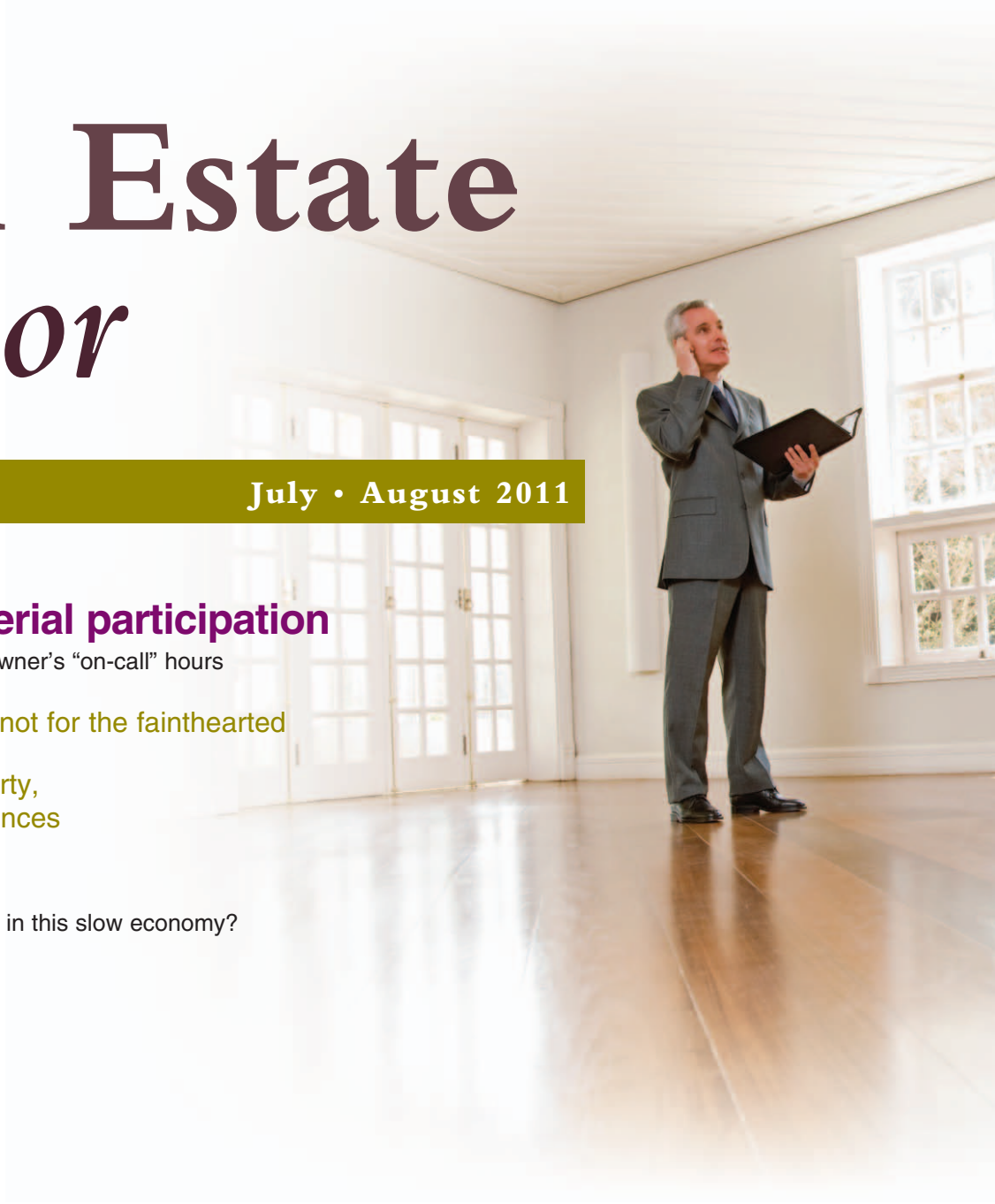
Real Estate *advisor*



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Ask the Advisor

How can lease options help me in this slow economy?

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Determining material participation

Tax court addresses property owner's "on-call" hours

You likely know that "real estate professionals" enjoy some tax benefits that aren't available to other taxpayers, but it's not as simple as merely giving yourself the label. You must meet strict rules to qualify. For example, you must perform more than 750 hours of real estate–related services. But does being "on-call" qualify for hours worked?

Rules on passive activity losses

The Internal Revenue Code (IRC) generally prohibits taxpayers from deducting passive activity losses, except to the extent that they have passive activity income. Taxpayers can carry forward any excess loss to offset passive income in future years or deduct it when the property is disposed of in a fully taxable transaction.

"Passive activity" is defined as any trade or business in which the taxpayer doesn't "materially participate" — that is, participate on a regular, continuous and substantial basis. A passive activity loss is the excess of the taxpayer's aggregate losses from all passive activities for the year over the aggregate income from all of those activities.

