

Real Estate *advisor*

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The tax man cometh, bearing gifts

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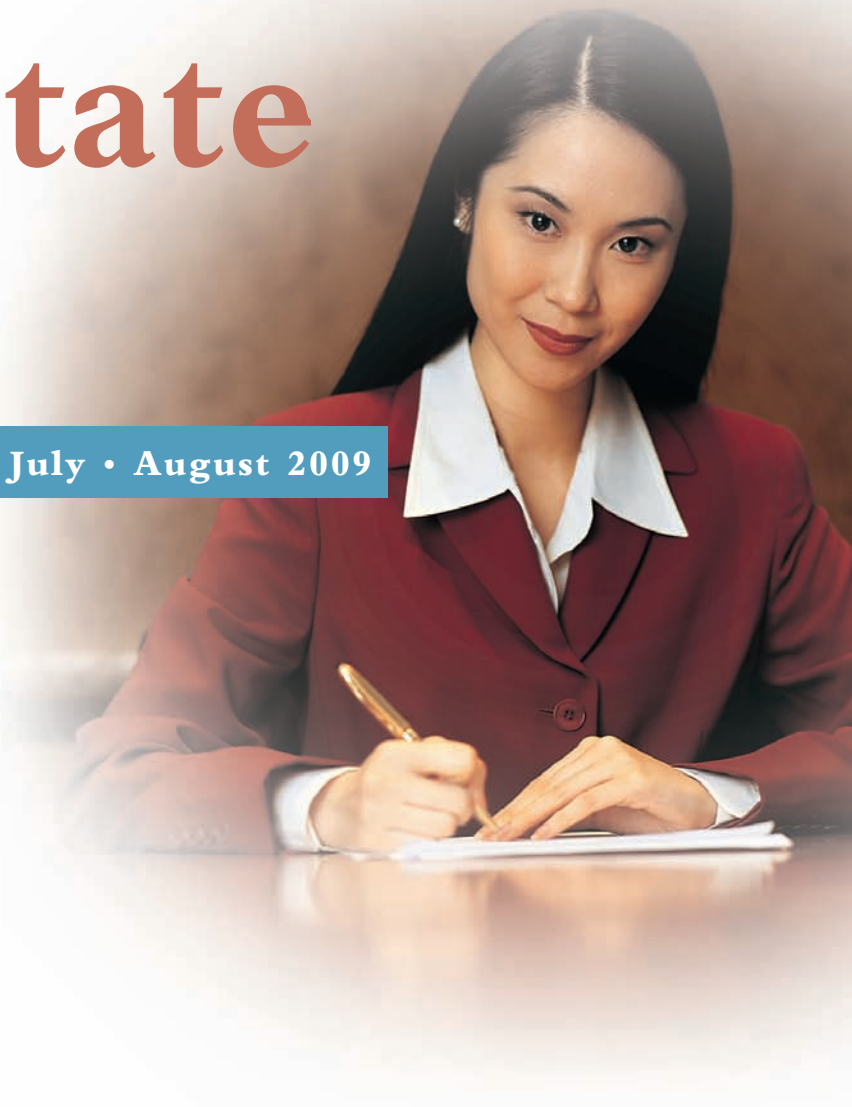
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and why are they so popular?



Elliott Davis

Accountants and Business Advisors

www.elliottdavis.com

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If all the bailout bills, budget proposals and credit crunch measures of the past year have left your head spinning, you're not alone! Deciphering the best tax strategies, which is always a challenge, becomes even more daunting when the tax laws are constantly shifting.

In the midst of all the changes, however, some of the old standbys have gotten a facelift which can greatly benefit real estate professionals. Let's see just what Uncle Sam has for you.

Leasehold and restaurant depreciation

Under the Emergency Economic Stabilization Act of 2008 (EESA), accelerated depreciation for leasehold and restaurant improvements is extended through 2009. The provision allows a shortened recovery period of 15 years — rather than 39 — for such improvements. And, new for this year, certain new construction for qualified restaurant property and improvements has been added to the list. (Depending on the categories, the improvements must be placed in service after year end 2007 or 2008.)

Section 179 expensing election

Internal Revenue Code Section 179 allows businesses to deduct the cost of certain capital expenditures — such as new equipment and furniture — in the first year of service, rather than depreciating them over time. The American Recovery and Reinvestment Act of 2009 (ARRA) extends the \$250,000 write-off opportunity through the end of 2009. This tax break begins to phase out dollar for dollar when total asset acquisitions for the tax year exceed \$800,000. You can claim the deduction only to offset net income, not to reduce it below zero.

