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Real Estate Report

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Depreciation for Trusts Invested in Real Estate Partnerships

By: Sally McColloch, Principal

With interest rates at historic lows and a gyrating stock market, many trustees have turned to real estate as an investment vehicle. While the potential for appreciation and steady income may be appealing, there are certain traps that a trust faces in owning depreciable assets such as rental real estate. This article discusses one of those traps facing a trust which invests in a partnership or limited liability company which owns rental real estate – the treatment of the deduction for depreciation and the requirement that the partnership separately state this expense apart from rental income.

In general, partnerships and S Corporations are required to separately state all income and expense items on the K-1 form if the tax treatment relies on the situation of the of the owner/partner. It is due to this rule, for instance, that the deduction arising from the IRC Sec 179 expensing election is required to be shown separately – the ability to take advantage of the deduction depends on the partner's tax situation and net income, not that of the partnership. For individuals which are partners in a partnership which owns rental real estate, there is usually no difference in how rental income and the direct expenses such as depreciation are treated on their tax returns – therefore, rental income is usually shown net of depreciation expense on line 2 of form K-1.

However, in the case of trusts and estates, depreciation itself can change the taxable income of a trust. This is due to the way the Internal Revenue Code requires depreciation to be allocated between a trust and its beneficiaries. As a result, a partnership is required to separately state, apart from the rental income, any depreciation expense on any K-1 for a trust or estate partner.

For example, take Trust T. Trust T is a limited partner in a partnership which owns rental real estate. The trust has one beneficiary. The partnership passes through to Trust T \$5,000 of rental income and \$1,000 of depreciation expense. The trust has distributed \$3,000 to the beneficiary. For purposes of this example the partnership has distributed \$5,000 to Trust T, and the accounting income of the trust equals that amount.

On the face of it, it would appear that Trust T has \$4,000 of net income, with \$3,000 being reported on form K-1 and taxable to the beneficiary (as reflected by total distributions) while the remaining \$1,000 would be taxable to the trust. However, due to the application of the rules related to the calculation of trust income, this would be incorrect. The trust is required to allocate the depreciation expense to both the trust and the beneficiary. In this example, the \$1,000 of depreciation expense should be allocated 60% to the beneficiary (\$3,000 distribution received by the beneficiary, divided by the \$5,000 of trust income before depreciation) and 40% to Trust T. As a result, the Trust T K-1 will show \$3,000 of income taxable to the beneficiary, \$600 of depreciation expense passed out separately to the beneficiary (60% of the \$1,000 depreciation expense) resulting in net taxable income to the beneficiary of \$2,400. The taxable income of the trust would be \$1,600 (\$5,000 rental income less \$3,000 distribution less \$400 depreciation).

This potential problem could lead to possible unforeseen tax burdens for trusts. In practice, most partnerships do not separately state depreciation for their estate or trust partners. In the case of large partnerships, the partnership itself may not even be aware that their partners include any trusts. And trusts, given their accounting rules which differ significantly from those of business entities, it may be near impossible for a real estate partnership to determine the tax effect of separately stating depreciation expense.

This is a very nuanced and tricky area of tax law. With more and more trusts acquiring depreciable assets, either through direct ownership or via investment in partnerships and other business entities, there must be careful consideration of the possible tax consequences. The tax professionals at RINA are here to help guide you through these decisions and to find the ownership structure most beneficial to your unique situation.

Potential Tax Trap in Seller Carry-back Financing of a Principal Residence

By: Brad Gai, Stockholder

The seller can exclude a portion of the gain on the sale of a principal residence if the seller meets certain minimum requirements. The main requirements are an ownership test and an occupancy test. The seller must own the principal residence for at least two years and the seller must have occupied the residence for at least two out of the five years prior to the sale. This allows the seller to rent the property for a portion of the time prior to the sale. The gain that can be excluded from income is up to $500,000 for a married couple or $250,000 if the owner is single.

The current market conditions in the Bay Area make it unlikely a seller will provide seller financing as an inducement to sell their property. There may be situations where a seller may consider providing seller financing, especially if the property has some issues that make conventional financing difficult to obtain.

A court case decided in the Court of Appeals 8th District dealt with a taxpayer well outside of the Bay Area (DeBough). The 8th District covers Nebraska, Iowa, and states in the central part of the United States. The Bay Area is in the 9th District. The taxpayers sold their home in 2006 on a seller carryback financing on the sale of their home. The taxpayer was qualified to exclude $500,000 of the gain and they used the installment sale treatment to report the taxable portion of the gain on sale. The total gain was $657,796. The taxpayer collected $505,000 on the installment note over the years 2006 to 2008. Taxpayer reported $56,920 as taxable gain and $448,080 was excluded as part of the $500,000 exclusion from gain on sale of principal residence.

Everything was fine up to this point. The buyer ran into some financial difficulty in 2008 / 2009 and stopped making payments. The court case does not comment on the economy and drop in real estate values across the nation in 2009 but I think it is safe to assume this played a factor in this case. The seller reacquired the property near the end of July, 2009. There is a provision in the Internal Revenue Code that provides tax relief for a seller that finds themselves with reacquisition of property. If the seller is able to sell the reacquired property within one year, the subsequent sale will be considered part of the original transaction and the exclusion on gain from sale of principal residence will be preserved.

Unfortunately for this taxpayer, they did not resell the property within a year. The tax consequence was loss of the exclusion of gain on the sale of principal residence of $500,000. As a result, the taxpayer was taxed on the entire $505,000 of receipts they had received on the installment note.

A homeowner can combine the exclusion from gain on the sale of their residence with the tax benefits of an installment sale to stretch out the recognition of taxable gain. If there is a default on seller carryback financing, seek tax advice on the implications to avoid a tax trap for the unaware.

The De Minimis Safe Harbor for the Purchase of Tangible Property Increased for 2016

By: Jamshed B. Gandi, Principal

The Tangible Property Regulations that were issued recently, had provided for a safe harbor of $500 in expensing of personal property, in the year of purchase. Just recently, the IRS in Notice 2015-82 increased the limit to $2,500 per item. This was after receiving substantial feedback from the public as to the need for an increment of the amount, considering that very few items cost $500 or less, such as computers etc, thereby increasing the burden of record keeping.

For Businesses with an applicable financial statement (e.g. audited financial statements) the safe harbor remains at $5,000, as in the previous year.

The new Safe Harbor amount of $2,500 will be applicable for tax years beginning on or after January 1, 2016. However, the IRS has indicated it will not question this higher amount for returns, under audit for tax years beginning after December 31, 2011 and ending before January 1, 2016.

This is a welcome change to the earlier imposition of the $500 threshold, as it will provide taxpayers with the impetus to purchase items providing them with instant deductions in the year of purchase, and furthermore, eases the need for keeping records related to the depreciation of such assets in future years. However, records on these assets will continue to be neccessary for personal property tax purposes.

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