



Real Estate Report

First Quarter 2011 Volume 6, Number 1



More Depreciation Options for Owners of Commercial Property

By: Brad Gai, Audit Stockholder

Leasehold improvements can be eligible for depreciation over a 15-year life. To better understand how, let's look at the example below.

Our building owner has a 3 story commercial building just outside the center of downtown which he/she has owned for 12 years and a single story building adjacent to the first building which is occupied by a restaurant. The ground floor of the 3 story building is occupied by a cell phone retailer. The second floor is occupied by an insurance agency, an attorney, and a psychologist, while an engineering firm occupies the third floor.

During 2010 the owner has made renovations to tenant space as part of lease renewals agreements. The modifications to the restaurant space include entry way replacement and interior wall changes as well as new hardwood flooring. The changes in the cell phone store space also required an entry way replacement and interior wall changes along with counter space construction. The second and third floor changes include upgrades to the internet wiring in the building and specific interior office wall changes for the third floor tenant.

The leasehold improvements described above are eligible for depreciation over a 15-year life. The election to write off certain assets under Internal Revenue Code (IRC) Section 179 has been extended to real estate that meets the definition of qualified real property (QRP). QRP includes qualified restaurant property, qualified leasehold improvement property, and qualified retail improvement property.

Qualified leasehold improvement property includes an improvement to an interior portion of nonresidential real property when the improvement was made pursuant to a lease; the lease does not involve a related party; the improvement is a structural component of the building (IRC Sec. 1250 property); and the improvement was made more than 3 years after the building was first placed in service. The following items don't

The most recent change to bonus depreciation is to increase the percentage to 100% for acquisitions after September 8, 2010 and before January 1, 2012.

count as qualified leasehold improvement property: enlargement of the building; elevator or escalator; structural component of a common area; or the internal structural framework of the building.

Qualified retail improvement property is defined in a manner similar to qualified leasehold improvement property when the property is open to the general public and is used in a retail trade selling tangible personal property. A leasehold improvement for a service business, such as a CPA Firm, would not qualify.

Qualified restaurant property includes a building or an improvement to a building if more than 50% of the space is used in preparation and serving prepared

meals. Many of the other limitations and qualifications listed for qualified leasehold improvements do not apply to qualified restaurant property improvements.

Normally the improvements described above would be considered structural components subject to depreciation over 39 ½ years. A 15-year depreciation recovery period has been available in one form or another since October 2004 for certain leasehold improvements. The law has extended this 15-year life to 2010 and 2011. However a taxpayer may write off up to \$250,000 of QRP under IRC Section 179 for 2010 and 2011. (The Sec. 179 limit is \$500,000 per year overall with an additional separate limit of \$250,000 for QRP)

Deductions under Section 179 are limited to net income generated from the property each year with a carryover of unused Section 179 deductions to the following year. A Section 179 deduction cannot generate a current year loss. There is an alternative planning opportunity if a building owner wants to generate a current year loss in order to use the net operating loss carry back provisions to recover taxes paid in a prior year.

The taxpayer can elect bonus depreciation on the qualified leasehold property made in the current year. (This does not apply to qualified restaurant property or qualified retail property) The bonus depreciation is 50% of the cost up to September 8, 2010 but it is not limited to income from the property. If the bonus depreciation and other deductions exceed income for the

continued on Page 2



Investor vs. Dealer Status in Real Estate Development Activities

By: John McGovern, Tax Supervisor

An entity actively engaged in the trade or business of development and sale of real estate creates ordinary income from its activities. Alternatively, real property owners engaging in investment activity may sell real estate using capital gains treatment resulting from the sale of an investment.

How does one determine whether the income resulting from the sale of real estate is capital or ordinary in nature? Court cases have been the primary source for determining what level of activity determines a trade or business in real estate development and hence the nature of the income.

The original case most often cited is *United States v. Winthrop*. In determining whether the gain from these sales was ordinary or capital in nature, the court relied on a series of facts and circumstances which it arranged into what have become known as the "Winthrop Factors."

Subsequent court cases have segregated this list into 9 factors, listed in importance, from 1 to 9.

1. The purpose for which the property was initially acquired
If the property was originally acquired for investment purposes, this helps the argument for investor status.
2. The purpose for which the property was subsequently held
Changing the use of property to an active business purpose is a mitigating factor against investor status.

3. The extent of improvements made to the property
Generally, property improvements indicate dealer status. Those required by local law solely to subdivide property are an exception.
4. The number and frequency of sales over time
A continued pattern of sales activity is common for a real estate dealer.
5. The extent to which the property has been disposed
The more sales (disposals), the less probable that investor status will be recognized.
6. The nature of the taxpayer's business, including other activities and assets
Related real estate businesses owned or engaged in by the taxpayer indicate dealer status.
7. The amount of advertising and promotion, either directly or through a third party
These are considered typical activities of a real estate dealer.
8. The listing of the property for sale through a broker
This is more typical of a real estate investor.
9. The purpose of the held property at time of sale

While this is significant, the taxing authorities are looking closely for recently converted use in anticipation of sale.



Ask the CPA

by: Larry Mar, Principal

Can we cause a reassessment of an apartment building that has a current value less than the assessed value? The real property was purchased in June, 2007 by the partnership owned 50% each by my brother and me.

A change of ownership of real property will cause a reassessment of the real property. For partnerships that purchased the real property, a change of ownership of real property occurs when one person acquires more than a 50% ownership of the partnership. If you purchase a 1% partnership interest from your brother, you will own more than 50% of the partnership which is a change of ownership of the real property. The reassessment is mandatory, whether the adjustment is an increase or a decrease. And the change to the assessed value will most likely occur sooner than a decrease to the assessed value based on a protest. Please check with a RINA professional.

More Depreciation Options for Owners of Commercial Property continues from page 1

year, the property can generate a loss that may qualify for a carry back to recover taxes paid in a prior year. The most recent change to bonus depreciation is to increase the percentage to 100% for acquisitions after September 8, 2010 and before January 1, 2012.

The Section 179 expense election and the bonus depreciation election also apply for alternative minimum tax (AMT) calculations. So there are no AMT adjustments required by electing to use either the bonus depreciation rules or the Section 179 expensing rules. California does not conform to the Federal tax law for bonus depreciation or Section 179 expensing with respect to qualified leasehold improvements.



accountancy corporation

Established 1946 • www.rina.com

Member of MGI

475 14th St., Suite 1200, Oakland, California 94612 / (510) 893-6908 / FAX: (510) 834-1522 / 1-800-RINA CPA

3200 Douglas Blvd., Suite 100, Roseville, California 95661 / (916) 771-3000 / FAX: (916) 771-3252 / 1-800-570-0272

1220 Oakland Blvd., Suite 300, Walnut Creek, California 94596 / (925) 210-2180 / FAX: (925) 210-2199

100 Montgomery St., Suite 2075, San Francisco, California 94104 / (415) 777-4488 / FAX: (415) 777-0680

The RINA Real Estate Report is published quarterly by RINA accountancy corporation for clients, employees and associates.

Any tax advice contained in the body of this newsletter was not intended or written to be used, and cannot be used, by the recipient for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions.