CalCPA – TAXI Conference

SHERATON UNIVERSAL
November 3, 2017

Capitalize, Amortize or Deduct Adjusting for a New Recipe (263(a))

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▪ General Information

Cameron L. Hess, Esq., C.P.A., a partner with the law firm of Wagner Kirkman Blaine Klomparens & Youmans LLP practices in the firm's transaction department handling tax and business law. Mr. Hess' has a broad, integrated practice working with nonprofits and closely held businesses. Mr. Hess has experience in multiple industries, including real estate/construction/development, manufacturing and IP growth industries. His niche practices include pass-throughs, succession planning for high net worth individuals, and state and local tax controversies (sales tax, franchise tax and property tax). Mr. Hess has over 30-years. Mr. Hess, a Certified Public Accountant, previously practiced with KPMG, as part of its real estate tax practice before working to assist in the start-up the Los Angeles office state and local tax practice.

▪ Practice Areas

Real Estate

Mr. Hess handles advises the real estate industry for acquisitions, financing, development, syndication, and tax representation. His clients include both investment groups and builders/developers in commercial, multifamily and residential developments. Mr. Hess has handled among the largest Sacramento area real estate home builder/developer acquisitions. Mr. Hess has chaired CalCPA Sacramento Chapter Real Estate Committee for 25 years, and its annual local real estate conference for 14 years. Mr. Hess is a past chair for the Cal CPA Education Foundation Real Estate Conference and continues on the TAXI Conference as a planning committee member.

Business Law

Mr. Hess represents closely held business owners with business transactions, including contracts, acquisitions, financing and sales. He has served as counsel for Sacramento area manufacturers, fabricators, medical, accountants/financial, including formation, mergers, sales and succession planning. Mr. Hess's practice emphasizes the use of pass-through entities, including partnerships, limited liability partnerships and limited liability companies.

Nonprofit Law/Planned Giving

Mr. Hess is Director of his form's Nonprofit Practice. Mr. Hess represents nonprofit entities with respect to nonprofit formation, administration and fund raising. Mr. Hess advises national, state and local nonprofits with respect to strategic planning, Board management, affiliation, planned giving and

unrelated business income tax.
Federal and State Taxation
Mr. Hess handles all areas of federal and state tax controversy representation, including audits, appeals and Tax Court representation. Representation has included manufacturers, real estate, general businesses and individuals. Mr. Hess focuses on complex tax controversies, including reconstruction of foreign business records, Section 1031 multi-property exchanges, and real estate professional status. Examples of tax controversies include employment, unitary/combined reporting issues, real and personal properties tax appeals, residency, sales taxes and local business taxes. Mr. Hess advises on California property taxation and has been successful major property tax reductions. While with *KPMG* in Los Angeles, Mr. Hess was a manager and participated in the start-up of its state and local tax practice.

Estate Planning
Mr. Hess represents high net worth individuals with estate planning, focusing on succession planning, irrevocable trusts (life insurance, charitable, grantor retained annuity/unitrusts), and family limited partnerships/LLCs.

▪ Education

University of California, Berkeley, B.S. Business Administration (Accounting Focus), 1980
University of Southern California, Juris Doctor and Master of Business Taxation, 1983

▪ Academic Activities

Mr. Hess has written/presented over 200 articles over the past 30 years, including before local, state and national conferences and webinars, including the CalCPA Tax Conference and the State Bar Tax Conference.
Published: Spidell's California Taxletter (1991-1993 Property Tax Columnist, contributing writer), CCH Taxes (1984), The Tax Executive (1986), The California Constructor (1991), SVAA Rental Property Management, Los Angeles Lawyer.

Instructor: Cosumnes River College (Adjunct, Intermediate Taxation); UC Davis CFP Program (Adjunct Instructor, Taxation, 1998-2004); State Bar of California; CalCPA Ed Foundation, Strafford Seminars, CSEA, , ISTC, SCA, , Lorman Education Services, National Business Institute, Nonprofit Resource Center (Sacramento), Strafford Group.

Tax Law Journal (USC)
Mortar Board Honor Society (UC Berkeley)
Beta Alpha Pi
Phi Alpha Delta
Student Member, UC Academic Senate, Committee on Student Affairs (UC Berkeley)

▪ Affiliations

CAA Sacramento (formerly Rental Housing Association of Sacramento (past-President/Director)
Easter Seals Superior California (former Board Director, Audit Committee)
American Bar Association (Tax Section)
State Bar of California

Tax Section (Corporate and Other Pass-Through Entities Committee (2017-2018 Chair, previous chair position 2009-2010)
Business Section, member (Pass-through Entities Leg Committee – 1995-1997)
Sacramento County Bar Association
Tax Section
Business Section
Real Property Section (Officer)
CalCPA,
CalCPA Ed Foundation Real Estate Conference (Co-Chair/Member 2003-present)
CalCPA State Estate & Financial Planning Committee (1995-1997)
Sacramento Chapter, active member
Chapter President, 2004, Board Member, 1995-2005)
Real Estate Committee (Chair, 1992-Present; Conference Chair);
Roseville Discussion Group (Chair/Co-Chair 2014-2017)
Ambassador Committee
Chapter Tax Committee
Chapter Estate and Financial Planning Committee

▪ Admissions

State Bar of California, 1984
U.S. Court of Appeals, 9th Circuit, 1984
U.S. District Court, Eastern District of California, 1984
U.S. District Court, Central District of California, 1991
U.S. Tax Court, 1991
Certified Public Accountant, 1988

▪ Representative Publications and Presentations

Representing Clients in Property Taxes (2013 Lorman Education)
FTB Research and Representation Practicum (2014 Cal Society of Enrolled Agents)
Net Investment Income Tax and Repair Regulations (2014 Cal CPA Ed Foundation)
Sailing the *Ocean* Decision To Avoid Property Tax Reassessments (2014 Spidell California Taxletter)
Self-Employment Tax and Net Investment Income Tax for LLCs (2015 Strafford Seminars)
Understanding Bitcoins & Virtual Currency (2015 Cal Society of Enrolled Agents)
Handling Real Estate – Capitalize, Amortize or Deduct? (Various Conferences)

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I. INTRODUCTION

In an imaginary, taxpayer-friendly world, everything that is bought, acquired or paid for could be deducted at the taxpayer's discretion, when taxpayer wanted – on purchase, incrementally, slow or fast. In that imaginary world, the tax adviser would have to simply ask "How much would you like to write off today on that purchase?"

The imaginary "taxpayer-friendly world" is not real; however, sometimes the current tax rules are not so far off from the imaginary world.

This outline highlights a number of the significant rules in connection with whether real estate related expenditures should be capitalized, amortized or deducted. What is interesting here is not the basic rules, but the creative areas where clients may accelerate or limit their deductions. Following a discussion of some practical steps for practitioners, this outline presents topics in the following order:

A. Purchases of real estate;

B. Construction of real estate;

C. Operation of real estate;

D. Lease of real estate; and

E. Sale of real estate.

II. PRACTICAL STEPS

A. Spreadsheet Tool. Anytime I get started with the issue as to how to treat real estate expenditures, I find that the best tool to work with is a simple five or six column spreadsheet on which I can take notes and analyze each expenditure. The spreadsheet starts something as follows:

Name of Property – Event					
Expenditure Item	**Amount**	**Capitalize**	**Amortize**	**Deduct**	**Notation**
1.					
2.					
3.					
4.					

B. Example 1 – Property Tax. For example, say on November 30, 2005, I bought a building in which the escrow shows that $1,000 in property taxes was paid as a first installment through escrow. The spreadsheet would show that escrow statement item as follows:

Expenditure Item	**Amount**	**Capitalize**	**Amortize**	**Deduct**	**Notation**
1. Property Taxes	$1,000			$166.67	Pro-rate to Buyer Schedule E – 2005

Creating this type of notation allows for a spreadsheet that can be used for 2005-year reporting as well as tracking the basis for purchased assets.

C. Example 2- Loan Fees. Similarly, assume $1,500 was paid as a loan fee based on a percentage of the loan (i.e., 1.5 percent). The spreadsheet would report the following:

Expenditure Item	Amount	Capitalize	Amortize	Deduct	Notation
1. Loan Fee	$1,500		$1,500		Pro-rate – 30 yrs, starting 12/1/05

The benefit of this spreadsheet is to take any transaction and present in a summary fashion an analysis of each item and its treatment as capitalized, amortized or deducted.

III. PURCHASE OF REAL ESTATE

One topic we are covering today is the treatment of expenditures incurred in connection with the purchase of real estate. For your clients, keep in mind that purchasing real estate involves not only the direct cost to purchase the real estate but also all of the related costs incurred to find real estate, to investigate the purchase, and to form a legal entity to hold the real estate.

