



REAL ESTATE INDUSTRY

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Wipfli Tax Update 2021

- Topics to be covered:
 - ▶ Classifying the Expenses of a Real Estate Holding Company
 - ▶ Sec. 1031 – Definition of Real Property in Final Regulations
 - ▶ Opportunity Zones – Business Perspective
 - ▶ Opportunity Zones – Investor Perspective
 - ▶ Real Property Taxes – Timing of Deduction

Classifying the Expenses of a Real Estate Holding Company

- Common ownership structure for rental real estate
 - ▶ Upper tier partnership (UTP)
 - This is a partnership or LLC that holds an equity interest in a lower tier partnership, referred to as a real estate holding company
 - ▶ Lower tier partnership (LTP)
 - This is a partnership or LLC that actually owns the rental real estate
 - ▶ Tiered partnership
 - An entity structure that consists of at least one UTP and one LTP
- Issue: What is the proper tax treatment of expenses that are incurred by the UTP
 - ▶ Sec. 162
 - ▶ Sec. 212

Classifying the Expenses of a Real Estate Holding Company

- Sec. 162 expense
 - ▶ Ordinary and necessary expenses incurred in carrying on a trade or business
 - Trade or business = if the primary purpose for engaging in the activity is for income or profit, and the taxpayer is involved in the activity with continuity and regularity
 - ▶ Deductible against the gross income of that trade or business
 - ▶ In the case of a tiered partnership, each partnership must be treated as a separate and distinct entity when determining whether the expenses are incurred in carrying on a trade or business
 - Thus, the activities of the LTP (the rental of real estate) cannot be attributed to the UTP

Classifying the Expenses of a Real Estate Holding Company

- Sec. 212 expense
 - ▶ Expense incurred for either:
 - The production or collection of income
 - The management, conservation, or maintenance of property held for the production of income
 - ▶ Commonly referred to as investment expenses and generally reported as miscellaneous itemized deductions
 - Allowed only to the extent the sum of all miscellaneous itemized deductions > 2% of AGI
 - TCJA suspended miscellaneous itemized deductions for tax years 2018 – 2025
 - ▶ A special exception under Sec. 62(a)(4) allows Sec. 212 expenses to be deductible against gross income, rather than as a miscellaneous itemized deduction, if they are attributable to property held for the production of rent or royalties
 - ▶ As was the case under Sec. 162, each partnership must be treated as a separate and distinct entity when determining whether the expense was incurred for the production of income

Classifying the Expenses of a Real Estate Holding Company

- Expenses incurred by the UTP related to its own activities
 - ▶ Examples: fees for maintaining the UTP's books and filing income tax returns for the UTP, fees for managing the UTP, etc.
 - ▶ Sec. 162 analysis
 - It would be extremely rare for a UTP that exists only to hold LTP interests to meet the requirements of being a trade or business (remember, no attribution between UTP and LTP)
 - ▶ Sec. 212 analysis
 - The UTP's expenses would also not meet the requirements of the Sec. 62(a)(4) exception under Sec. 212, since the expenses the UTP incurs related to its own activities are attributable to the holding of partnership interests, and not attributable to rental real estate property (remember, no attribution between UTP and LTP)
 - Therefore, these expenses should be separately reported as portfolio deductions subject to the 2% limit on Sch. K and K-1

Classifying the Expenses of a Real Estate Holding Company

- Expenses incurred by the UTP related to the LTP's activities
 - ▶ Examples: fees for maintaining the LTP's books and filing income tax returns for the LTP, fees for managing the LTP, etc.
 - ▶ It is implicit in the Code that a taxpayer generally may not deduct the expenses of another taxpayer
 - ▶ Therefore, the UTP generally has only two options with respect to their payment
 - Request reimbursement from the LTP and the LTP then claims the deduction under Sec. 162
 - Treat the payment as an additional capital contribution, adding the amount to the UTP's tax basis in its ownership interest in the LTP

Classifying the Expenses of a Real Estate Holding Company

- Expenses incurred by the UTP related to the LTP's activities (continued)
 - ▶ Exception: If the expenses meet the requirements of Unreimbursed Partnership Expenses, the UTP can deduct the expense on Form 8825 (where rental real estate income is reported)
 - ▶ Unreimbursed Partnership Expenses must satisfy all three of the following requirements:
 - An amount paid by a partner
 - On behalf of a partnership
 - Either
 - The partnership/operating agreement contains a provision that specifically requires the partner to pay the expenses without the possibility of reimbursement
 - It is the partnership's unwritten policy that the partner pays the expenses without the possibility of reimbursement (email from tax matters partner or BBA partnership representative confirming this policy should be put in client file)

