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December 2014

Real Estate Industry - Specific Tax Issues

Dear Client:

This communication is being sent to you because you operate a business in the real estate industry. Real estate businesses have some specific federal tax issues that we would like to highlight and encourage you to discuss with us in person. It is easy in the daily rush of running a business to overlook or postpone reviewing tax laws that could, in some cases, generate savings.

Leasehold improvement property. Improvements made to a building or other real property subject to a lease are depreciable. Under MACRS (the Modified Accelerated Cost Recovery System), the term of the lease is irrelevant. MACRS improvements to the interior of nonresidential real property can be depreciated over 15 years if placed in service before January 1, 2014, provided the building was at least three years old. Without this rule, the improvement could be treated as 39-year MACRS property. Bonus depreciation may be taken on leasehold improvement property.

Leases. Ordinarily, the lessor takes depreciation; the lessee can deduct rental payments. The owner of property may decide to engage in a sale-leaseback transaction, where the owner sells real or personal property to a buyer, who leases it back to the seller. If the transaction is bona fide, the seller-lessee can free up capital in the property, and can deduct rental payments to the buyer-lessor. This may provide a larger deduction than depreciation and interest. The lessor can also depreciate the property. However, a sale-leaseback may be recharacterized as a financing device, if the seller retains the economic risks of ownership; this may diminish the seller's tax benefits. The IRS and the courts have identified several factors to consider when characterizing the transaction.

The tax treatment of amounts paid to cancel a lease may vary. A lessor that pays to cancel a lease for its own use generally has to amortize the payment over the unexpired term of the lease.

However, a lessor that cancels a lease so it can sell the property adds the payments to the property's basis. A lessee that pays to cancel a lease so that it can make improvements or put up a new building must amortize the payments over the life of the new building or improvements.

If the lessor provides an option to buy, payments under the lease made after the option is exercised are treated as purchase price installments. If the lease is treated as a disguised sale, the payments are also treated as purchase price installments, not rent. The characterization depends on objective economic factors and whether the lessor retained sufficient indicia of ownership.

Sales and exchanges; like-kind exchanges. Gain or loss on the disposition of real property is capital gain or loss, unless the property is held primarily for sale to customers or is depreciable property used in a trade or business. As described below, depreciable property is subject to recapture on its disposition. If real property is sold to a related party, any gain is ordinary income, and any loss is disallowed.

If the taxpayer exchanges like-kind property, no gain or loss is recognized, except for items such as depreciation recapture. Taxpayers may engage in a deferred exchange involving three parties, to accomplish a like-kind exchange. Real property can be like-kind. Unlike personal property, parcels of real property may qualify as like-kind even if they differ as to grade or quality.

Depreciation recapture. Gain from the sale of property usually is treated as capital gain, and taxed at a lower rate than ordinary income. However, on the sale of Code Sec. 1245 property or Code Sec. 1250 property, the seller must recapture depreciation taken on the property as ordinary income. For Code Sec. 1245 property, all depreciation taken on the property has to be recaptured. For Code Sec. 1250 property, the excess of accelerated depreciation over straight-line depreciation must be recaptured as ordinary income.

Code Sec. 1245 property generally is tangible personal property, but it also includes certain real property whose basis was reduced by specified deductions (such as the five-year amortization rule for pollution control facilities). Code Sec. 1250 property is depreciable real property that is not Code Sec. 1245 property. It includes intangible property, such as a leasehold, and buildings and their structural components.

Real estate professionals. Real property that is held primarily for sale to customers in the ordinary course of business is not a capital asset. Any gain or loss on its disposition is ordinary. The seller is identified as a dealer. However, if the property is acquired and held principally for investment, any gain is capital. The determination of whether property is held primarily for sale depends on the facts of the case; the courts have identified a number of factors for making this determination.

Under Code Sec. 1231, property must be property used in the trade or business for taxpayers to apply Code Sec. 1231, which treats gains as capital and losses as ordinary for gains and losses resulting from the sale or exchange of the property. Rental real estate can be a trade or business if the owner rents properties and is substantially involved on a regular basis with renting, servicing tenants, and maintaining the properties. However, a taxpayer with a single rental property may have a harder time demonstrating that the rental is a trade or business.

REITs and REMICs. Taxpayers may invest in real estate, mortgages and similar assets through a corporation that is treated as a real estate investment trust (REIT). Income that is earned by a REIT and distributed to its shareholders is taxed only to the shareholders, and not at the REIT level. REITS must satisfy a number of requirements as to structure, income source, assets and distributions.

Taxpayers may also invest in pools of mortgages (mortgage-backed securities) through a real estate mortgage investment conduit (REMIC). Like REITs, REMICs are subject to a number of requirements. A REMIC is not a taxable entity, whereas a taxable mortgage pool may be treated as a corporation.

Tax credits. There are two special tax credits that can involve real estate: the low-income housing tax credit (LIHTC), and the New Markets Tax Credit (NMTC). The LIHTC is claimed over a 10-year period as a percentage of the qualified basis of a qualified low-income building. While the purchase of an existing building generally does not qualify for the credit, rehabilitation expenses may qualify. A qualified building is rental real estate that provides a portion of its units at lower rents to low-income renters

For the NMTC, an investor is entitled to a credit, which could reach as high as 39 percent over seven years, for an equity investment in a community development entity that makes qualified investments in a low-income community. A qualified investment can be made in a business or in real estate. Currently, most investments are made in real estate.

Conservation easements. Another tax benefit involving real estate is the deduction for conservation easement. The owner of the property must donate a real property interest to charity for conservation purposes, such as the preservation of open space or wildlife habitat. A restriction on the use of real property, such as a restrictive covenant that preserves a façade, may also qualify.

We have highlighted only some of the many federal tax laws that impact real estate businesses. Every business is unique and has particular tax considerations. Please contact our office so that we can set a time to discuss your business in more detail.

Sincerely yours,
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