A. Acquisition Costs.

1. Basic Rule – Capitalization. With the purchase of real estate, the basic rule is straightforward: most purchase costs must be capitalized. These costs are added to and become part of the client's basis in the property. (Thompson v. Com'r. (1928) 9 BTA 1342.) For example:

- Legal fees paid in connection with acquiring real property generally must be capitalized. Fees to capitalize include a review of purchase and title documents or to defend or settle title to property. (Millinery Center Building Corporation v. Com'r. (1954) 21 TC 817, revd on other issues 221 F.2d 322 (Cal.App.2d 1955), affd 350 US 456, 100 L.Ed. 545, 76 S.Ct. 493 (1956).)

- The costs to survey land to be purchased, including boundary, topographical and use surveys, must also be capitalized. The costs of a survey incurred after a purchase that is used to perfect title provides an extended benefit that must be capitalized. (Johnson v. Com'r. (1955) 14 TCM 81.)

- Brokerage commissions, title searches, deed preparation, transfer taxes, survey costs, geological surveys, title company and other miscellaneous settlement fees and charges must be capitalized and added to the basis of the property.

2. Exception: Unsuccessful Search Costs – Section 165. On the other hand, if the taxpayer fails to acquire a real property, it would seem that there should be no requirement to capitalize purchase expenditures, and that they should be deductible. However, the rules are more complex, and the courts may disagree. The Service's positon under Section 165 is that where a profit motive can be demonstrated, the taxpayer generally may currently deduct his or her expenses incurred from an unsuccessful search. Rev. Rul. 71-191, 1971-1 CB 77. (Fees paid by an individual for expert geological advice and filing services rendered in connection with an unsuccessful attempt to acquire noncompetitive oil and gas leases.)

3. In Revenue Ruling 79-346, 1979-2 CB 84, the Service further refined its position and held that a preliminary or general search was not deductible, because it was a personal expenditure, but if costs related to a specific acquisition, if successful in the acquisition, would be capitalized, and if failed, deductible.[1] Likewise, because Revenue Ruling 74-104, 1974-1 CB 70 when the corporation incurred evaluation expenses, and on basis of the evaluations it decided not to purchase particular residential properties, these expenses were ruled deductible under Section 165. This logic by the Service may be appropriate for an individual exploring the possibility of a new investment; however, for an investor expanding his or her portfolio of investments, the no deduction rule for general searches would seem to be incorrect.

The courts, however may not all be in accord as to the deduction of either general or specific expenditures. The Seventh Circuit Court of Appeals has allowed general expenses to be deducted for a corporation that had not yet made a single sale. While not involving real estate acquisitions, the Court of Appeals ruled that a corporation that had been formed to sell, install

[1] Unfortunately, this ruling did not say what to do with preliminary or general search expenses. For example, assume that a taxpayer pays $100 per month to get monthly listings of rental properties for sale.

and maintain a product was engaged in a trade or business. It was entitled to report losses. Cabintaxi v. Comm., 63 F. 3d 614 (7th Cir. 1995) revg in part and affg in part T.C. Memo 1994-316. Conversely, specific expenditures on failed acquisitions were disallowed a realtor who for a period of several years had attempted several purchases of homes to sell or rent – however, the taxpayer did not argue Section 165; but only 162. Woody v. Com'r, T.C. Memo. 2009-93
The Service's allowance of the use of Section 165 to claim a deduction has interesting potential. Section 165 is seemingly broader than either Sections 162 or 212. Section 162 is limited to the deduction of expenses be paid or incurred in carrying on a trade or business. Section 212, which contains its own limitations.

Whatever the uncertainties in failed acquisitions, in order to claim a deduction under Section 165, there must in fact be an actual loss. (Revenue Ruling 83-137, 1983-2 CB 41) Where no acquisition occurred and an option fee is refundable, no loss is sustained.

4. Exception – Entity Formation and Start-up. Another exception, if you can call it that, is the right to deduct up to $5,000 in start-up expenses and to amortize the balance over 15 years when incurred in connection with any activity engaged in for profit prior to the start date of the business. (Code Section 195).

In classifying costs that are formation and start-up costs, they are distinguished from real estate acquisition costs. The Service will look to whether an expenditure is "directly connected" to the real estate acquisition. The Service will also look as to whether such expense – directly connected, must be capitalized under Section 263(a) or 263A. Any expenditure that must be capitalized as part of the basis in real estate will not be treated as a Section 195 start-up expense.

Revenue Ruling 99-23, 1999-1 CB, 998 is a good illustration. The Service distinguished between (i) expenditures for a specific acquisition, construction or improvement of real estate which must be capitalized to the basis in real estate under Section 263, and (ii) general investigation or pre-operating expenses that are separately capitalized but will qualify for a deduction under Section 195. The Service found qualified Section 195 expenditures to include:

(i) legal costs for a letter of intent (i.e., a proposal to buy real estate),

(ii) a "preliminary" due diligence (i.e., reviewing public records), and

(iii) the legal costs to form a separate legal entity to hold real estate (i.e., a limited liability company, limited partnership or corporation).

Conversely, directly connected expenses involved (i) an accountant’s review of the seller's specific records (such as books of account, ledgers and the like) and (ii) the legal costs of a purchase and sale agreement should be capitalized as part of the real estate and are not Section 195 amounts.

While Section 195 is advantageous, it must be elected by a proper statement made on the taxpayer's return for the year incurred. The election must be on an original or an amended return if the amendment is filed within the period allowed as if the taxpayer had extended his return and filed on the last day of a six month extension.

Under Treas. Reg. Section 1.195-1, the election requires a separate statement attached to the taxpayer's return. The election may be filed either on (i) the return prior to the commencement of the business or (ii) the return for the first year in which the business begins. (In other words, it is okay to file early and be safe.) The statement must identify that the election is being made, the number of months of the amortization, describe each start-up expenditure, the date business began or was acquired, and describe the business. Because regulations pre-date current Section 195 provisions, the election probably should also indicate the amount to be deducted (up to $5,000). In other words, simply stating the amount and that the election is being made is no longer accepted for returns filed after December 17, 1998. The following is an example:

ELECTION TO AMORTIZE START-UP EXPENSES
TREAS. REG. Section 1.195-1

Taxpayer elects to amortize the following start-up expenses under Section 195 with respect to its purchase of an 18-unit apartment building at 123 Hess Road, Sacramento, California on June 1, 2005:

Legal Expenses - Letter of Intent	$1,700.00
Pre-Investigation Expenses - Title/Permit Review	300.00
Total	$2,000.00

Taxpayer elects to deduct $2,000 of the foregoing expenses for the 2005 year and amortize $-0- over 180 months beginning as of June 1, 2005, the first day taxpayer acquired the apartment building.

5. Summary. Given the complexity of the law, the following summary illustrates the usual treatment of acquisition expenses.

ACQUISITION COMPLETE

	Expenditure Item	Capitalize	Amortize	Deduct	Notations
1.	Search for Property		X	X	Section 195 election
2.	Review Property	X			
3.	Contract to Acquire	X			
4.	Points on Loan		X		Amortize over loan term.
5.	Other Loan Costs	X	X		Unclear—acquisition or loan cost?
6.	Escrow/Title Fees	X			
7.	Title Insurance	X			
8.	Property Taxes			X	Prorate—may create deduction or reduce a deduction
9.	Purchase Cost	X			

ACQUISITION FAILED

	Expenditure Item	Capitalize	Amortize	Deduct	Notations
1.	Search for Property			?	Section 165(?)
2.	Review Property			X	Section 165
3.	Option Payment			X	Section 165

B. Re-Development.

1. Capitalization Requirements. During the past several years, California urban growth has seen rapid expansion resulting in the demolition of smaller structures to enable more concentrated developments. Under Section 280B, no loss is allowed for either: (i) demolition costs - the cost to demolish a structure; or (ii) demolished improvements - the taxpayer's basis in improvements sustaining a demolition. The total of these costs and basis must instead by capitalized and made part of the taxpayer's basis in the land (upon which the demolished structure was located). Once added to the land costs, there is no recovery by depreciation or otherwise until the property is sold.

2. Structure Defined. Because the demolition costs (or loss of improvements) is not deductible, it is important to know what is not a "structure."

The Regulations define the term "structure" under Section 280B as a building and its structural components. Those terms are further defined in Treas. Reg. § 1.48-1(e). Thus, structures are not just buildings. It may include other inherently permanent structures. What is possibly unclear is the treatment of pavement, fencing, and nonbuilding improvements. For example, if the buyer of a rental property removes the remnants of an old concrete garage pad (where the building was previously torn down), concrete driveways and fencing, these may be treated as structures. While Section 280B was enacted in 1984, there are surprisingly few cases since enactment.

3. Exceptions to Capitalization. Obviously, clients do not always like Section 280B. They may ask whether their situation should be treated differently. While the Code itself contains no exceptions to the capitalization rule, there are in fact few exemptions to the capitalization requirement under Section 280B.

a. Obsolescence. Despite Section 280B, one exception may apply to obsolescence. Obsolescence occurs if there is an "abnormal" retirement or actual physical abandonment, in which event a loss is allowed. (Treas. Reg. § 1.167(a)-8). Regulations take a "facts and circumstances" test as to abnormal retirements and therefore the following factors are considered:

- Property lost its usefulness suddenly as the result of extraordinary obsolescence;
- Loss of usefulness was unexpected;
- Actual physical abandonment;
- Technology changes eliminated the utility of the property.

