Income Tax-Saving Ideas for Industrial and Office Property Owners

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Legally, taxpayers are entitled to minimize their income taxes. This includes industrial and office real estate owners who have numerous opportunities to minimize or delay their federal income tax liabilities.

The choice of entity decision can have a significant impact on tax liabilities. Income and losses from limited partnerships flow through to the partners, resulting in a single level of tax at the partner level. In contrast, the income from regular C corporations is taxed twice, once at the corporate level and again at the shareholder level when the income is distributed as dividends. In addition, under certain circumstances, the limited partners may use partnership losses to offset their income from other sources in the same tax year. C corporations are limited to carrying back their losses two years and forward 20 years to offset only the C corporation's prior or future years' income.

Like limited partnerships, income and losses from S corporations flow through to the shareholders and are taxed once. Also, S corporation shareholders' losses may offset certain income from other sources. However, S corporations are not as flexible as limited partnerships for two reasons. First, mortgage loans on rental properties do not give tax basis to S corporation shareholders to deduct rental losses. Such "suspended" losses are carried over until the S corporations have net income to offset them. Second, unlike limited partnerships, S corporations cannot give special allocations or preferred returns to specific owners.

Determining Depreciation for Property, Assets, Improvements

Depreciation for tax purposes is based on Internal Revenue Code rules that mandate depreciable lives and methods. Industrial and office buildings are generally depreciated over a 39-year period, using the straight-line

method (i.e., 1/39th of the cost per year). Land is not depreciated or amortized, but if a building is on land that is leased (i.e., ground lease), the lease payments can be deducted. Land improvements are generally depreciated over a 15-year period, using either the straight-line method or the 150 percent declining balance method. The latter method increases the depreciation deductions in the first few years. Examples of 15-year land improvements are sidewalks, roads, docks, bridges, fences, parking lots, and landscaping.

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Certain assets that are not permanently affixed (tangible personal property) may qualify for a 200 percent declining balance depreciation over five or seven years. Seven-year property generally includes office furniture, fixtures, equipment, and personal property that do not fall into any specific IRS-asset class. Five-year property includes appliances, cabinets, shelves, window treatments, and non-weight-bearing and moveable walls.

Specific tenant improvements can be depreciated over a 15-year period using the straight-line method if placed in service prior to January 1, 2008. This provides a valuable opportunity to take larger depreciation deductions in the early years compared to the normal 39-year life generally applicable to tenant improvements. The 15-year period applies to tenant improvements made by a lessor or lessee pursuant to a lease agreement more than three years after the building was placed in service.

Benefits of Cost Segregation

Industrial and office property owners generally allocate the purchase prices and/or construction costs of their properties to land and buildings, the latter being a 39-year property depreciation rate for federal income tax purposes. However, cost segregation studies can be done on real estate acquisitions and construction projects to identify costs allocable to specific components that have shorter depreciation tax lives. This will increase depreciation deductions in earlier years of ownership. For example, a re-class of $100,000 of assets from a 39-year life to a five-year life would generate about $16,000 in net-present-value savings, assuming a five percent earnings rate on the tax savings and a 35 percent marginal income tax rate.

The IRS is more likely to accept a cost segregation study provided by an unrelated third-party professional who is an engineer, versus a study provided by the taxpayer, a CPA, or a non-engineer consultant. A local third-party consultant reported that nine recent clients saved tax dollars ranging from $19 to $73 for each dollar spent on his fees for cost segregation studies.

The landlord has an opportunity for a large tax deduction when a tenant no longer occupies its space and is no longer paying rent. Under certain circumstances, if the landlord has been depreciating the now-abandoned tenant improvements, the landlord may deduct the undepreciated abandoned tenant improvements as a loss on sale of rental real estate, which may be treated as an ordinary loss. The landlord can also deduct the unamortized tenant acquisition costs as an ordinary deduction.

When a Property Is Sold

Gains on sales of rental real estate are taxed at lower income tax rates than ordinary income. For property owned for more than one year, the tax is 25 percent of the real estate's accumulated depreciation and 15 percent of the remaining amount of gain. If there is a loss on sale, such a loss may be treated as an ordinary loss, which can offset ordinary income taxed at up to 35 percent.

Some taxpayers opt to defer paying income tax on the gain of the sale of rental real estate by exchanging it for "like-kind" property. Other taxpayers prefer to pay tax based on the current 25 percent and 15 percent tax rates described above because they believe Congress will increase those rates so that higher rates may apply to their eventual gains on sales of rental real estate in a later tax year.

Major Renovation or Incidental Repair?

A repair expense is a current-year deduction for the full amount incurred, whereas a capitalized improvement has to be depreciated over its applicable period (e.g., 39 years). Incidental repairs that neither materially add to the value of the property nor appreciably prolong its life, but keep it in ordinarily efficient operating condition, may be deducted as an expense. Repairs include repainting the inside and outside of buildings, repairing gutters or floors, repairing leaks, plastering, and replacing broken windows. Taxpayers need to be careful to segregate small repairs from major renovations by getting separate invoices for the small repairs and by documenting the reasons for such repairs.

Repairs, in the nature of replacements to the extent that they arrest deterioration and appreciably prolong the life of the property, must be capitalized and depreciated. If the replaced asset was removed, then the landlord may deduct the undepreciated replaced asset as a loss on sale of rental real estate, which may be treated as an ordinary loss.

The IRS and courts generally maintain that the replacement of all of the shingles or asphalt on a roof is a capital expenditure. But a replacement of a portion of a roof to stop a particular leak is a currently deductible repair expense. Nevertheless, the Tax Court has ruled several times that the replacement of a roof can be a deductible repair. Regarding one leaky roof, the Court noted that after numerous repair attempts had failed, the replacement of the roof merely kept the building in operating condition and did not significantly increase its useful life or value. Thus, taxpayers should consider whether their circumstances are sufficiently similar to claim a deduction for major roof repairs.

Here are a few more points to consider:

- Real estate professionals who satisfy certain requirements can escape passive activity loss limitations and use rental real estate losses to reduce earned and/or portfolio income.
- Certain rental agreements that satisfy certain requirements may, in the early years of a lease, allow landlords to recognize less income than payments received, while tenants deduct less rent expense than their payments made.
- A 10 percent tax credit is available for a substantial rehabilitation of a building for which depreciation is allowable and that was originally placed in service before 1936; a 20 percent tax credit is available for qualified rehabilitation expenditures of certified historic structures.
- Taxpayers may be eligible for a tax deduction of up to $1.80 per square foot for improving the energy efficiency of existing commercial buildings or designing high efficiency into new buildings, for qualifying property placed in service between January 1, 2006 and December 31, 2008.
- Refinancing of rental real estate can provide cash that is not taxed until the property is ultimately sold.
- A sale of rental real estate can be structured as a tax-free capital contribution to a partnership, thus deferring the tax due on appreciated property until it is sold.
- Cash distributions received by a partner within two years of contributing rental real estate can be taxed as a disguised sale of a portion of the rental real estate.

We strongly recommend that you consult a tax professional to assist with your planning and compliance with respect to these income tax savings ideas. We have significant income tax experience with real estate and other business clients, and we work with our clients on approaches that enable them to legally minimize federal and state income tax liabilities.

Note: *This article is intended as an overview and not in any way as legal advice. Before making any accounting decision, consult with your attorney, CPA, or other Accounting professional.*