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The Fiscal Cliff and Real Estate Tax Issues

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Fiscal Cliff and Real Estate

Fiscal Cliff Overview

- The fiscal cliff was a combination of across-the-board spending cuts (sequestering) and tax increases set to take effect in January 2013
  - Income, estate, and payroll taxes were scheduled to increase
  - Sequestering of $100B per year from 2013-2022 would begin
- The 2012 Taxpayer Relief Act (TRA), signed into law on January 2, 2013, enacted less drastic tax increases, and postponed the sequestering until March 1, 2013
- Additional tax increases and/or spending cuts are likely

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2012 TRA and Other Recent Tax Changes

1. Income Tax Rates and Deduction Limitations
2. Estate Taxes
3. Tenant Improvements
4. Other Income Tax Changes
5. Proposed Conveyance Tax Legislation

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Income Tax Rates and Deduction Limitations

Income Tax Rates

Ordinary Income Tax Rates

- Ordinary income rates apply to all income except capital gains and some dividends (e.g., wages, rent, interest)
- Before 2013, the highest marginal federal income tax rate was 35%
- From 2013, a higher marginal federal rate of 39.6% will apply to taxable income (except for C corporations) in excess of the "applicable threshold"
  - $400,000 for single taxpayers
  - $450,000 for married taxpayers filing jointly
  - The applicable threshold amounts will be inflation-adjusted for years after 2013

Income Tax Rates

Capital Gain Rates

- Capital gain rates apply to gain from the sale of business or investment property held for more than 1 year, and to most dividends received from domestic C corporations
  - All income of C corporations is taxed at the highest rate of 35%
- Before 2013, the federal capital gain rate was 15%
- From 2013, a higher federal capital gain rate of 20% will apply to taxpayers with total taxable income exceeding the "applicable threshold"
  - $400,000 for single taxpayers
  - $450,000 for married taxpayers filing jointly
  - Inflation-adjusted for years after 2013

Income Tax Rates

Additional Tax on Investment Income

- U.S. residents (other than C corporations) must also pay an additional tax of 3.8% on "net investment income" in excess of the "threshold amount"
  - "Net Investment Income" includes, for example, rental income and gain from the sale of rental or investment property
  - "Threshold amount" is adjusted gross income (i.e., not reduced by itemized deductions) of $200,000 for single taxpayers, and $250,000 for married taxpayers (not indexed for inflation)
- May not apply to rental income earned by real estate professionals performing more than 750 hours, and more than half of their total services, per year on real estate activities (e.g., development, leasing, management)

Deduction Limitations

Itemized Deduction Limitations

- Itemized deductions include, for example, deductions for home mortgage interest and charitable contributions
- From 2013, if the taxpayer's adjusted gross income exceeds the "applicable amount," itemized deductions are reduced by 3% of the excess income, up to a total 80% reduction in deductions
  - The applicable amount is $250,000 for single taxpayers, and $300,000 for married taxpayers filing jointly (adjusted for inflation)
- The limitation does not apply to itemized deductions for medical expenses, investment interest, casualty losses or gambling losses

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Estate Taxes

Estate Taxes

Estate Taxes

- For 2012, the federal estate and gift tax exemption was $5,120,000 per individual with portability between spouses, and the top estate and gift tax rate was 35%
  - Without legislative action, the exemption amount would have been $1,000,000 with no portability, and the top rate would have 55%, beginning in 2013
- From 2013, the exemption amount is $5,250,000 (indexed for inflation) with portability, and top rate is 40%
  - For Hawaii estate tax purposes, the exemption amount should be the same as the federal, and the top rate is 15.7%
  - Hawaii estate tax is allowed as a deduction against the federal estate tax

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Tenant Improvements

Tenant Improvements

Deduction vs. Capitalization

- Costs of fixing-up a property can generally be deducted when incurred, unless they "improve" the "building structure" or any of the "building systems"
  - "Building structure" includes roof, floor, ceiling, windows, doors
  - "Building systems" include heating, plumbing, electrical or security systems, or the elevators or escalators
  - The building structure or a building system is "improved" if the payments result in either: (1) betterment; (2) restoration; or (3) adaptation to a new or different use
- If the costs "improve" the structure or any of the systems, they must be capitalized and depreciated

Tenant Improvements

<u>Deduction vs. Capitalization</u>: Examples

- <u>Restoration #1</u>: Replacement of 30 out of 300 exterior windows in a building is not a restoration. Replacement of 200 out of 300 exterior windows is a restoration.
- <u>Restoration #2</u>: Replacement of the wood flooring in a hotel lobby is not a restoration. Replacement of the flooring in all common areas of the hotel is a restoration.
- <u>Betterment</u>: Floor and lighting repairs and replacement of display tables is not a betterment. If, in addition, all the bathroom fixtures are also upgraded, then it is a betterment.
- <u>Adaptation</u>: Reconfiguration of 3 small retail spaces into one large retail space is not an adaptation. Conversion of a manufacturing space into a showroom is an adaptation.

Tenant Improvements

<u>Depreciation of Capitalized Costs</u>: Default Rules

- Recovery period and method depends on the type of TI
  - Nonresidential Buildings: 39 years, straight-line
  - Residential Buildings: 27.5 years, straight-line
  - Land Improvements: 15 years, 150% declining balance
- "Tax-Exempt Use Property" has a longer recovery period
  - Includes nonresidential buildings, if more than 35% is leased to a tax-exempt entity (including a foreign person) under a "disqualified lease"
  - "Disqualified lease" includes leases in excess of 20 years (including renewal options not at fair market value)
  - The recovery period of tax-exempt use property becomes the greater of 40 years or 125% of the lease term
  - Bonus depreciation is not allowed

Tenant Improvements

<u>Depreciation of Capitalized Costs</u>: Special Rules

- 50% bonus depreciation is allowed for "qualified leasehold improvement property" placed in service before 2014 (for federal income taxes only)
  - Must be placed in service more than 3 years after the building
  - Must be made to interior occupied exclusively by the tenant
  - Must be made to pursuant to a lease between unrelated parties
- 15-year recovery period applies to QLIP placed in service before 2014 (retroactive to 2012)
- Up to $250K of QLIP may also be eligible for Sec. 179 expensing if placed in service before 2014

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Other Income Tax Changes

Other Income Tax Changes

Other TRA Real Estate Tax Provisions

- Itemized deduction for mortgage insurance premiums extended until end of 2013
- Exclusion of home mortgage forgiveness COD income extended until end of 2013
- S corporation built-in gain period shortened to 5 years (rather than 10) for assets sold in 2012 and 2013
- Qualified conservation easements donated in 2012 or 2013 deductible up to 50% of income (100% for qualified farmers/ranchers); excess carried forward up to 10 years

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Pending Conveyance Tax Legislation

Conveyance Tax Legislation

Pending Conveyance Tax Legislation

- SB 1166; HB 935
  - Would increase conveyance taxes on transfers of property valued at $2,000,000 or more
  - The highest rate would be 1.75% for non-residential real estate and 2% for non-owner occupied residential real estate
- HB 386; HB 680; SB 22
  - Would impose conveyance tax on transfers of controlling interests in entities that hold Hawaii real estate
  - Would continue to impose conveyance tax on most transfers of property to and from entities