For real property, the right to take a write-off, even if there is a later replacement following a tear-down appears to be viable in some circumstances. For example, in Revenue Ruling 2000-7, 2000-1 CB 712, the IRS concluded that a business is not required to capitalize the costs of retiring and removing an old depreciable asset even if such costs are incurred in connection with the installation of a replacement asset. The ruling focused on retirement of assets that no longer had a useful life.

> Example. Say a builder acquires a 1920's hotel with the intent to refurbish it. After the acquisition, the developer determines that the cost to bring it up to current earthquake safety standards would not only exceed the cost for an identical new building, but that the exterior walls have deteriorated beyond use. In that event, the demolition costs of the existing hotel, if replaced with a similar new hotel, arguably would be deductible under Revenue Ruling 2000-7.

Unfortunately, it is not always clear whether a loss for obsolescence is allowed in real estate situations. The following three decisions illustrate the risks.

(1) Letter Ruling 9131005. In Letter Ruling 9131005, the taxpayer received notice that their building had to be demolished or repaired. The building was in disrepair and was not habitable. In this ruling, the IRS determined that no Section 165 loss would be allowed. Rather, the cost had to be capitalized as part of the land.

(2) C.H. De Cou (1994) 103 TC 80. In De Cou, the Tax Court did allow a deduction for abnormal retirement loss from a building. The taxpayer purchased three old buildings in Corpus Christi, Texas, with the intent to remodel them and upgrade the tenants.[2] Shortly after the purchase, the taxpayer obtained estimates, hired experts and began renovation, but soon discovered that repair costs were between 150% and 200% of the cost to replace the buildings in their entirety due to previously unknown structure problems. For example, with the Neptune building, floors were rotten, raw sewage leaked under the building, plumbing, foundation, walls, roof and electrical systems were all in hazardous condition.

The Tax Court considered the concept of abnormal retirement under Treas. Reg. Section 1.167(a)-8 and IRS Notice 90-21. While the deterioration had occurred for years, the Tax Court found that usefulness of the Neptune building suddenly and unexpectedly terminated upon discovery of its true condition and the suspension of use by city officials. Therefore, the Neptune building's cost could be written off. Only the actual demolition costs had to be capitalized.

(3) Linden Gates v. U.S. (3rd Circuit 1998) 168 F. 3d 478 [98-2 USTC 50814]. In this decision, Linden and Lois Gates in 1984 acquired an old school building that they were unable to lease. After four years, in 1988, they found that the building had asbestos and was in substantial disrepair due to vandalism during that year. The Gates waited until 1991 when they decided that the building was worthless, had it demolished, and reported a loss of the cost of the building due to obsolescence.

[2] The buildings were known locally as Sonja, leased as a topless bar, the Hole in the Wall, which sat vacant, and the Neptune building, also leased as a topless bar.

Unfortunately, the District Court and Third Circuit disagreed. The Court distinguished <u>De Cou</u> and found that the events in 1988 were not sudden and unexpected, but merely gave rise in 1988 to a vandalism loss and not to a sudden obsolescence loss in 1991.

While it is fair to say that the Linden Gates case clearly involved an issue of proof, given the three-year delay between the discovery of the asbestos and the vandalism problems and the weak proof of worthlessness, it is difficult to say how far C.H. De Cou can be interpreted. Arguably, at least, property that is condemned for health or safety risks and is torn down by a government authority may entitle the owner to a loss. On the other hand, a write off for obsolescence under Section 167 is not based on a "sudden and unexpected" loss and this term in De Cou creates uncertainty.

b. <u>Casualty Loss</u>. Second, Section 280B also should not apply to disallow casualty losses allowable under Section 165. If a casualty damages or destroys a structure, and the structure is then demolished, the taxpayer's basis in the structure must be reduced by the casualty loss allowable under Section 165 before any loss sustained on account of demolition is determined. This means that the amount of the loss deduction *may* be limited to the decline in value of each building or structure. Notice 90-21, 1990-1 CB 332. In light of Hurricane Harvey, this notice may be of particular interest.

> <u>Example</u>: Assume that an uninsured rental home is completely destroyed by flooding, but the detached garage is spared. Under Notice 90-21, if the loss from the house is allowed, but the cost of the garage if demolished must be capitalized. The demolition costs for both the house and garage, if not reimbursed by insurance, may be required to be capitalized.

> <u>NOTE</u>: No PAL Limited. Where losses are allowed under Section 165 due to a casualty or theft, the losses will not be treated as passive activity losses even where the property involves rental real estate.

c. <u>Safe Harbor – Expansion/Remodeling</u>. Third, Section 280B also will not apply to certain structural modifications to buildings. Under the safe harbor provisions of Revenue Procedure 95-27, 1995-1 CB 704, certain modifications of a building (other than a certified historic structure, as defined in Section 47(c)(3)), will be capitalized to building improvements rather than to land and will not be treated as a demolition for purposes of Section 280B. Building capitalization will apply if there is a "partial" demolition and (i) 75% or more of the existing external walls of the building are retained in place as internal or external walls; and

(ii) 75% or more of the existing internal structural framework of the building is retained in place. A modification of a certified historic structure will also satisfy the safe harbor if, in addition to satisfying the foregoing requirements, the modification is part of a certified rehabilitation (as defined in Section 47(c)(2)(C)) of the structure.

d. Satisfying Revenue Procedure 95-27 prevents such modification costs from being capitalized to the underlying land, which is a nondepreciable asset. These costs and losses, will, however, be subject to capitalization under Sections 263 and 263A, and, thus, depreciation under Section 168.

C. Real Property Taxes. When real property is purchased, the closing statement almost always shows charges for property taxes.

Under Section 164, real property taxes generally are not capitalized, but are deductible when paid or incurred, depending on the taxpayer's method of accounting. Real property taxes are not a cost to acquire property, but are actually a cost to hold property. The deduction for real property taxes is apportioned between the buyer and seller in proportion to the part of the tax year elapsed before the date of sale and the part remaining thereafter.

On the other hand, there are circumstances where property taxes are capitalized. Under Regulation Section 1.1001-1(b)(2), if the seller's share of real property taxes is paid for by the buyer, the buyer must capitalize that amount as an addition to basis for the property. Similarly, delinquent real estate taxes paid by the successful bidder for property foreclosed on under a property tax sale are not subject to Section 164; instead, they are part of the purchase price.

D. Purchases or Sales with Imputed Interest or Original Issue Discount. When purchasing real property, it is not atypical to have the sale be on an installment method. There is a complex web of statutory rules that may recharacterize a portion of the purchase price as deemed interest by either imputing interest or treating the instrument as if there is original issue discount.

The original issue discount (OID) rules are not necessarily bad for taxpayers, particularly as to buyers of real estate. Whereas, the buyer of commercial real estate takes depreciation on the capitalized building over 39 years, a reallocation of the price to imputed interest usually results in faster (and almost always greater) deduction.

IV. CONSTRUCTION OF REAL ESTATE

The second area we are covering is when your client constructs or develops real estate.

A. Capitalization of Construction Expenses. Generally, the costs associated with building structures on land are not deductible. They are capitalized under Section 1012. This capitalization requirement culminated in 1994 with final Regulations issued under Section 263A requiring capitalization of all direct and indirect construction related costs.

Under Section 263A, the costs of developing real estate, either produced by or for the taxpayer, include the direct costs of the property and such property's proper allocable share of all indirect costs. The term "produce" includes the cost to construct, build, install, manufacture, develop, improve, create, raise or grow real estate improvements. (Treas. Reg. §1.263A-2(a)(1).) Such costs in connection with real estate development include direct material costs, direct labor costs and indirect costs to be capitalized. Direct material costs are those which become an integral part of the property. Direct labor costs include basic compensation, overtime, vacation and holiday pay, sick pay, payroll taxes and payments to a supplemental unemployment benefit plan. Indirect costs are all costs which directly benefit or are incurred by reason of the construction of the real property.

The regulations provide that, except as specifically provided in Section 263A(f) with respect to interest costs, direct and indirect costs must be capitalized, without regard to whether those costs are incurred before, during or after the production period. Thus, a real estate developer must capitalize property taxes, insurance and other costs incurred with respect to property if, at the time the costs are incurred, it is reasonably likely that the property will be subsequently developed. In addition, producers are required to capitalize all indirect costs incurred after production that are properly allocable to the property produced.

B. Loan Fees. Loan fees are the costs of negotiating and obtaining a loan. Loan fees include appraisal and legal fees, title costs, brokerage commissions and surveys. These fees are not considered generally to be compensation for the use or forbearance of money, and so are not deductible as interest.