Sec. 1031 Definition of Real Property in Final Regulations

- TCJA restricted the like-kind exchange income tax deferral opportunity provided by Sec. 1031 to real property
 - ▶ Personal property and intangible property no longer eligible under Sec. 1031
- Proposed regs
 - ▶ Definition of real property for Sec. 1031 = specifically excluded reliance on the applicable state and local law definition of real property
 - ▶ Excluded property that contributed to the production of income that was unrelated to the use or occupancy of the space (the “purpose or use test”)
 - ▶ Clarified definition of incidental personal property and implications of incidental and nonincidental personal property being included as part of the exchange (covered in 2020 Tax Update)

Sec. 1031 Definition of Real Property in Final Regulations

- Final regs

- ▶ Definition of real property for Sec. 1031 = specifically relies upon applicable state and local law definition of real property (and several other minor tests for unusual type properties)
 - Which state?
 - The state where each of the properties is located
 - Which state definition?
 - Property tax, sales tax, transfer tax, or income tax apportionment purposes?
 - IRS' unofficial answer – “We would interpret that in the taxpayer’s favor – that by meeting any one of those definitions you have real property for state law purposes”
- Eliminated the “purpose or use” restriction
- Did not change the definition and implications of incidental personal property contained in the proposed regs

Opportunity Zones – Business Perspective

- An investment in a qualified opportunity zone fund (QOFs) can provide significant tax deferral and reduction benefits for the investing taxpayer
- But QOFs can also be a significant source of capital investment into qualified businesses (both operating and real estate) that are located in an opportunity zone (QOZBs)
- The key to making sure that investors and qualified businesses can take advantage of these benefits, there are very specific testing requirements for both the QOF and the QOZB
- Therefore, each associate who encounters one of these entities should:
 - ▶ Include someone from Wipfli's OZ team on the initial setup of the entity
 - ▶ Have an annual specialty review of the resulting tax returns in both the year of creation and all subsequent years

Opportunity Zones – Business Perspective

- QOFs

- ▶ QOF qualification test

- Must hold at least 90% of its assets in qualified opportunity zone property
 - Test occurs every 6 months and results are reported on a Form 8996 included with annual return

- ▶ Implications of failing the test

- Monthly penalty
 - Exceptions available
 - Reasonable cause
 - Grace period allows exclusion of cash and cash equivalents contributed within 6 months prior to the testing date
 - Temporary Covid relief waives penalty if the last day of the 6-month testing period or last day of tax year falls between 4/1/20 and 6/30/21

Opportunity Zones – Business Perspective

- QOZBs

- ▶ At least 50% of total gross income derived from the active conduct of a trade or business in the OZ
 - 3 safe harbor tests and a facts and circumstances test
 - Leasing real property can be considered an active trade or business, but not a triple net lease
- ▶ At least 70% of the trade or businesses' tangible property, owned or leased, is qualified “opportunity zone business property”
 - Acquired after 12/31/17
 - Purchased from an unrelated party (20% standard applies)
 - Original use of property must commence with the QOZB or “substantial” improvements must be made to the property (i.e., double tax basis in the asset, excluding land cost)

Opportunity Zones – Business Perspective

- QOZBs

- ▶ Less than 5% of the average aggregate unadjusted basis of its property is attributable to “nonqualified financial property”
 - Nonqualified financial property – cash and equivalents, stocks, debt, partnership interests, etc.
 - Working capital exception – written plan, written schedule for expenditure of working capital assets within 31 months of receipt, actual expenditure is consistent with that schedule
- ▶ A minimum of 40% of its intangible property is part of the active conduct of a trade or business in the OZ
 - Not generally applicable to a rental real estate business
- ▶ It cannot conduct a “sin” business
 - Golf course or country club; massage parlor, hot tub facility, or suntan facility; racetrack or other gambling facility; liquor store

Opportunity Zones – Investor Perspective

- Introduced by the TCJA as a tax strategy for investors to defer capital gains while optimizing a social and economic strategy to improve designated low-income areas
- As tax advisors, we must be aware of the OZ tax benefits available and the rules that must be satisfied to ensure an investment qualifies for those benefits
- Tax benefits
 - ▶ Deferral of capital gains that are reinvested into a Qualified Opportunity Fund (QOF) until the earlier of
 - When the taxpayer sells their investment in the QOF
 - 12/31/26

Opportunity Zones – Investor Perspective

- Tax benefits (continued)
 - ▶ Reduction of original deferred capital gain
 - 10% reduction if QOF investment held at least 5 years before 12/31/26 (expires 12/31/21)
 - 15% reduction if QOF investment held at least 7 years before 12/31/26 (expired 12/31/19)
 - ▶ Exclusion of eventual gain on sale of QOF investment
 - Taxpayer must hold the investment for at least 10 years
 - Exclusion must be elected, but a tax loss on sale can still be recognized

