviewing documents that facilitate the acquisition of the property,
- Evaluating the property's title,
- Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees,
- Conveying property between the parties, including sales and transfer taxes and title registration,
- Finders' fees or brokers' commissions,
- Architectural, geological, engineering, environmental or inspection services pertaining to particular properties, and
- Services provided by a qualified intermediary or other facilitator of a like-kind exchange.

The regs do, however, provide an exception for costs relating to activities such as marketing studies that are performed to determine whether to acquire real property and which real property to acquire.

A cost results in a *new or different use* if the adaptation isn't consistent with the taxpayer's intended ordinary use of the property at the time the taxpayer started using it. For example, suppose a taxpayer has owned a manufacturing facility since the early 1970s, using it for manufacturing. If the taxpayer decides to convert the facility to a showroom, the costs incurred are paid to adapt the building to a new or different use, so they must be capitalized.

Deciphering the regs

If you're uncertain about past or current classifications of maintenance costs, your tax advisor can help you find your way through these regs. He or she can review your capitalization decisions to determine whether any of the capitalized expenditures can be reclassified as deductible maintenance expenses.

Moreover, your tax advisor can review your past tax returns and perform a cost segregation study to see if you qualify for a retroactive change of accounting method. Such a change would allow you to claim a deduction in the current year for costs that were mistakenly capitalized. However, you must obtain IRS consent in order to change your accounting method. ■

Noncorporate business structures can provide ease and flexibility

Choosing the right business structure for a real estate venture requires serious thought. A corporation is one possible structure that can provide many benefits, but let's take a closer look at noncorporate options, which generally are subject to fewer rules and regulations and may offer more flexibility.

Enjoy simplicity, flexibility with a partnership

One reason partnerships are popular choices for real estate ventures is that they're easy to set up. It's a matter of obtaining a business license and giving notice of your partnership's name under your state's assumed-name statute.

Partnerships are also popular because of their flexibility. Partners typically draw up a customized agreement spelling out pertinent details such as goals, management practices, capital investments, individual partner responsibilities, income distribution, dispute resolution and buyouts. Partnership agreements should be in writing and reviewed by an attorney.

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Although a general partnership provides simplicity and management flexibility, it doesn't protect partners from personal liability for the actions and debts of the company — or the other partners — key considerations in today's real estate climate.

For tax purposes, this structure is a "pass-through entity," which means that owners report their share of the income or losses on their personal income tax returns, regardless of whether cash distributions are made.

Curb personal liability with an LLC

Another popular entity choice for real estate ventures is the limited liability company (LLC). This option offers the flexibility of a partnership and the liability protection of a corporation.

Like corporation owners, LLC owners aren't personally liable for company debts or liabilities, unless they "misuse" the corporation through fraud or other illegal activity. So, creditors normally can't go after the owners' personal assets. Unlike a corporation, however, an LLC isn't required to allocate profits and losses in proportion to ownership interests.

To set up an LLC, you must file articles of organization with the state and pay the applicable fee. LLC owners must elect officers to run the company, and they're subject to state regulations on how they keep records of major decisions.

Like a partnership, an LLC may elect to be treated as a flow-through entity, with all tax paid at the individual member level.

Weigh other partnership options

Still another popular structure is the limited partnership. It affords personal liability protection to limited partners who provide financing but don't want to take an active role in operating the business. Running the business is left to general partners, who assume the personal liability in the partnership. All federal tax is paid at the individual partner level, although limited partnerships may pay state and local taxes in some jurisdictions.

It's much easier to attract investors with a limited partnership than with a partnership, and the structure is often used to acquire and hold real estate. As with an LLC, creating a limited partnership requires filing documentation with the state and paying state fees.

You also may have heard about limited liability partnerships (LLPs). These operate much like a limited partnership but allow all partners to be active in running the business, facing legal liability for only their own negligence or for that of employees directly under their supervision. LLP partners aren't subject to liability for actions by employees who aren't under their direct supervision or by other partners. However, they're liable for partnership debts that don't necessarily involve their own negligence.

The LLP is also a pass-through entity, so taxes are paid at the individual partner level. Owners of LLPs can also split proceeds however they wish. Some states recognize LLPs but limit the use to professional firms. Consult an attorney to see if LLPs make sense for real estate companies in your state.

Get it right

Although noncorporate structures offer many benefits, a corporate structure may be a better choice in some situations. So be sure to consider all of your options.

No matter which type of business structure you choose, you must address certain items when you draw up the governing agreement. Carefully consider the purpose and goals of the venture, and the overall investment needed. Working with your advisors can help ensure your venture gets off on the right foot. ■

Tax Court finds street lights qualify for 7-year depreciation

The U.S. Tax Court recently ruled against the IRS in a dispute over the proper period of depreciation for street lights. The IRS had claimed that the lights were subject to a 20-year period, but the court held that they're subject to a period of only seven years. As a result of this ruling, owners of property with a significant number of street lights, such as shopping centers and office complexes, could recover the costs of the lights much more quickly.

How are recovery periods determined?