1. Loan Commitment Fees. Generally, loan commitment fees must be amortized over the term of the loan (Revenue Ruling 81-160, 1981-1 CB 312). If the property is sold or the loan is paid off early, then the unamortized portion is deductible at the time of sale or

payment. However, where construction is incurred, amortized loan fees may end up in the basis of real property. Where there is a construction project, the computation depends on whether there is: (i) one loan that covers both construction and permanent financing; or (ii) two separate loans – one for construction financing and one for permanent financing.

If there is a single loan commitment, the fees must be amortized over the entire life of the loan. This will result in capitalization into the real estate's basis of the amortized amounts during the construction stage. At the end of construction, the remaining loan amortization will be currently deductible.

If there are clearly two loans, with two separate loan commitment fees, the fee for the construction financing generally will be added to the basis of the building, and the loan commitment fee for the permanent loan will be amortized over that term. When amortization of the permanent loan occurs it will be currently deductible over the life of that loan.

2. Example 1. A incurs $40,000 in loan fees January 1, 1991, to acquire a construction loan which will be outstanding for two years. The proceeds of the loan will be used to construct a building. In taxable years 1991 and 1992, A will amortize the fees $20,000 a year. This amount will be added to the building's basis as long as it is under construction. When the building is complete if there are any remaining amounts, they will be currently deductible.

C. Construction-Period Interest. Currently, under Section 263A, interest must be capitalized for "designated" real property and tangible personal property regardless of whether it is produced by or for the taxpayer or for resale.

For real property, interest is capitalized only during the "production period" that commences on the first day that any "physical production activity" occurs with respect to the real property and continues until the property is completed. Activities which do not constitute physical production activities include early stages of real property development such as planning and design.

1. Future Interest. Another complication to capitalization is the handling of allocations among multiple lots if there is a common area (Charlevoix Country Club, Inc. v. Com'r., 105 F.Supp.2d 756 (WD Mich 2000). In Charlevoix, the court rejected the taxpayer's argument that estimated interest expenses should be included in the calculation of estimated construction costs for common improvements under the alternative cost method. IRC Section

263(a)(f) prevented the allocation of estimated future period interest expense to a developer's cost basis in lots sold in a particular tax year.

D. Real Property Taxes. Under Section 263A, real estate taxes must also be capitalized as an indirect production cost. The amount to be capitalized is dependent on the amount of tax which has met the all-events test and for which there is economic performance.

E. Legal and Accounting Fees. Generally, legal fees that result from services incident to the construction of the building must be capitalized and added to the building costs. For example, in WP Brown & Sons v. Com'r., fees for legal services of examining contracts with subcontractors, settling accident claims, reviewing loan documents and working on leases were all capitalized. The same capitalization rule applies to accounting fees. (WP Brown & Sons Lumber Co. v. Com'r. (1932) 26 BTA 1192. While legal and accounting fees are not specifically referenced as indirect costs of construction in the Regulations under Section 263A, it would clearly be appropriate to treat such fees as costs which "directly benefit or are incurred by reason of the performance of production or resale activities."

For legal expenses, where the taxpayer owns the asset to which the legal services are tied, success or failure does not matter. In Godfrey v. Com'r. (1963) 22 TCM1, affd 335 F.2d 82 (6th Cir. 1964), the taxpayer incurred legal fees in an unsuccessful zoning fight. Nevertheless, the Court ruled that the fees must be capitalized as part of the land cost. Likewise, in Galt v. Com'r. (1963) 19 TC 892, affd in part and revised in part 216 F.2d 41, (7th Cir. 1954), the Court held that legal fees incurred to effectuate the lease of property must be amortized over the term of the lease. The Court rejected an argument by the taxpayer that fees related to unsuccessful efforts to obtain a tenant should be currently deductible, with the remainder subject to amortization over the lease term. In Baylin v. United States (Ct Cl 1993) 94-1 USTC 50,029, affd 95-1 USTC 50,023, the Court ruled that legal fees incurred in defending a condemnation suit were capital expenditures. While this decision was not unique from a legal standpoint, the facts involved a recovery of interest on the condemnation award. The taxpayer agreed that it was entitled to deduct legal fees "allocable" to the interest component of the condemnation award. Similarly, in Jasko v. Com'r., (1996) 107 TC 30, the Court held that the taxpayers may not claim a deduction under Section 212(1) for legal expenses incurred in challenging their insurance company's determination of the replacement value of their home. The Court noted that the "origin of the claim" was recovering a loss with respect to the taxpayers' residence, a capital asset not held for the production of income.

On the other hand, it may still be possible to argue, consistent with the tax rules for Section 165 and 195, above, that at least some legal fees associated with real estate construction are deductible, if not amortized. In many cases, legal counsel may be asked to do preliminary work such as (i) helping to investigate possible development options, or (ii) drafting a letter of intent for discussions with potential builders. Arguably, these expenditures may qualify for deduction under Section 165 or amortization under Section 195.

F. Subdivision Development Costs. When it comes to the costs of future construction and improvements, the key to capitalization for subdivisions is Rev. Proc. 92-29, 1929-1 CB 748.

The problem that arises with subdivisions is that generally a developer cannot capitalize the cost of improvements until they have in fact been provided. Because of the limitation under 461(h) wherein amounts to be capitalized must also meet the "all events test" to the same extent as deductions, a difficult situation may occur with subdividers. In fact, for many projects a fair portion of common improvements, such as parkways and street dedications may be postponed to later in the project, particularly where development is completed in phases. The problem is, therefore, that initial lots sold without capitalization for future development costs may otherwise show inordinately high profits without a ratable inclusion of all project site improvements to be later completed.

While this problem may seem to be important only for sophisticated developers, it applies as well to a long-term landowner who wants to subdivide his farm and sell off lots.

1. Example. For example, assume John Developer is required, with a 10 lot commercial development, to install a berm along the lots before the conclusion of the project to create a more aesthetically pleasing and less plain view of parking on the lots. The cost of the berm (with plantings) is expected to run about $100,000. Absent a special election, the basis in the initial lots sold for purposes of computing gain might not reflect the expected allocable cost of the berm.

To circumvent this problem, the Service approved capitalization of future development costs under the alternative cost method under Rev. Proc. 92-29 as the exclusive method for capitalization. This capitalization applies to common improvements that benefit two separate parcels, such as streets, sidewalks, sewer lines, playgrounds, club houses and other common improvements.

To effect the provision of Rev. Proc. 92-29, requires that a formal request be made as a separate filing made by the due date for the tax return for the first applicable year and that certain other requirements be met.

If properly elected, a developer may capitalize and allocate to separate lots the total estimated cost of common improvements. Changes in the estimate will be allocated to future unsold lots. In addition, at the time of the sale of a lot, the amount capitalized with the lot sold may not cause there to exceed, for all lots then or previously sold, an amount greater than the total of all common improvements made to date (without reference to the benefiting lots). Thus, at no time can there be capitalized, for lots sold in any year, an amount greater than project-to-date common improvement costs incurred.

The estimated cost of common improvements as of the end of any taxable year equals the amount of common improvement costs incurred under Section 461(6) as of that date plus the amount of common improvement costs that the developer reasonably anticipates will be incurred during the 10 taxable year horizon that consists of the 10 taxable years following the end of the taxable year in question. A developer may request to determine the estimated cost of common improvements without regard to the 10 taxable year horizon.

The limitation is applied on a project-by-project basis, which precludes costs incurred with respect to one project from being taken into account with respect to another project. In addition, common improvement costs incurred under Section 461 may provide the basis for additional computations, such as interest computations under Section 263A(f), because the alternative cost method does not affect the application of general capitalization rules to developers of real estate.

2. Example. John Developer plans to build 10 houses on a tract of land. He must provide common improvements that will benefit the houses equally. The cost of these improvements and the land associated with them is estimated to be $400,000, and is not depreciable. John Developer obtains IRS permission to use the alternative cost method. The portion allocable to each house is $40,000. During the first year, the developer incurs $200,000 of common improvement costs under Section 461(h) and sells four houses. The developer may include $40,000 in the basis of each house that is sold. The limitation does not apply because the

$160,000 does not exceed the $200,000 of costs actually incurred. Had the developer not obtained permission to use the alternative cost method, the amount added to the basis of each house that was sold would be $20,000 ($200,000/10).

If the developer chooses to use the 10 taxable year horizon in determining the estimated cost of common improvements, the developer must file a request with the District Director of the appropriate Internal Revenue Service District. For individuals, estates, and trusts, the appropriate district is the one in which the developer's legal residence or principal place of business is located. For corporations and partnerships, the appropriate district is the one in which the developer's principal place of business or principal office or agency is located.

The request must be filed on or before the due date, including extensions, for filing the income tax return for the taxable year in which the first benefited property in the project is sold. A copy of the request must be attached to the developer's original tax return for the taxable year. No user fee is charged for this request. A developer who complies with the automatic consent procedure and the other conditions of Rev. Proc. 92-29 is automatically granted IRS permission to use the alternative cost method for the project that is the subject of the developer's request.

- The legend "Request to Use the Alternative Cost Method as Provided by Rev. Proc. 92-29" at the top of the first page.