Rental real estate activities are usually deemed to be passive regardless of whether the taxpayer materially participates, but the IRC grants an exception for real estate professionals. For these taxpayers, rental activities are treated as a trade or business, and they can deduct their losses.

A taxpayer qualifies as a real estate professional by satisfying two requirements:

1. More than 50% of the personal services the taxpayer performs in trades or businesses must be performed in real property trades or businesses in which he or she materially participates.
2. The taxpayer must perform more than 750 hours of services in real property trades or businesses in which he or she materially participates.

When taxpayers file a *joint* tax return, the requirements are satisfied only if one of the spouses *separately* meets the requirements.

According to federal tax regulations, a taxpayer can establish the extent of its participation "by any reasonable means." "Reasonable means" include the identification of services performed over a period of time and the approximate number of hours spent performing those services during the period based on appointment books, calendars or narrative summaries.

The Tax Court case

In *James F. Moss v. Commissioner*, the taxpayer worked full-time at a New Jersey power plant. He and his wife owned several rental properties — four in New Jersey and three in Delaware. When he

wasn't working at the plant, he performed activities related to the rental properties, such as maintenance, rent collection and preparation for new tenants.

The couple filed a joint return for the 2007 tax year and reported a total loss from the rental properties of $40,490 on Schedule E, *Supplemental Income and Loss*. The IRS disallowed $31,318 of that figure, ultimately finding a tax payment deficiency of $8,070 for the 2007 tax year.

Even though the taxpayer didn't qualify as a real estate professional, the court allowed the couple to deduct $9,172, under IRC Section 469(i). This provision allows taxpayers to deduct up to $25,000 of passive activity losses from nonpassive income if they actively participate in a passive real estate rental activity.

But the special allowance phases out when modified adjusted gross income (MAGI) is greater than $100,000. The court found that the husband actively participated in the rental properties, but most of the $25,000 special allowance was phased out because the couple's MAGI was greater than $100,000.

The couple sought a redetermination of their liability from the Tax Court, contending that the husband qualified as a real estate professional. As evidence, they offered a calendar he kept that detailed the dates he'd performed activities related to the rental properties (without noting the time spent on the activities), as well as a summary of time he'd spent on the activities, which he prepared after the fact, in October 2009.

Based on those documents, he claimed 137.75 hours traveling to and from their rental properties and 507.75 hours working on the properties — for a total of 645.5 hours.

"On-call" time disallowed

To make up the gap between the husband's 645.5 hours and the 750-hour requirement, the couple argued that "on-call" time should be counted. They asserted he'd been on call for the properties for all of the hours he wasn't working at the power plant because he could have been called to perform work at the properties at any time.

The Tax Court rejected that argument, noting that, while the husband had been on call and could have been called to perform services, he'd never actually performed those services. Therefore, his on-call time for the rental properties didn't satisfy any part of the 750-hour service performance requirement. Because the second requirement wasn't met, the court found it unnecessary to address the first requirement (noted on page 2).

Not only did the IRS disallow about 75% of the couple's loss on their rental real estate activities, but it also imposed an accuracy-related penalty that the Tax Court upheld. (See "Put in the penalty box" above.)

Meeting the requirements

The *Moss* case demonstrates the hurdles you must clear to claim the real estate professional exception that will allow you to deduct losses related to rental real estate activities. The exception is even more relevant in slow rental markets, so consult your real estate and tax professional for advice on how to ensure you fulfill the requirements. ■

Put in the penalty box

In *James F. Moss v. Commissioner* (see main article), substantial penalties were imposed on the taxpayers. Why were they put in the penalty box?

A taxpayer may be liable for a 20% penalty on the portion of an underpayment of tax that's either 1) due to negligence or disregard of rules or regulations, or 2) attributable to a substantial understatement of income tax. The latter is defined as an understatement that exceeds the greater of 10% of the tax that should have been shown on the tax return or $5,000. In *Moss*, the taxpayers' understatement was greater than $5,000.

The penalty isn't imposed on the portion of underpayment for which the taxpayer acted with reasonable cause and in good faith or for which the taxpayer had a reasonable basis or substantial authority for the improper tax treatment. The *Moss* taxpayers, however, failed to show that they had so acted when deducting the losses claimed on Schedule E, *Supplemental Income and Loss*.

Foreclosure investing: It's not for the fainthearted

Unfortunately, the number of homes being foreclosed upon continues to climb. According to online real estate and foreclosure listing service RealtyTrac, U.S. cities that lead the pack in the number of foreclosures include Chicago, Las Vegas, Los Angeles, Phoenix, and Sacramento, Calif.

