Your Future is Our Focus

RINA
accountancy corporation

Real Estate Report

3rd Quarter 2017 Volume 12, Number 3

1031 Exchanges and Bonus Depreciation

By: Jeff Curtis, Manager

1031 Exchanges are mainly used for the benefit of deferring the taxable gain from the sale of real estate. By deferring the taxable gain, the taxpayer has more money to reinvest. When 1031 exchange is combined with bonus depreciation, the tax savings increase as bonus depreciation allows a 50% deduction on the new assets. However, for bonus depreciation to apply in a 1031 exchange certain circumstances must be met along with additional considerations for the taxpayer. In order to understand the benefits of using bonus depreciation, you must first qualify for a 1031 exchange and the assets placed in service on the replacement property must also qualify for bonus depreciation.

In the world of real estate, a 1031 exchange is common consideration when a property owner wants to sell their property and purchase a new one. Generally speaking, the gain on the sale of the first property reduces the cost of the new one, deferring any tax that would normally be owed. One of the many complexities in qualifying for a 1031 exchange is that the replacement property must be like-kind. For real estate, this means that the replacement property can be commercial, residential, or land. In order for bonus depreciation to apply, we have to understand the qualifications necessary to take a 50% deduction.

The America's Small Business Tax Relief Act of 2014 created a special depreciation allowance known as bonus depreciation. The bonus depreciation is a 50% deduction for assets placed in service during the tax year. The general rule is that the asset placed in service must be the original use of the asset and the asset must have a depreciable life of 20 years or less. These two qualifications often preclude real estate from being eligible for bonus depreciation because the life of a building or residential unit is greater than 20 years and the building must be newly constructed. This is where a cost segregation study can be an effective tool for tax planning. In a cost segregation study the asset of the building, for example a 39 year asset, can be broken down to the structural components and depreciated over 39, 15, 7 and 5 years. While the 39 year portion of the building is not eligible, the 15, 7 and 5 year life assets will qualify for bonus depreciation. If the building is not newly constructed there still may be assets in the purchase that are original use, i.e. leasehold and tenant improvements. Bonus depreciation is also elective, meaning that it is optional each year.

The combination of the 1031 exchange along with bonus depreciation can be very effective for tax planning. The tax deferment of the 1031 combined with the 50% deduction on the non-building assets can save a large amount of tax. It is important to keep in mind that the cost basis of the new property will be reduced by the gain of the sold property, thus reducing the amount of available bonus depreciation. However the tax savings along with the time value of the money spent makes taking the bonus depreciation worth the reduction in basis. There are a lot of qualifications and special rules for both 1031 exchanges and bonus depreciation so it is important to know all of the facts and circumstances of your situation to see if either applies.

6th Annual Real Estate Advice Series

Ask the Experts Luncheon

Wednesday, August 9, 2017
11:30 am to 1:30 pm

Scott's Seafood Restaurant
1333 N. California Blvd.
Contra Costa Room
Walnut Creek

Our Speakers
Teresa Moss Fluegel, Sr. Vice President CDEC
Ray Evans, RINA Stockholder
Tim Tikalsky, RINA Stockholder

RSVP: www.rina.com/rsvp/aug-9-17

For More Information, Contact Amanda Vergara
(925) 627-2829 or at avergara@rina.com

Growing Rental Housing in California is a Tough Bet Without a Reality Check on Policy

By: Jill Broadhurst, Executive Director, East Bay Rental Housing Association

As the state of California grapples with a very obvious housing shortage; cities have been very busy implementing their fix to local individual housing problems. The million dollar question is: do these new add-on ordinances help the current shortage, add new units, or encourage the prospect of building more projects within a realistic financial plan?