- The developer's name, address, telephone number, and taxpayer identification number.

- The Internal Revenue Service Center where the developer's federal income tax return is filed.

- A description of the project to which the request applies, including a description of the tract or tracts of land where the project is located, using the name of the state, county, town, and plat map number, any subdivision name, and any lot numbers.

- A schedule showing the cost or other basis of the entire tract or tracts of land where the project is located and how that amount was determined, a listing of the lots by subdivision, the portion of the basis allocable to each lot and a description of how the allocation was determined, and for requests not involving lots, the portion of the basis allocable to each property and a description of how the allocation was determined.

- A schedule showing a description of each common improvement that the developer is contractually obligated or required by law to provide for the project, the persons to whom the developer is contractually obligated or required by law to provide the common improvements, a description of the document evidencing the obligation or requirement and a description of the nature of the obligation, the estimated cost of the common improvements for each common improvement and the manner in which made, the portion of the estimated cost of common improvements allocable to each lot and a description of how the allocation was determined, for requests not involving lots, the portion of the estimated cost of common improvements allocable to each property and a description of how the allocation was determined, and the estimated date production will begin on each common improvement and estimated date of completion.

- A declaration that states "Under penalty of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the requested ruling are true, correct, and complete," which must be signed by a person with personal knowledge of the facts, whose duties are not limited to obtaining rulings from the IRS, and for corporations, an officer must sign, for members of a consolidated group, an officer of the group's common parent, for trusts, a trustee, and for partnerships, a general partner.

G. Agreement to Extend Statute of Limitations. To use the alternative cost method for a particular project, the developer must sign a consent extending the statute of limitations on the assessment of income tax with respect to the use of the method for that project. The consent must accompany the request for IRS permission to use the alternative cost method.

The consent must permit the assessment of a deficiency for each taxable year in which the alternative cost method is used within one year after the return is filed for the taxable year that the developer specifies it expects to complete the project. For this purpose, a return filed before the due date, ignoring extensions, is deemed filed on that due date. If any other provision provides for a longer period in which to assess a deficiency that longer period applies.

The consent must be filed on the applicable Form 921 or 921A. Generally, if the developer is a partnership, each partner must file a consent unless the partnership is subject to the unified audit and litigation provisions, in which case the tax matters partner or any other authorized person may file the consent on behalf of the partnership. If the developer is an estate or trust, each beneficiary must file a consent.

H. Annual Statement Requirement. To use the alternative cost method for a particular project, the developer must file an annual statement for that project. The statement must be filed with the District Director of the appropriate Internal Revenue Service District. For individuals, estates, and trusts, the appropriate district is the one in which the developer's legal residence or principal place of business is located. For corporations and partnerships, the appropriate district is the one in which the developer's principal place of business or principal office or agency is located.

The annual statement must be filed on or before the due date, including extensions, of the developer's original tax return for the first taxable year following the taxable year for which the developer received permission to use the alternative cost method and for each succeeding taxable year in which the developer uses that method. A copy of the statement must be attached to the developer's original tax return for each taxable year.

The annual statements must include the following information:

- The legend "Annual Statement on the Alternative Cost Method Provided by Rev. Proc. 92-29" at the top of the first page.
- The developer's name, address, telephone number, and taxpayer identification number.
- The Internal Revenue Service Center where the developer's federal income tax return is filed.
- The Internal Revenue Service in which the request to use the alternative cost method is filed.
- The date of expiration of the statute of limitations to which the developer consented.
- A description of the project to which the request applies, including a description of the tract or tracts of land where the project is located, using the name of the state, county, town, and plat map number, any subdivision name, and any lot numbers.
- A schedule showing the updated estimated cost of common improvements for each common improvement, the portion of the estimated cost of common improvements allocable to each lot or property and a description of how the allocation was determined, the lots or properties sold as of the end of the immediately preceding taxable year, the common improvement costs incurred under Section 461(h) as of the end of the immediately preceding taxable year, the common improvement costs included in the basis of the lots or properties sold as of the end of the immediately preceding taxable year, the lots or properties sold during the taxable year, the common improvement costs incurred under Section 461(h) for the taxable year, and the common improvement costs included in the basis of the lots or properties sold during the taxable year.

I. Supplemental Request Requirement. To use the alternative cost method for a particular project, the developer must file a supplemental request for each project. The supplemental request must be filed on or before the expiration of the extended statute of limitations to which the developer consented. The developer must continue to use the alternative cost method for all common improvements not completed by that date.

The request must be filed with the District Director of the appropriate Internal Revenue Service District. For individuals, estates, and trusts, the appropriate district is the one in which the developer's legal residence or principal place of business is located. For corporations and partnerships, the appropriate district is the one in which the developer's principal place of business or principal office or agency is located.

The request must contain a consent that permits the assessment of a deficiency for each taxable year in which the alternative cost method is used within one year after the return is filed for the taxable year that the developer specifies it expects to complete the project. For this purpose, a return filed before the due date, ignoring extensions, is deemed filed on that due date. If any other provision provides for a longer period in which to assess a deficiency that longer period applies. The consent must be filed on the applicable Form 921 or 921A.

In the request, the developer must substantiate the following information:

- that for a valid reason the developer was unable to complete all of the common improvements it is contractually obligated or required by law to provide within the period covered by the original consent.
- that the developer continues to be contractually obligated or required by law to provide the common improvements.
- that the developer has complied with the requirements of Rev. Proc. 92-29.

V. REAL ESTATE LOSSES/CASUALTIES

A. Overview. A number of provisions provide for losses/casualties incurred with respect to real estate. Losses come from one of several sources, (i) losses incurred with respect to operating real estate (see VI. Operation of Real Estate), (ii) losses with respect to the sale of real estate (see VII. Sale of Real Estate), and (iii) losses caused by way of obsolescence, casualty or theft. While losses caused by way of obsolescence or a casualty or theft were covered in the context of a demolition of a structure (page 6 of this outline), in light of the recent events, it is important to touch upon casualty losses.

B. Casualty Losses Generally. With respect to real estate (and any other property for that matter), Section 165 allows a deduction for any loss sustained during the taxable year that is not compensated for by insurance or otherwise. While normally losses are allowed only for business losses or losses incurred in income producing activities, losses of property are allowed in all circumstances where they arise from a casualty or theft.

While the allowance for casualty losses has been available for many years, beginning after 1982, the amount of the loss reportable was limited not only to an excess over $100 but since 1982, it has also been limited to that amount of the total losses (after the $100 reduction) which exceeds 10 percent of the taxpayer's adjusted gross income. These limits, however, do not apply to losses by casualty or theft with respect to a business or income producing activities.

In addition, where the losses are attributable to an area declared a Presidential Disaster Area, taxpayers are allowed to elect to claim the loss on their tax returns for the tax year immediately preceding the taxable year in which the disaster occurred.

C. Katrina Emergency Tax Relief Act of 2005. On September 23, 2005, the President signed the Katrina Emergency Tax Relief Act of 2005 to provide further tax relief for individuals affected by Hurricane Katrina. Several of its provisions directly impact the consequences of casualties from destruction of real estate caused by Hurricane Katrina:

1. Unlimited Personal Casualty Loss Deduction. The proposal allows taxpayers to include individual losses less than $100 in the calculation of the total when the separate losses are attributable to Hurricane Katrina. In addition, all losses attributable to Hurricane Katrina are deducible, not just the portion that exceeds 10 percent of ACI;

2. Extension of Replacement Period – Involuntary Conversions. The replacement period for property destroyed by Hurricane Katrina is extended to five years under Section 1033; this extended period will allow more taxpayers to avoid gain by having a longer opportunity to find replacement property where gain would otherwise be recognized (out of insurance proceeds.)

3. Cancellation of Indebtedness Income Forgiven. It is expected that a number of homeowners whose homes were destroyed by Hurricane Katrina will default on their home loans and will lose their homes to foreclosure. The provisions of the act provide relief by forgiving the resulting taxable income from cancellation of indebtedness income that would otherwise result.

> Observation: While these provisions grant relief, it should be noted that it will not assist those affected by other hurricanes during the 2005 storm season. In addition, the foregoing provisions do not provide for a full recovery as to the losses sustained, but merely grant a measure of relief.

VI. OPERATION OF REAL ESTATE

The third area we are covering involves expenditures associated with the actual operation of activities associated with real estate.

A. Deductions Generally. Generally, the costs to operate a real estate project are deductible either: (i) under Section 162 (as a trade or business); or (ii) under Section 212 (as an investment). Before delving into the details, it is important to keep in mind that even if an expenditure *seems* deductible, several possible positions may limit any deduction, including:

1. First, in INDOPCO, Inc. v. Com'r. (503 US 79, 117 L.Ed 2d 226, 112 S Ct 1039 (1992)), the Supreme Court recognized that certain expenses must be capitalized when it held the issue of deductibility involves whether the taxpayer would realize benefits beyond the year of expenditure, rather than whether the expense was ordinary and necessary.