Certain nonstructural components of a building can even qualify for Sec. 179 expensing. To find out if you could benefit, consider a cost segregation study. It identifies property components that can be depreciated faster than the building itself, increasing your current year deductions. Examples of assets that may qualify include decorative fixtures, wall and floor coverings, and security equipment.

50% bonus depreciation

ARRA also extends the 50% first-year bonus depreciation allowance for certain property acquired and placed



in service in 2009. This valuable deduction may be applied to tangible property with a recovery period of 20 years or less, computer software, water utility property, and qualifying leasehold improvement property. The break isn't subject to any asset purchase limits, so if you're ineligible for Sec. 179 expensing you can still take advantage of the bonus depreciation provision.

The cumulative effect of the Sec. 179 and 50% bonus depreciation tax breaks can be substantial. For example, a developer investing \$300,000 in qualifying nonstructural building components and furniture and \$100,000 in qualifying leasehold improvements during 2009 could potentially:

- Take an immediate Sec. 179 write-off of \$250,000 for the building components and furniture;
- Apply the 50% bonus depreciation provision to the remaining \$50,000 depreciable basis in the building components and furniture and to the \$100,000 of leasehold improvement property, for another \$75,000 write-off; and
- Apply regular depreciation to the remaining \$75,000 in basis (for still another write-off).

Consult with your tax or financial advisor to see how these tax breaks can work for you.

NOL carrybacks

If you're lacking the cash to invest in leasehold improvements now, don't worry: The tax man has provided a way for those suffering net operating losses (NOLs). For 2008 only, ARRA extends the maximum NOL carryback to five years for qualifying small businesses (those with an average of \$15 million or less in annual revenue over the three-year period ending with the tax year of the NOL). Any loss not absorbed in the carryback period is then carried forward for up to 20 years.

If you qualify for this benefit, carrying back an NOL and receiving a current tax refund can give your business a much-needed influx of cash.

Energy-related breaks

The depreciation provisions can be leveraged even further if your qualifying leasehold improvements or equipment purchases relate to making your buildings

“green.” That's because EESA extends (through 2013) a tax deduction for making commercial buildings more energy efficient. The deduction, though not directly tied to the cost of equipment or improvements, is set at \$1.80 per square foot of floor area for buildings achieving a 50% energy-savings target. (The savings must be accomplished through power cost reductions for heating, cooling, ventilation, hot water and interior lighting systems.)

In addition, ARRA includes an eight-year extension of the investment tax credits for expenditures related to solar energy, as well as breaks for wind (see below), geothermal and other alternative energy sources.

Window of opportunity

Remember: The tax man cometh and the tax man goeth. Don't miss the window of opportunity for taking advantage of as many of these tax breaks as you can in 2009. ■

The perfect windstorm



The rising costs of energy, the falling price of wind turbines and the lure of federal and state tax credits are all converging into a perfect windstorm that may inspire more building owners to make wind power part of their energy mix.

The Emergency Economic Stabilization Act of 2008 (EESA) provided a 30% investment tax credit to home- and business owners installing small wind systems with 100 kilowatts of capacity. This tax credit is available for wind power equipment installed between Oct. 3, 2008, and Dec. 31, 2016. The American Recovery and Reinvestment Act of 2009 (ARRA) has now uncapped the credit, making it even more valuable. ARRA also extended through Dec. 31, 2012, the income tax credit of 2.1 cents per kilowatt hour allowed for electricity production from utility-scale wind turbines. Plus, tax credits and Treasury Department grants are available to wind project developers through ARRA.

The net effect of these tax law provisions is to make small wind turbines more affordable and accessible. Many states have also implemented rebates for small wind-turbine installation. In addition to making wind power more viable for homeowners and small businesses, the provisions are expected to encourage utility companies to develop large wind farms.

Wind turbines are being installed on the rooftops of corporate headquarters, government structures, high-rise residential towers and even ski resorts. The Sugar Bowl Ski Resort in Truckee, Calif., is one of many ski resorts to turn to wind power. And Meijer's Thrifty Acres, a Midwest grocery chain, has committed to installing wind turbines on top of their stores.

Savvy building owners interested in the greening of America can benefit greatly by combining the investment tax credit with other available tax breaks, such as the Section 179 expensing election, the 50% bonus depreciation, and net operating loss carrybacks. (See “The tax man cometh, bearing gifts” on page 2.)