In rent controlled cities like Oakland, Richmond, Alameda, and Berkeley, the general understanding of rent control only touches a surface layer, in what is a very complicated web of price controls and restrictions that make it difficult for any owner to navigate without assistance. Oakland, for example,which has older, rent-controlled construction as the bulk of its inventory, has experienced, at a micro level, a unique and critical set of circumstances. The local ordinances, which dictate annual allowable rent increases for established residents are level one, with subsequent levels going into newly created programs, or astronomically increased annual fees, that provide detailed tenant protections, which restate much of what has existed in state laws for years but add onerous gray areas that entrap rental property owners with high legal fees.

With the inventory of housing in Oakland being primarily older units, owned by smaller property owners who are into their second or third generation of ownership, it paints a bleak story. The fear that current rules entrap those owners who are, in good faith and majority, doing the right thing, making the right choice is very real. As an owner, you are on your own, and the playbook reads that renters receive city assistance tapping into local and state funds.

For someone to have the opinion that all these restrictions will not hamper new construction is misguided. A city that restricts, and unfairly holds a bias against rental property owners, who indeed do provide a service, and if in rent controlled jurisdictions, provide the only means for affordable housing, really need to be understood and acknowledged. Further a city that implements price restrictions without creating a criteria of qualifiers like income, but solely bases it on length of tenancy never serves the most needy just the lucky. At some point this scenario is unsustainable and it comes at a cost to all.

Cities carry much of the regional responsibility in ensuring units are built and meet the needs of the growing population, however many of these annual reports issued by paid consultants, are put on a shelf and forgotten. And we are back to the same set of solutions that include restriction on all properties that are built before a certain year. Fairly short sighted and this mindset does not even touch on the lack of inventory as a whole.

What is required is a hard look by our local and state legislators at the current state of housing, and advocating for metrics and baselines. Cities should not be allowed to further restrict and penalize private property owners if they have not done their share of solving the housing shortage. Let us hold our cities accountable for contributing in solving this housing shortage, force them to address why the picture isn't any brighter with the policies and fee structures they have supported and passed. Surely, over 30 years of restrictions is plenty of time to evaluate the success of current policy.

The legislative goal of California and local municipalities should detail the future of where we want to be as a state or city, support ideas for the greater good not the smaller few, and preserve the success and future of all residents and businesses.

Lease Termination Payments

By: Kelly Creed, Manager

With rents and property values increasing at a rapid rate, landlords are looking for ways to increase rents when locked into long term leases — one method has been to buy out their current tenant leases in order to fill the lease with new tenants at current market rates.

How is this lease termination payment treated by the tenant receiving the payment? The tax treatment is not always obvious. In some cases the tenant can receive favorable capital gain treatment on the lease buy out. Sec 1241 - states that amounts received by a lessee for cancellation of the lease shall be considered as amounts received in exchange for such lease or agreement. Therefore if the lease is a section 1231 asset, the tenant could recognize the lease termination income as capital gain. Generally a lease held for use in a tenant's business is considered section 1231 asset. However in order to receive this treatment the tenant would need to have had the lease over a year and give up all ownership rights to the leases - meaning subleases or other rights of re-entry would not qualify the tenant for capital gain treatment.

How is the treatment to the landlord? It depends on the reason the landlord paid the tenant to vacate the space before the end of the lease.

When a landlord terminates a lease to make the space available to a new tenant — the landlord should amortize the payment over the life of the old tenant's remaining lease. If the landlord is terminating a lease in anticipation of selling the building — the landlord should add the termination payment to the cost of the building. If the payment was required to vacate the space due to build out, the termination payment should be added to the capitalized cost of the improvements.

If you are considering buying or selling a lease please contact your RINA representative for more information.

RINA accountancy corporation

Established 1946 • WWW.RINA.COM • Member of MGI • 1-800-RINA CPA

475 14th St., Suite 1200, Oakland, California 94612 • (510) 893-6908 • FAX: (510) 873-0977
625 Market Street, 15th Floor, San Francisco, California 94105 • (415) 777-4488 • FAX: (415) 837-1260
201 North Civic Drive, Suite 220, Walnut Creek, California 94596 • (925) 210-2180 • FAX: (925) 210-2190