2. Second, for accrual method taxpayers, they must satisfy both the "all events test" and the "economic performance" test in order to meet the requirements for deducting a liability. Under the all events test generally, all events which determine the fact of the liability must first occur, and the amount must be determined with reasonable accuracy.

3. Third, cash and accrual taxpayers have to follow the economic performance test as a deductible.

4. Under the economic performance test, economic performance generally occurs simultaneously with the performance of the act which gives rise to the liability. For example, the liability arises as the property or services are provided. A deduction is allowed for a payment, so long as the taxpayer reasonably expects to receive the property or services within 3-1/2 months of payment (Reg. § 1.461-4(d)(6)(ii), or there is a recurring item (Reg. § 1.461-5).

B. Depreciation.

1. General Rule. A major deduction for real estate is depreciation. Because of the detailed depreciation rules, the following is a brief highlight as to real estate under Modified Accelerated Cost Recovery System ("MACRS").

For real estate, there are several categories of "classes" which each have different depreciation periods. Generally, the three periods that most commonly apply to real estate over which depreciation may be taken are as follows:

Period	Types
15-year	Nonstructural improvements, i.e., fences, landscaping, pavement.
27.5-year	Residential rental real estate
39-year	Other real estate

In addition, carpets, drapes, appliances and other personal property not incorporated into the real estate qualify for depreciation. In addition to 3-year, 5-year and 7-year depreciation, Section 179 may be available for commercial rental property.

2. Bonus Depreciation. For property placed in service after December 31, 2007 but prior to January 1, 2020, under Section 168k, an additional first-year depreciation deduction equal to fifty percent (50%) - (40% for 2018-year and 30% for 2019-year) of the adjusted basis of qualified property after a Section 179 deduction is claimed.

3. Qualified Leasehold Improvements. Qualified leasehold improvements, i.e., interior additions or alterations to the leased premises (not part of a common area) made under a tenant commercial building lease if the building has been in service for at least three (3) years are allowed to be recovered over 15-years. (Code Section 168(e)(3)(E).

In addition, qualified restaurant property, whether leased or owned if the building is predominantly used as a restaurant – the building and improvements, may qualify for recovery over 15-years. This is limited to mostly stand-alone structures. A restaurant within a strip mall may not qualify due to the predominant building use test.

There is also a 15-year recovery for qualified retail improvement property. This is any improvement to an interior portion of a building which is nonresidential real property and placed in service more than three years after the date the building was first placed in service

C. Interest on Debt Incurred to Acquire Real Estate. Code Section 163 prescribes rules for allowing interest expense deductions. Generally, interest expense on a debt incurred to acquire or improve real estate is deductible against the real estate's income, but there are limitations. If not otherwise limited, total investment interest expense cannot be deducted beyond investment income. Also, personal interest is generally not deductible from investment income.

The rules for a passive activity are discussed below.

D. Tenant Finder Fees. The costs incurred by a lessor in finding a tenant are not deductible but are included in the lessor's basis in the lease, regardless of the length of the lease and regardless of the taxpayer's method of accounting. This principle applies to brokerage commissions, legal fees, title searches, cleaning costs, survey expenses, appraisal fees, rent-up fees paid to management consultants to locate tenants, the costs of moving the tenant into the building, retainer fees, and cash inducements paid to lessees to sign or renew a lease. For these purposes, a lessee who subleases real property is treated as a lessor for these purposes and must also include the costs of obtaining a subtenant in the basis of the sublease.

E. Repairs. A frequent issue is as to deductible repairs. Prior to the issuance of regulations, taxpayers were dependent on numerous cases to provide guidelines as to whether an item was a repair or required to be capitalized. While the regulations set out more precise guidelines, interestingly, many of the outcomes will not be changed by these regulations. For example, the following published guidance will generally remain true (Source: BNA Portfolio 590 Taxation of Real Estate Transactions.):

- Brush clearing to negate overgrowth;
- Cleaning exterior walls of a building;
- Cleaning interior of run-down building;
- Cutting out concrete cracks;
- Dismantling unsafe partition;
- Eliminating hump in driveway entrance;
- Encapsulating damaged asbestos insulation;
- Filling and grading property to alleviate water seepage caused by construction on adjacent property;
- Filling concrete cracks;
- Installation of steel columns and cross members to support sagging floor;
- Insulating above a roof;
- Insulating house;
- Makeshift repair of floor;
- Painting an interior room;
- Painting the exterior of a building;
- Painting the interior of a building;
- Painting roof;
- Painting window sash;
- Patching floors;

- Patching porch;
- Patching roof;
- Plastic finish on building canopy;
- Plastering a room;
- Pouring concrete over pre-existing floor to restore its use;
- Reflashing a roof;
- Removal of damaged building cornice;
- Removal of damaged windows;
- Repaving parking lot;
- Repainting the exterior of a building;
- Repairing building damage caused by storm;
- Repairing building damage caused by water seepage;
- Repairing ceilings;
- Repairing counters;
- Repairing doors;
- Repairing driveway;
- Repairing electrical wiring;
- Repairing fences;
- Repairing foundation;
- Repairing floor;
- Repairing foundation piles after sudden recession of river;
- Repairing gutters;
- Repairing plaster;
- Repairing plumbing;
- Repairing railings;
- Repairing roads after storms;
- Repairing roof damaged by wind;
- Repairing shingles;
- Repairing stairs;
- Repairing stairway;
- Repairing steps;

- Repairing the roof of a building;
- Replacing broken glass;
- Replacing damaged building cornice;
- Replacing glass panes;
- Replacing areas of carpet that are worn or threadbare;
- Replacing part of ceiling;
- Replacing part of floor;
- Replacing retaining wall after collapse;
- Replacing wall damaged by demolition of adjoining buildings;
- Replacing wall with iron beam supported by iron posts to compensate for damage caused by use of heavy machinery;
- Replacing windows damaged by water leaks;
- Replacing wooden sidewalk supporting timbers to prevent collapse threatened by basement excavation;
- Replastering room;
- Resetting skylights;
- Restoring roof supports shifted by sudden sinking of filled ground and threatening collapse of building;
- Restoring underpinning of building built over canal caused by water damage;
- Resurfacing parking lot with same material;
- Resurfacing the roof of a building with materials that would last only one year;
- Scarifying road;
- Shoring up wall after foundation exposed by sudden river recession;
- Soil remediation and groundwater treatment to remove toxic waste and restore land to pre-contamination condition;
- Straightening steel window sash;
- Structural repairs to stop roof leakage;
- Survey to re-establish boundary after fence damaged by storm;
- Temporary electrical installation after fire;
- Temporary improvements to permit immediate use of new building to comply with forced sale of old building;

- Tree trimming;
- Tuck pointing the exterior walls of a building; and
- Whitewashing a building.

New Regulations. Neither your client, nor property management companies, are tax experts and, therefore, it should not come as a surprise that allocations between deductible repairs and capital improvements are difficult. On the one hand, the costs of repairs to property used in a trade or business are deductible when paid or incurred; on the other hand, it is difficult sometimes to discern the distinction between a repair and a capital expenditure. Unchanged under final regulations is that under Regulation Section 1.263(a)-1, no deduction is allowed for (1) new buildings or for permanent improvements or betterments; or (2) restoring property to add to the value, or substantially prolong the useful life, or to adapt property to a new and different use. However, the revised regulations vastly enhance the discussion, including providing a number of safe harbors. Under these guidelines, many of these decisions will remain unchanged and may be cited. For example, an expenditure made for an item which is part of a general plan of rehabilitation, modernization or improvement is capitalized, although the item, standing alone, may be classified as a repair. (Moss v. Com'r. (9th Cir. 1987) 831 F.2d 833.) Likewise, in Northwest Corporation and Subsidiaries v. Com'r. (1997) 108 TC 265, the Court held that the costs of asbestos removal must be capitalized under the plan of rehabilitation doctrine. The removal and rehabilitation were part of one intertwined project.

F. Real Property Taxes. Subject to the construction period exception, Section 164 allows a deduction for state, local and foreign real property taxes paid or incurred.

1. Cash Basis Taxpayers. A cash basis taxpayer is allowed a deduction for amounts actually paid during the year for real property taxes. If the taxpayer includes real property taxes are part of a mortgage payment, a deduction is allowed only in the year the taxing authority receives the money, not as and when the taxpayer remits the funds to the lender.

2. Accrual Basis Taxpayers. An accrual basis taxpayer must also await a deduction on accrued property taxes only when actually paid during the year for real property taxes. Thus, the accrual basis taxpayer is effectively put on the cash method. However, the taxpayer is allowed to make an election under Section 461(c) ratably to accrue real property taxes. This election may be made without Service consent for the first taxable year in which the taxpayer incurs real property taxes. A taxpayer may also choose to elect the "recurring item"

exception of Section 461(h)(3). Under this election, taxes are treated as incurred if the all-events test is satisfied, the liability is recurring, economic performance occurs (that is, payment is made) on or before earlier of the taxpayer filing its return or 8-1/2 months after the close of the taxable year, and either the amount is not material or will result in a better matching of income and deduction.