If you're considering installing a wind turbine, there are a few things to watch out for. Zoning issues can be a deterrent. Plus, wind turbines can create undue noise, endanger birds, attract lightning and mar an otherwise spectacular view. Even so, they're worth checking out. Just be sure to consider all the angles before moving ahead.

How to thrive in a tenants' market

As the deteriorating economy continues to impact the real estate market, landlords are taking a hit as rents continue to drop and vacancies go up in many real estate sectors. This is backed up by market research firm Reis, which predicts office rental rates will drop about 7.4% this year, and another 3.8% in 2010. Reis also expects office vacancy rates in the United States will reach 16.7% in 2009, and 17.6% in 2010.

Boosted by investor decisions to convert condo developments into rental units, apartment vacancy rates are on the rise as well. Meanwhile, foreclosed homes entering the market as rental units are taking a toll on the housing rental market, as investors who scoop up foreclosures choose to rent rather than sell in a down market.

Testing the “pain threshold”

With employment growth down and virtually all companies focused on cost reduction, office and residential tenants alike are testing the pain threshold of landlords in their search for the bottom of the market. Tenants with good credit and leases coming up for renewal are requesting — and in many cases getting — early renegotiation, lower rents, shorter lease terms and other concessions.

Property owners, for their part, are grappling with whether to succumb to market pressures to retain a tenant, or let them leave in hopes that others are just around the corner.

Let's make a deal

Despite the significant drift toward a tenants' market, the opportunity for deal-making still exists in tenant negotiations. Tenants requesting lower rents can be offered a rent reduction — bundled with a longer lease tradeoff. Tenants who have always been creditworthy in the past, but have now fallen on hard times, may merit discounted rental rates (which, in the end, may or may not be less than current market rates).

In lieu of rent reductions, amenity-related concessions also can be offered. Examples of such concessions might include free use of a gym or pool that would normally



carry a cost, or an upgrade to a more spacious apartment or one with a better view.

Some building owners, fearing that this summer's crop of college graduates will move in with their parents instead of into apartments, are even resorting to gift cards, one or two months of free rent, leasehold improvements, and moving allowances to lure in potential tenants. Some complexes are even offering a free month's rent upon lease renewal to tenants whose contracts are expiring.

Feeling the pressure

Even if asking rates haven't declined much in your particular market, it's likely you're feeling pressure to increase tenant incentives to secure new leases. There are some savvy steps you can take to nab those leases as you navigate through a difficult rental market:

Set a realistic price. Now, more than ever, you must be realistic on price. If your locality doesn't have the job growth necessary to sustain high rental demand, take that into consideration. Moreover, determine the price points for your particular class of property (and location) and set your rates accordingly.

Focus on finding quality tenants. It isn't enough to lower vacancy rates. You need tenants that have good payment histories, can afford to make security deposits and care enough to take care of the rental property.

Keep apartment complexes and rental homes in top-notch shape. Investors who milk a property dry by collecting rent but refusing to perform repairs will pay the piper sooner or later — either in reduced occupancy rates, lower rents or a deflated price when the property goes up for sale.

Facing the music

If you decide to sell a rental property in today's market, remember that, in the eyes of potential purchasers, vacancy equals risk. In contrast, a stable tenant base and higher occupancy rates signal a safer opportunity for potential investors.

With more job losses and a slowing market expected to continue in the foreseeable future, 2010 promises to be a challenging year for real estate investors. The winners will be those savvy enough to creatively out-negotiate, out-lease, and out-manage the competition. ■

7 signs your tenant is tanking

To avoid losing future rental income, property managers should be on the lookout for vital signs that a tenant may be tanking. Here are seven you should be aware of:

1. Late rent payments by formerly timely tenants,
2. Spending sprees (tenants on the brink of bankruptcy often have one last fling),
3. Rent concession demands,
4. Managerial shuffling,
5. Tax liens,
6. Persistent rumors about tight cash flow, spiraling debt, large balance sheet accruals or financial distress, and
7. Tight lips — tenants who used to talk freely may be hiding something.

LLC or LP: Finding the best fit

Limited liability companies (LLCs) and limited partnerships (LPs) are two of the most popular business entities for real estate investors today, and with good reason. By providing both tax and non-tax benefits, they achieve many investor goals. Both entity types benefit from pass-through federal income tax treatment, which, by avoiding the C corporation

dilemma of double taxation, effectively lowers the cost of capital. Pass-through entity status also allows investors to benefit from lower capital gains tax rates.