Under the Modified Accelerated Cost Recovery System (MACRS), taxpayers recover the cost of property, including real property and improvements, by taking annual depreciation deductions

over the specified life of the property. The IRS has established numerous asset classifications, with a specified period of depreciation for each class.

The Electric Utility Transmission and Distribution Plant class, for example, has a 20-year depreciation period. Property that doesn't fall in any of the classes is considered part of the "residual class," which is subject to a seven-year period.

What were the court's findings?

In 1997, an electric utility company (PPL Corporation) reclassified its street lights, removing them from the Electric Utility Transmission and Distribution Plant class and classifying them as part of the residual class. PPL then claimed a negative adjustment to its 1997 taxable income of about $18,600. The IRS disallowed the adjustment, asserting that the lights were subject to the 20-year depreciation period.

It was left to the Tax Court to determine the appropriate asset class — and therefore depreciation period — for street lights. The court began by considering whether the lights were "distribution property," as the IRS contended. It noted that the tax regulations dictate that property be included in the asset class for the activity in which the property is "primarily used."

The court found that street lights are primarily used to make light, not to distribute electricity. In fact, it emphasized that "*no one* uses street light assets in the distribution of electricity for sale." This suggests that the court's conclusion that street lights aren't properly classified as distribution property applies to both utilities and nonutilities.

The IRS alternatively argued that street lights should be treated as part of the Land Improvements class and be subject to its 15-year period. The class generally includes sidewalks, roads, canals, waterways, drainage facilities, nonmunicipal sewers, wharves and docks, bridges, fences, landscaping, shrubbery, and radio and television transmitting towers.

The court applied the so-called *Whiteco* factors to determine whether street lights qualify as land improvements. As the court noted, the primary focus of the factors is the permanence of the depreciable property and the damage caused to it upon removal. The court found that street lights — even those bolted to a concrete foundation — aren't affixed to anything in an inherently permanent way and that removal of the lights doesn't damage them. Thus, they weren't land improvements.

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Does this mean a brighter future for your properties?

The Tax Court concluded that street lights fall within the residual class and are subject to a seven-year depreciation period. But this case has broader application, beyond street lights. As the IRS continues its initiative against faster property depreciation rates, this case underscores the importance of applying common sense and revisiting the plain language of the law when battling the IRS.

Contact your CPA to determine if *any* of your assets could be reassigned to classes with shorter recovery periods, and, if so, how to make the necessary accounting changes. ■

Ask the Advisor

Should I use an FLP to transfer real estate to my heirs?

Recent tax law changes have prompted many owners to reassess their plans for transferring real estate and other assets to their heirs. One vehicle worth considering is the family limited partnership (FLP). It can help you limit gift and estate taxes related to asset transfers, while still retaining some control over the property.

Tax advantages

After you establish an FLP, you transfer assets to it and grant limited partnership interests to family members. As the general partner, you can hold as little as 1% of the FLP units and still control how FLP assets are managed.

The value of the limited partnership interests for gift tax purposes is discounted to reflect the lack of control those interests have over the FLP and the lack of a market for them. Together, these discounts can be 40% or more, depending on factors such as asset liquidity, dividend-paying history and transfer restrictions.

The reduced value means you can transfer more of your estate without incurring taxes. In addition, on your death your taxable estate will be reduced because it will include only the value of your general partnership interest, not the value of the FLP's underlying assets.

Potential pitfalls

The IRS frequently challenges FLPs. Internal Revenue Code Section 2036(a) has been the IRS's most successful line of attack. It states that a taxable estate should include the *undiscounted* value of all property that the deceased transferred during life while still retaining:

- The possession or enjoyment of, or the right to income from, the property, or
- The right, either alone or in conjunction with any person, to designate the persons who will possess or enjoy the property or the income generated by the property.

To preserve valuation discounts and keep FLP assets out of the estate, the estate must show that either 1) the assets were transferred in a bona fide sale for adequate and full consideration in money or something with monetary value, such as shares in a business, or 2) the deceased didn't retain possession or enjoyment of, or the right to income from, the transferred assets. To constitute a "bona fide sale," the transfer must serve a legitimate business or other nontax purpose. Most FLPs fail due to "bad facts," such as deathbed transfers or failure to adhere to the terms of the partnership agreement.

Withstanding attack

Court decisions provide numerous insights on how best to structure and operate an FLP to withstand an IRS attack. Work with your tax advisor to determine if an FLP is right for you. ■

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Is a Family Limited Partnership Right for Your Estate Plan?

Do you have real estate assets that you are looking to transfer as part of your estate plan?
Are you looking to transfer those assets but not give up control?
Are you looking to maintain cash flow from those assets?

The current economic conditions, along with recent estate and gift tax law changes, could make this the right time to transfer your real estate assets.

The right **ideas**.
The right **results**.
Achieved with the right **firm**.

*Zinner & Co. LLP can advise you on the benefits of using a Family Limited Partnership as part of your estate plan. For a summary of the estate and gift planning ideas, visit our website at **www.zinnerco.com**.*

Your Success Is Our Business!

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