G. Environmental Cleanup Costs. With the enactment of environmental clean-up acts, real estate owners have become responsible for remediating different types of hazardous waste. Initially the treatment of these cleanup costs was generally thought to be deductible. (See Regulation Sections 1.162-4 and 1.263(a)-1.) However, the Service, in three Technical Advice Memoranda (See Ltr Ruls. 9240004 (June 29, 1992), 9315004 (Dec. 17, 1992), and 9411002 (Nov. 19, 1993), called for the capitalization of clean-up costs resulting in Congress enacting Section 198. While that section provides that taxpayers may elect to deduct certain "qualified environmental remediation expenditures" which would otherwise be capitalized, its provisions expired December 31, 2011.

Consequently, the analysis of these expenses has become complicated. While it appears under regulations that self-clean up is a regular expense, the remediation of prior owner contamination must be capitalized. Also, at issue is where ordinances change requiring clean up – a higher standard of operations and maintenance. Arguably there may be a position that clean-up such as to remove a substance no longer permitted on a premises may be deductible.

H. Insurance. Insurance premiums expended in connection with the taxpayer's trade or business are generally deductible in the year paid or incurred. This includes protection against fire, theft, accident or similar loss. However, payments that fund a reserve account of self-insurance are nondeductible because there is no deduction allowed for payments which the business believes will one day be necessary to spend. (Rev. Rul. 69-512, 1969-2 CB 24.)

I. Capitalized Interest and Taxes. For unimproved land held for investment, there is the option to either claim a deduction or to elect to capitalize interest, taxes, and other carrying charges (IRC Section 266). This election can be made annually by attaching a statement to the taxpayer's return indicating the items which the taxpayer elects to treat as chargeable to a capital account rather than to claim a deduction. The benefit of this election is that a taxpayer may avoid creating losses that may otherwise be limited by investment loss limitations while concurrently increasing the property's tax basis.

J. Administrative Costs – Multiple Properties. A frequent overlooked item is general administrative expenses relating to more than one property. While this may cover easily a computer, supplies and equipment used exclusively for the rental business, it would be difficult to extend the home office deduction as the taxpayer must establish that a trade or business is maintained. On the other hand, an overlooked item is the cost of an enrolled agent to prepare a summary of income and tax preparation relating to determining rental income. As a tax strategy, a reasonable portion of services may be allocable to a deduction on Schedule E rather than Schedule A.

K. Vacation Home Expenses. When a client reports rental income, it is important to remember to ask if there is any personal use. Special rules limit the amount of rental expense deductions that may be taken by an individual taxpayer on a residence that is rented out for part of a year and used for personal purposes during other parts of the year. (Code Sec. 280A.) If a personal residence is rented out for less than 15 days during the year, any rental income received is excluded from gross income and no rental expense deductions are allowed. (Code Sec. 280A(g).) However, if a residence is rented out during the year for more than 14 days, then the property will either be a personal residence (personal-use property) or rental property (which could provide a deductible loss subject to the passive loss rules).

A vacation home becomes a personal residence when its owner uses it "excessively." Excessive personal use is measured by greater than 14 days or 10 percent of the number of rental days. In that event, the dwelling will be a personal residence and rental losses are not deductible.

> Example: Edgar Agnes owned a condo in a resort area. During the year, he personally used it for 17 days, and it was rented for 100 days. Because he used the condo for more than either 14 days or 10 percent of rental days (10 days), the vacation home will be treated as a personal residence and losses will not be allowed.
>
> However, if in individual rents out a vacation home for more than 14 days and does not use it excessively for personal purposes, then it will be treated as rental property. If an individual actively participates in the rental real estate activity, then up to $25,000 of losses can be used to offset passive income.
>
> Example: Harvey Rents owns a vacation home in Palm Springs. Assume Mr. Rents rents out the home for less than 15 days during the year and uses it personally for more than 14 days. He receives rental income of $4,000. None of the rental income is reported on his income tax return, and no rental expenses are

deductible on his tax return. The mortgage interest and taxes of $20,000, however, are allowable.

However, in determining rental expense deductions, allocation formulas are used to segregate out personal use. For regular expenses allowable to all taxpayers, the Tax Court allocation formula is based on a full year (365 days). D.D. Bolton, 82-2 USTC §9699, 694 F.2d 556 (CA-9 1982). The IRS prefers to allocate regular expenses based on total usage of the residence. For other expenses. The allocation formula is based on total usage of the residence.

His expenses related to the home during the year are as follows:

Mortgage interest and taxes		$20,000
Utilities, maintenance and repairs		5,000
Depreciation		15,000
Total expenses	$40,000	

Example: Assume Harvey rents out the home for 25 days during the year and receives rental income of $10,000. He uses the home for personal purposes for seven days during the year. Under these assumptions, all rental income is recognized on Schedule E on his income tax return since the dwelling was rented out for more than 14 days. Because the residence will be treated as rental property (personal use was less than 14 days or 10 percent of rental days), losses are allowed. His rental income and rental expenses are computed as follows:

	Tax Court	**IRS**
Rental Income	$20,000	$10,000
Less: Mortgage interest and property taxes ($20,000 x 25 rental days/365 days a year) ($20,000 x 25 rental days/32 total use days)	 1,370 	 15,625
Less: Utility expenses, maintenance, and repair expenses, etc. $5,000 x 25 rental days/32 total use days)	3,906	3,906
Income or loss before depreciation	$4,724	($9,531)
Less: Depreciation ($15,000 x 25 rental days/ 32 total use days	11,718	11,718
Net Rental Loss	($6,994)	($21,249)

While the Tax Court method shows a smaller loss, the method may be more advantageous since interest and taxes are shifted to Schedule A (personal itemized deductions) so that fewer deductions are subjected to personal activity loss limitations.

L. Strategies for Deductions with Entities. For partnership trusts and S corporations, most of the planning considerations are done at an entity level.

1. Interest Deduction on Acquisition. An interesting strategy is available for partners and S corporation shareholders in entities owning real estate is to report interest expense on any loans incurred to buy their partnership/S corporation interest directly as an offset against Schedule E income. With respect to debt-financed acquisitions, partnership and S corporation shareholders may be better off than their C corporation counterparts. If the owners are materially participating, interest expense incurred may qualify as a trade or business deduction and be reported directly as an offset against that reported income. Furthermore, it seems that under Regs. Section 1.163 8T(j)(1)(i)(B), a reallocation of the interest expense to trade or business interest could occur merely by the election of S corporation status.

> Example: John Adventure purchased all of the stock of "The Realty Investor," an S corporation. For the 2004 year, The Realty Investor is expected to generate $70,000 of business income reportable on a Schedule K-1. Adventure will pay $27,000 of interest in 2004 to the SBA on this purchase. On the 2004 Schedule E, Mr. Adventure may be allowed to report as follows:

	Income	**Type**
Realty Investor (from K-1)	$70,000	P
Less: Acquisition Interest	(27,000)	

2. Interest Deduction Loans Between S Corporations and Shareholders – Self-Charged Interest. In August 2002, the IRS finalized regulations regarding the treatment of self-charged income and expense items for limitations on passive activity losses and credits in certain lending transactions involving S corporations and partnerships. The regulations address two types of lending transactions:

3. • Loans to a pass-through entity by the taxpayer(s), and

• Loans to the taxpayer(s) by the pass-through entity.

For purposes of these regulations, a pass-through entity is defined to include partnerships, S corporations and identically owned pass-through entities. The regulations apply to a taxpayer that has an indirect interest in an entity if the interest is held through one or more pass-through entities.

Generally, the regulations provide for the recharacterization of all or a portion of a taxpayer's share of self-charged interest income as passive so it can be offset by passive interest expense from the loan.

4. Special Elections. Partners may receive individual allocations that may also affect rental income on Schedule E in certain circumstances. For example, a partner may actually qualify to reduce his or her reported partnership K-1 income if there is a special allocation of depreciation to that partner due to both the partner's purchase of a partnership interest and a Section 754 election in the year of the partner's purchase.

M. Other Concerns.

1. At-Risk Rules. An investor's losses are limited to the amount at risk. In most cases, "at risk" is quite simple and just means the tax basis. An investor will not be considered "at risk" for any amount with respect to which he is protected against loss through nonrecourse financing, guarantees by third parties, stop-loss agreements or similar arrangements. However, for real estate a partner will be "at risk" for the amounts of "qualified nonrecourse financing." Qualified nonrecourse financing is money: (i) borrowed for a purpose related to holding real property; (ii) from a "qualified person;" (iii) for which no one is personally liable for repayment; and (iv) which is not convertible debt. A "qualified person" is a person regularly engaged in the business of lending money who is not related to the taxpayer, who did not sell the property to the taxpayer, and who did not receive a fee with respect to the investment in the property.

2. Passive Activities. In addition to the foregoing limits on deductions, Section 469 of the Code limits the deductibility of rental losses. Under Section 469, activities that are "passive" are not entitled to deductions for losses from that activity.