LLCs and LPs also allow investors to share asset ownership while still maintaining control. This feature is especially valuable in family situations — hence the popularity of family limited partnerships (FLPs).

Let's look at how you can determine which entity type will best fit your business.

Are you protected from creditors?

LLCs and LPs both provide liability protection for the members or partners involved. In most states, LLCs provide the same liability protection as corporations, but with much less red tape. All LLC members can actively participate in management without jeopardizing liability protection.

In contrast, LPs expose the general partner to liability from the partnership's creditors and other liability claims. And, although creditors who seize partnership interests may not be able to force liquidation of the partnership, the absence of liability protection for general partners is a major drawback.





Are there gift and estate tax benefits?

Due to the valuation discounts they generate, LLCs and LPs are good tools for gift and estate tax planning. For example, if your LP owns property worth \$500,000 and you own 50% of the partnership, your interest would generally be worth 15% to 40% less than the \$250,000 you'd receive if the partnership terminated and distributed its assets.

The IRS allows this discount because partnerships are somewhat illiquid. Because one partner generally can't force a partnership to terminate or distribute its assets and the market for partnership interests may be limited, separate partnership interests are worth less than their proportionate share of the partnership as a whole. The same discounted value rules apply to LLCs.

As a result, gifts of an interest in either entity type may benefit from a reduction in value for gift tax purposes. One caveat: As of this writing, legislation has been proposed that would limit the availability of valuation discounts in certain situations and thus could increase the gift tax cost of transfers of LP and LLC interests. (Check with your tax advisor for the latest information.) Also keep in mind that the more power you retain in the partnership or LLC (and the less power the recipient has), the smaller the value of the gift. While this may save gift tax, it can leave more value in your estate and thus result in greater estate tax liability. Finally, if an LP or LLC isn't properly structured and administered, there may be unexpected tax consequences.

What differences tip the scale?

Despite their similarities, there are some important differences between LPs and LLCs. On the tax side of the equation, limited partners in an LP are subject to passive loss limitations that prevent them from deducting property losses against other ordinary income. Managing members of an LLC, on the other hand, can avoid such limitations.

Although an LP will always be treated as a partnership for tax purposes, LLCs are tax "chameleons" in that they can choose to be treated as a partnership, C corporation or other entity type for federal income tax purposes. This has led many real estate investors to seek the best of both worlds by setting up an LLC that's treated as a partnership for federal income tax purposes.

On the down side, some states levy franchise or capital value taxes on LLCs. Franchise taxes may be based on revenue, profits, the number of LLC members, the amount of capital employed in the state or any combination thereof. Because a few states tax LLCs but not LPs, it's important to know the laws in your state — and the effect of any taxes levied — when selecting an entity type.

Also, while most states now allow LLCs to have a perpetual duration, perpetuity can be an issue. For example, if the consequences of member withdrawal aren't clearly spelled out in the operating agreement, an LLC could be involuntarily dissolved.

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Need help?

In the end, the best entity for holding your real estate investment will be influenced by a number of details, including the size of your portfolio, your source and type of income, the number of individuals involved, and applicable state laws. As always, get professional advice before making a decision with such long-lasting gift and estate tax consequences. ■

Ask the Advisor

What are short sales, and why are they so popular?

Short sales are a form of preforeclosure where a home sells for less than the mortgage amount. A homeowner facing foreclosure may benefit from a short sale because it reflects more favorably on the owner's credit report than does a foreclosure. When the numbers are right, banks also benefit from short sales, because they avoid the hassle and expense of foreclosure. A real estate investor purchasing through a short sale wins too, because it's getting a home at a discounted price.

Does the home qualify?

The fact that a homeowner is facing foreclosure doesn't necessarily make his or her home a good candidate for a short sale. Homes that likely won't qualify include those where:

The owner is involved in bankruptcy proceedings.

Negotiating a short-sale payoff is considered a collection activity, and collection activities are generally prohibited during bankruptcy proceedings.

The homeowner has substantial equity in the home. In such cases, the bank would be better off foreclosing on the property and selling it later with the hope of getting it at closer to retail value.

The home loan is government-insured. Because the bank is protected against foreclosure, it will have little incentive to do a short sale.



The best candidates for short sales are homes where the owner owes more on the home than the property is worth. The more “underwater” the mortgage, the more likely it is that the lender will consider a short sale.

How can you “win over” the bank?