Opportunity Zones – Investor Perspective

- Requirements to ensure tax benefits
 - ▶ Only reinvestment of capital gains qualify
 - Other investments can be made into a QOF, but are not eligible for the OZ exclusion of gain on the eventual sale of those investments
 - Capital gains include any income taxed as capital gain (STCG, LTCG, Sec. 1231 gains)
 - ▶ Taxpayer generally has 180 days to invest their capital gain into a QOF
 - 180-day period generally begins on the date of the sale that generated the capital gain
 - For gain passed through to the taxpayer on a K-1, the 180-day period can start on
 - The last day of the tax year of the entity issuing the K-1
 - The day of the sale or exchange
 - The unextended due date of the entity's tax return

Opportunity Zones – Investor Perspective

- ▶ Taxpayer generally has 180 days to invest their capital gain into a QOF (continued)
 - For gain generated by an installment sale, the 180-day period can start on
 - The last day of the taxable year that the eligible gain under the installment sale would be recognized
 - The date a payment under the installment sale is received
- Reporting requirements
 - ▶ In the initial year of deferral
 - Form 8949, showing a negative adjustment for the reinvested gain and using Code Z
 - ▶ In the initial year of deferral and every year thereafter, ending when the taxpayer sells their investment in the QOF
 - Form 8997

Real Property Taxes – Timing of Deduction

- Accelerating the deduction for accrued real property taxes is a common planning technique for rental real estate entities
- The general strategy is for the entity to elect the overall accrual method of accounting, and then make one of two elections available to accelerate the deduction of real property taxes
- Why choose the overall accrual method of accounting?
 - ▶ Generally, taxpayers would choose the overall cash method because it is easier and allows the deferral of income until it is received
 - ▶ However, rental income is generally required to be recognized when received, regardless of whether the taxpayer uses the cash or accrual method of accounting
 - ▶ Thus, in a rental real estate entity, the ability to accelerate expenses instead becomes the determinative factor which favors the use of the accrual method

Real Property Taxes – Timing of Deduction

- Deduction of real property taxes under the accrual method
 - ▶ Under Sec. 461, accrued expenses can be deducted for tax purposes when
 - The all-events test is met
 - Requires that all events necessary to establish the liability have occurred and the amount is determinable with reasonable accuracy
 - For real property taxes, the all-events test is satisfied when the liability becomes a lien upon the property or when personal liability arises – the “assessment” date set by state law – which is usually, but not always, the first day of the real property tax year
 - Economic performance has occurred
 - When economic performance has occurred depends on the type of liability
 - For real property taxes, economic performance occurs when payment is made
 - Thus, an accrual basis taxpayer must deduct real property taxes on a cash basis method

Real Property Taxes – Timing of Deduction

- Election #1: Recurring item exception
 - ▶ An accrual method taxpayer may adopt the recurring item exception to treat numerous types of liabilities, including real property taxes, as deductible in the current year if the item meets the following requirements:
 - The all events-test described above is met
 - Economic performance has occurred by the earlier of:
 - The date the taxpayer timely files (including extensions) a return for the tax year or
 - 8.5 months after the close of the tax year
 - The item is recurring in nature
 - The item is not material or the accrual of the item results in a better matching of the item with related income – this matching is automatically satisfied for taxes

Real Property Taxes – Timing of Deduction

- Election #1: Recurring item exception (continued)
 - ▶ How to make the election
 - The election is made for each recurring expense item by deducting the item in the first taxable year the liability is incurred on a timely-filed tax return (including extensions)
 - No formal election statement is required, although one can be added if desired
 - Once elected with respect to a recurring item, the recurring item exception must be applied consistently year over year with respect to that item
 - If the recurring item exception is not elected in the first year that real property taxes are incurred, a switch to the recurring item exception can be made on Form 3115 under the automatic accounting method change procedures
 - ▶ An entity that meets the definition of a tax shelter, including a syndicate, is NOT eligible to make the recurring item election – therefore a rental real estate pass-through entity with 35% of losses allocated to passive investors must instead consider making the ratable accrual election

Real Property Taxes – Timing of Deduction

- Election #2: Ratable accrual election

- ▶ An accrual method taxpayer may make the ratable accrual election to deduct real property taxes which relate to a definite period ratably over that period, regardless of when the liability actually accrues or economic performance is met
- ▶ How to make the election
 - The election is made by attaching a statement to the timely filed (including extensions) tax return for the first year that real property taxes are incurred
 - Once elected with respect to a recurring item, the ratable accrual method must be applied consistently year over year with respect to that item
 - If the ratable accrual method is not elected in the first year that real property taxes are incurred, a switch to the ratable accrual method can be made on Form 3115 under the automatic accounting method change procedures