Passive activity loss limitations may apply to both rental income and partnership/S corporation income reported on Schedule E. Unfortunately, by statutory definition, passive activities generally include any rental activity for real estate. Therefore, losses generated from rental real estate, unless exempted, cannot be applied against any other types of income.

Although all rental real estate is deemed to be a passive activity, and losses are suspended, there are two exceptions. First, under a special rule, active participation in real estate management will permit the losses to be allowable up to $25,000 per year. Active participation does not require a minimum number of hours, but that the owner actively participate in managerial decisions such as who to rent to and what to repair. Second, for persons engaged in the real estate trade or business, i.e., brokers and developers, for at least 750 hours per year are not limited as to their losses. This second exception, while of limited use, is helpful to those whose business is real estate itself.

3. Single Activity Election. PLR 200409016, released February 27, 2004, illustrates that taxpayers wishing to qualify for the exemption for real estate business and avoid loss limitations under the passive activity loss rules may wish to elect to treat all rental real estate as a single trade or business. In order to show at least 750 hours of material participation, the election may allow all rental activities to be treated as a single business. The election must be made on an original income tax return for the year. A sample is as follows:

JOE REALTOR SSN 123-45-6789
ELECTION UNDER SECTION 469(c)(7)(A)

The taxpayer, ____________________, declares that he is a qualifying taxpayer and elects under Section 469(c)(7)(A) of the Code to treat all interests in rental real estate as a single activity.

N. Self-employment Tax – "No Worries" Man. While business income reportable on Schedule C is almost always subject to self-employment tax, a number of categories of income on Schedule E do not get taxed. These are important to know and the position for no self-employment tax usually falls into one of two categories:

1. If the owned interest is equivalent to a limited partner interest, self-employment tax should not apply;

2. If the income is considered to be "rental income," self-employment tax should not apply.

This reporting (properly) income on Side 1 of Schedule E is not subject to self-employment tax. However, reporting on Side 2 for income from partnerships requires further inquiry.

VII. LEASES.

A. Rent.

1. In General. Where real property is leased rather than owned, many of the same considerations discussed above will apply with respect to the use of real estate and determining what must be capitalized, amortized or deducted.

- Related parties. Rent paid to a related person must be reasonable to be deductible;

- Rent paid to cancel a business lease is generally deductible.

- Rent Paid in Advance. Generally, rent paid in your trade or business is deductible in the year paid or accrued. If you pay rent in advance, you can deduct only the amount that applies to your use of the rented property during the tax year. You can deduct the rest of your payment only over the period to which it applies.

  Example 1. You leased a building for 5 years beginning July 1. Your rent is $12,000 per year. You paid the first year's rent ($12,000) on June 30. You can deduct only $6,000 (6/12 x $12,000) for the rent that applies to the first year.

  Example 2. Last January you leased property for 3 years for $6,000 a year. You paid the full $18,000 (3 x $6,000) during the first year of the lease. Each year you can deduct only $6,000, the part of the lease that applies to that year.

- Canceling a Lease. You generally can deduct as rent an amount you pay to cancel a business lease.

B. Lease or Purchase. There may be instances in which it must be determined whether payments are for rent or for the purchase of the property. One must first determine whether the agreement is a lease or a conditional sales contract. Payments made under a conditional sales contract are not deductible as rent expense.

Because sometimes ownership is not straight forward, it is important to determine who has the incidents of ownership. Incidents of ownership include the following:

- the legal title to the property;
- the legal obligation to pay for the property;
- the responsibility to pay maintenance and operating expenses;
- the duty to pay any taxes on the property; and

- the risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion.

1. Conditional Sales Contract. Whether an agreement is a conditional sales contract depends on the intent of the parties. No single test, or special combination of tests, always applies. However, in general, an agreement may be considered a conditional sales contract rather than a lease if any of the following is true:

- The agreement applies part of each payment toward an equity interest;
- Taxpayer gets title to the property after making a stated amount of required payments;
- The amount taxpayer must pay to use the property for a short time is a large part of the amount you would pay to get title to the property;
- Taxpayer pays much more than the current fair rental value of the property;
- Taxpayer has an option to buy the property at a nominal price compared to the value of the property exercising the option;
- Taxpayer has an option to buy the property at a nominal price compared to the total amount to pay under the agreement;
- The agreement designates part of the payments as interest, or that part is easy to recognize as interest.

2. Leveraged Leases. Leveraged lease transactions may not be considered leases. Leveraged leases generally involve three parties: a lessor, a lessee, and a lender to the lessor. Usually, the lease term covers a large part of the useful life of the leased property, and the lessee's payments to the lessor are enough to cover the lessor's payments to the lender.

In general, Revenue Procedure 2001-28 provides that, for advance ruling purposes only, the IRS will consider the lessor in a leveraged lease transaction to be the owner of the property and the transaction to be a valid lease if all the factors in the revenue procedure are met, including the following:

- The lessor must maintain a minimum unconditional "at risk" equity investment in the property (at least 20% of the cost of the property) during the entire lease term;
- The lessee may not have a contractual right to buy the property from the lessor at less than fair market value when the right is exercised;
- The lessee may not invest in the property, except as provided by Revenue Procedure 2001-28;

- The lessee may not lend any money to the lessor to buy the property or guarantee the loan used by the lessee to buy the property;
- The lessor must show that it expects to receive a profit apart from the tax deductions, allowances, credits, and other tax attributes.

<u>Example</u><u>*: Third Party Holder*</u>. Nadia Dwight provided the down payment on the purchase of a senior care home. Because Nadia had no credit, her parents, Roy and Gina Dwight, took title and are the borrowers on the loan. Nadia reimbursed her parents for all taxes and mortgage payments and lists on her charts the amount as "rent". Nadia reports on Schedule C the interest as a deduction. While the facts are not clear, Nadia would probably be treated as the owner entitled to depreciation.

C. <u>Taxes on Leased Property</u>. If a taxpayer leases property, the taxpayer can deduct as additional rent any paid to or for the lessor.

1. <u>Cash Method</u>. Under the cash method of accounting, the taxpayer may deduct the taxes as additional rent for the tax year paid.

2. <u>Accrual Method</u>. Under an accrual method of accounting, taxpayers can deduct taxes as additional rent for the tax year in which they can determine all the following:

- Taxpayer has a liability for taxes on the leased property;
- The liability is known;
- That economic performance occurred.
-

<u>Example 1</u>. Oak Corporation is a calendar year taxpayer that uses an accrual method of accounting. Oak leases land for use in its business. Under state law, owners of real property become liable (incur a lien on the property) for real estate taxes for the year on January 1 of that year. However, they do not have to pay these taxes until July 1 of the next year (18 months later) when tax bills are issued. Under the terms of the lease, Oak becomes liable for the real estate taxes in the later year when the tax bills are issued. If the lease ends before the tax bill for a year issued, Oak is not liable for the taxes for that year.

<u>Example 2</u>. The facts are the same as in Example 1 except that, according to the terms of the lease, Oak becomes liable for the real estate taxes when the owner of the property becomes liable for them. As a result, Oak will deduct the real estate taxes as rent on its tax return for the earlier year. This is the year in which Oak's liability under the lease becomes fixed.

D. Cost of Getting a Lease.

1. In General. Taxpayers may either enter into a new lease with the lessor of the property or get an existing lease from another lessee. If taxpayer gets an existing lease on property he or she generally must amortize any amount he or she paid to get that lease over the remaining term of the lease. For example, if you pay $10,000 to get a lease and there are 10 years remaining on the lease with no option to renew, you can deduct $1,000 each year.

2. Commissions, Bonuses and Fees. Commissions, bonuses, fees and other amounts paid to get a lease on property in a business are capital costs. Taxpayers must amortize these costs over the term of the lease.

E. Improvements by Lessee. Improvements to leased property are depreciated using the modified accelerated cost recovery system (MACRS) over its appropriate recovery period. Lessees cannot amortize the cost over the remaining term of the lease. If taxpayer lessee does not keep the improvements when you end the lease, gain or loss will be based on the adjusted basis in the improvements at that time.

F. Capitalizing Rent Expenses. Under the uniform capitalization rules, taxpayers have to capitalize the direct costs and part of the indirect costs for production or resale activities. Indirect costs include amounts incurred for renting or leasing land. Generally, taxpayers are subject to the uniform capitalization rules if they do any of the following in the course of a trade or business or an activity carried on for profit.

- Produce real property for use in the business or activity;
- Produce real personal property for sale to customers;
- Acquire property for resale. However, this rule does not apply to personal property acquired for resale if your average annual gross receipts for the three previous tax years were not more than $10 million.

VIII. SALE OF REAL ESTATE.

Where real property is sold, a number of rules previously discussed above will apply. Namely:

- Unamortized loan fees and points may be written off;
- Property taxes must be prorated between buyer and seller;
- In determining gain, costs otherwise capitalized reduce the tax basis/gain in the property sold.