Even with the above factors in place, short sales are never a given. Most investors who have profited from one short sale have also had other offers rejected. There are three steps you can take, however, to improve your success in short-sale negotiations:

1. Using the criteria above, determine whether the home you're interested in really is a short-sale opportunity.
2. Prepare a complete package for the mortgage lender, including a hardship letter from the homeowner, estimates for needed repairs to the property, an estimate of the property's market value, copies of the homeowner's tax returns, and a cover letter with your offer for the property.
3. If your initial offer is rejected, don't take “no” as the final answer — your offer may have been so low that the bank wouldn't net the amount needed to justify a short sale.

Banks also reject short sales if the investor's offer is much lower than the appraisal or Broker Price Opinion (BPO) the bank relied on. The lender may wait for a better offer, or it may think it would be much better off financially by foreclosing. Moreover, sometimes the homeowner doesn't prove sufficient hardship to justify a short sale, or the banker wants to explore alternative payment options with the homeowner first.

Learn the numbers game

In the end, short sales are really a numbers game. A true win-win situation for all is when the homeowner avoids foreclosure, the bank unloads a property without the hassle and expense of foreclosure, and you — the real estate investor — purchase a great property at a discounted price. ■



ElliottDavis

Accountants and Business Advisors

P.O. Box 6286 • Greenville, SC 29606 - 6286

In the real estate industry, the numbers are big and so are the risks. Poor timing, bad advice, even small oversights can have substantial consequences. Whether you're a developer or an investor, Elliott Davis' Real Estate Practice helps keep your business grounded.

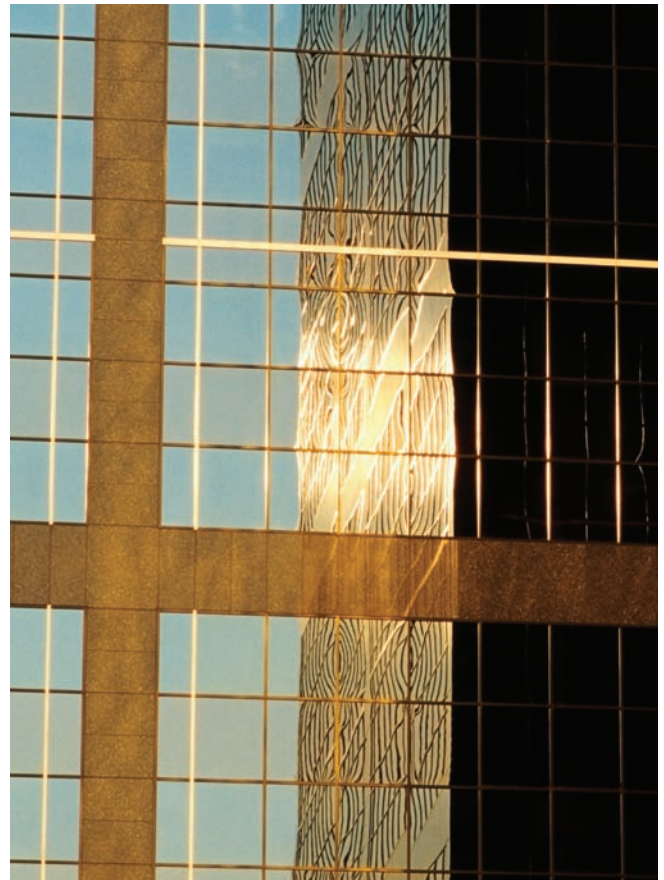
Our team puts its deep industry knowledge and experience to work for you with customized solutions based on your specific situation and requirements. With our network of locations throughout the Southeast we deliver personalized service wherever your business lands.

ACCOUNTING SERVICES:

Our team reviews your historical financial statements, evaluates trends, pinpoints strengths and weaknesses in your financial and operational business performance, and makes certain you're receiving the right kind of financial information to run your business and ensure tax compliance. We provide not only traditional credit, review compilation, and tax preparation services but also forecasts, projections and acquisition evaluation and accounting.

BUSINESS ADVISORY SERVICES:

Our Real Estate practice helps you consider and structure various alternatives to maximize return on investment. A sampling of our services include: 1031 exchange consulting, cost segregation studies, revenue recognition and cost allocation techniques, tax credits, and business entity planning and organization choice.



With offices located throughout the Southeast, members of the Elliott Davis Real Estate Practice can respond quickly to their clients' needs. Please contact us at 1-877-340-6802 to tell us your real estate goals and learn how we can help you achieve those goals, or visit us online at www.elliottdavis.com for more information.