Flipping foreclosures may *seem* like a tempting investment opportunity, but it isn't for the faint-hearted. It often requires a lot of work, research and money.

Surprise, surprise!

Clearly, financial and managerial difficulties drive a property owner into loan default and subsequent foreclosure. Although you may be able to snap up a foreclosed property for a reasonable price, understand that you'll likely be investing thousands of dollars to repair perhaps years of neglect and to make the property salable. So be sure to add to the purchase price the cost of necessary repairs.

To gain clear title, any mortgages will have to be paid and tax liens released. So be sure there's enough value in the property to cover these outstanding debts.

Before making an offer, research MLS listings to ensure you're not overpaying — and taking on the same headaches as the seller. Then investigate the property for other hidden surprises, including federal tax liens, partial interests, leased land, unpaid property taxes and incorrect common descriptions.

To gain clear title, any mortgages will have to be paid and tax liens released. So be sure there's enough value in the property to cover these outstanding debts. Without clear title, you could be prevented from mortgaging or selling the property. You may obtain a title insurance policy to ensure that the title is free from all defects, liens and encumbrances.

Consider your options

One way to avoid liens — and a number of other hassles — is to buy bank-owned foreclosed properties. These properties often include title insurance. And, because banks are usually anxious to jettison the properties as soon as possible, you can probably negotiate a favorable interest rate and loan-to-value ratio.

Another option that many experienced foreclosure investors choose is to find *pre*foreclosures — that is, property at risk of going into foreclosure. When a property owner falls behind on mortgage payments — usually for two months — the lender issues a public notice of default. The owner then has anywhere from 90 to 120 days, depending on state law, to bring the loan current.

During this preforeclosure period, financially strapped owners are often willing to sell at bargain prices. You, in turn, save the owner from suffering a major hit to his or her credit rating. So it's a win-win transaction.

Scrutinize commercial foreclosures

If the foreclosure is a commercial property, be sure to assess the property's revenue-generating capabilities. In the case of a multifamily or retail property, that will mean poring over rent receipts and lease agreements to determine if it's a going concern and which tenants may have contributed to the previous owner's woes — and which leases will soon expire, thereby increasing future vacancy rates.

If the property is in the warehouse or industrial sector, look at rent receipts and company financials to determine whether a current tenant will help you keep your own balance sheet in the black.

Look before you leap

In spite of all the drawbacks of purchasing foreclosed property, there's a good chance you *will* make money on the deal. So, do your homework, consult your financial and real estate advisors, and then get ready for some hard work. ■

Before surrendering property, consider the tax consequences

With the real estate market still sluggish, some property owners are wondering: Would they be better off surrendering their property, rather than continuing to struggle with the loan obligations? Although the answer may seem obvious, discharging debt in this way can have significant tax consequences that should be considered.

Nonrecourse loans

If you default on a nonrecourse loan, your lender's only recourse is to seize the property that secured the loan. When you surrender property, the transaction is generally treated as a sale to the lender for the amount of debt.

Your capital gain or loss equals the difference between the amount of outstanding debt and your adjusted tax basis in the property. For example, if outstanding debt is $1 million and your tax basis is $700,000, your taxable gain would be $300,000. A discharge of nonrecourse debt, however, doesn't result in any taxable cancellation of debt income (CODI) because the lender has no right to pursue other corporate or personal assets.

Recourse loans

If you default on a recourse loan, the lender can hold the corporation or the owners (if they've signed personal guarantees or if the business is structured as a pass-through entity) liable for the outstanding debt.

When you surrender property financed with recourse loans, the net amount of taxable gain or

loss is the same, but it's categorized differently. The capital gain or loss generally equals the difference between the fair market value (FMV) of the property and your tax basis in the property. So, in the example above, if the FMV was $750,000, the taxable gain would be $50,000 ($750,000 – $700,000).

The Internal Revenue Code allows commercial taxpayers to exclude CODI after surrendering property in some circumstances.

In addition, CODI (calculated as the amount of outstanding debt less the property's FMV) is realized when the debt is discharged following the surrender of the property. CODI is taxable as ordinary income. Here, it would be $250,000 ($1 million – $750,000).

The Internal Revenue Code allows commercial taxpayers to exclude CODI after surrendering property in some circumstances, including:

Bankruptcy. CODI generally is excludable if the taxpayer's debts have been discharged in a Title 11 bankruptcy proceeding.

Insolvency. If the taxpayer is insolvent before the debt is discharged, CODI generally is excluded to the extent of insolvency (determined by deducting the value of the taxpayer's assets from its liabilities).

Qualified real property business indebtedness. If the indebtedness is incurred in connection with trade or business real estate, the taxpayer can elect to reduce the basis of depreciable property rather than recognizing CODI, thereby reducing future depreciation deductions. The reduction will be recaptured as ordinary income.

If CODI is excluded from taxable income under one of the exceptions, though, the taxpayer must reduce certain tax attributes to reflect the amount excluded. The taxpayer can elect to reduce the tax basis of depreciable property (including real property inventory) before reducing tax attributes such as tax credits or net operating losses. If all tax attributes are reduced to the point of elimination, any outstanding CODI is permanently excluded.

Exceptions not available for certain entities

The exceptions aren't available at an entity level for pass-through entities. So in, for example, a limited liability company (LLC), the availability of the first two exceptions turns on the bankruptcy or insolvency of the members, not the LLC.

Similarly, it's not the LLC's tax attributes that are subject to reduction if CODI is excluded from taxable income. It's those of the individual members that are reduced.

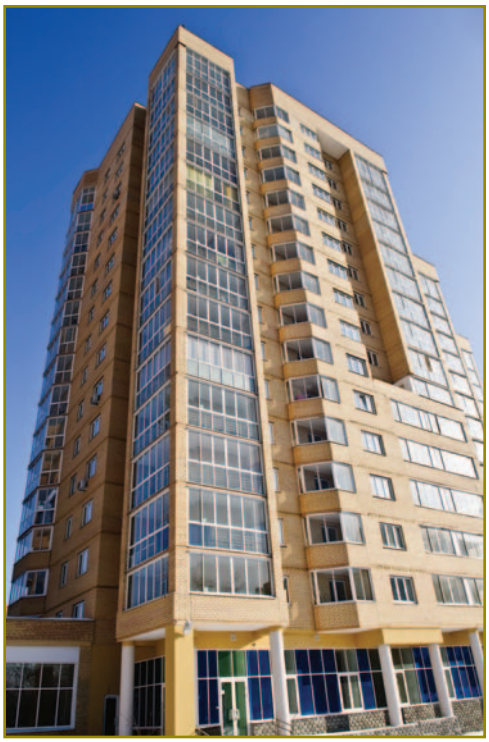
Surrender or not surrender?

Surrendering property may be the best answer for you, but before doing so, tap into the expertise of your CPA or financial advisor. He or she can help you understand and potentially minimize any adverse tax effects. ■

Ask the Advisor

How can lease options help me in this slow economy?

Property owners who've had trouble locking down sales are offering potential buyers a gradual approach to purchasing their property — lease options. Although a lease option may not be the ideal structure for a sales transaction, it offers some attractive benefits, especially in today's down market.



How does it work?

Lease options — more commonly known as lease-to-own arrangements — combine a traditional lease and a purchase option. Under the option, the seller/landlord gives the buyer/tenant the exclusive right to buy the property. There's usually a fixed price at the beginning of the lease. But the price could also be the market value on the exercise date or the amount offered by another interested buyer. The buyer can exercise the option at any time during the option period, which typically runs concurrent with the lease term.

The buyer generally pays an above-market monthly rent, receiving a nonrefundable credit of 10% to 100% of the rent toward the eventual down payment. The buyer also pays some nonrefundable consideration upfront for the purchase option.

What are the potential benefits?

This leasing tool lets you benefit from market appreciation (if the exercise price equals market value on the exercise date). Monthly rent payments provide a cash flow that you can use to pay monthly mortgage payments and property tax bills. And, because you're still technically the owner, you can also deduct the interest payments and property taxes.

A lease option also gives the buyer/tenant a vested interest in and an incentive to care for the property. The greater the upfront option consideration, the greater that incentive. Plus, some lease option contracts require buyer/tenants, not landlords, to pay for routine maintenance on the property.

Are there drawbacks?

With a lease option, you'll likely receive a smaller down payment if you sell the property to the buyer/tenant (because of the rent credit) than you would otherwise. Plus, monthly rental payments might not cover your mortgage obligations. An option could also keep you from offering the property for sale to other prospective buyers who might be ready to buy before the buyer/tenant.

Worth considering

If you have property that's been lingering on the market for some time, a lease option might be just what you need to grease the wheels on your sale and improve your cash flow. Your real estate and financial professional can show you the way. ■

THE RIGHT IDEAS

THE RIGHT RESULTS

ACHIEVED WITH THE RIGHT FIRM.

UNDERSTANDING THE TAX CONSEQUENCES OF YOUR DISTRESSED PROPERTY

- **Are you facing the loss of real estate through foreclosure, short sale or a deed in lieu?**
- **Are you personally liable on your debt?**
- **Is the distressed real estate your principle residence, investment property or used in your business?**

Depending on your answer to these questions, you could be facing very different tax treatment in each of these situations.

Zinner & Co. is here to help...

Let us help you to unravel the confusion and advise you on how to minimize the tax consequences of the loss of your real estate. For more information about distressed real estate and how it affects you, visit our website at www.zinnerco.com or contact us.

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