PRACTICAL PLANNER NEWSLETTER
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RETURN SERVICE REQUESTED

More Info:

◦**Seminars:** Feb. 1, 2008 8-10 a.m., Heckerling Review. Free. Call 201-845-4500 for more info.

Moving Announcement

New address: 4 Forest Ave., Paramus, NJ 07652. Telephone 201-845-8400. Facsimile: 201-845-8433.

Creative solutions that coordinate all your planning goals:
· Estate · Tax · Business · Personal
·Financial ·Asset Protection

Planning Potpourri

New Year's Resolutions:

Set up a file with all key medical records for yourself and each family member/loved one.

Review disability, business interruption, and other insurances, as well as your rainy day funds.

Send your Crummey notices.

Consider how your estate plan affects those receiving it. Focus on their perspective, not just yours.

Back up your home computer and store it with a trusted person geographically distant. Scan all key records onto a CD, DVD or memory stick for emergency use.

Have an annual meeting for every closely held entity (corporation, LP, LLC) you own an interest in. Sign a written record (minutes) of the meeting.

Consolidate your assets to no more than a couple of institutions and prepare an overall asset allocation model of all accounts.

Reduce the number of credit cards and other accounts.

Order credit reports and review them for anomalies and issues.

Review life insurance policies and be sure your coverage is consistent with your goals.

Give something more to charity.

Have an annual review meeting with all your tax, legal and financial professionals.

Review and update your estate planning documents. Yes Virginia, this is important for you, not only your estate planners retirement account.

Distribute to key people a list of emergency contact information.

Have a trustee meeting with investment, legal and tax advisers for every trust for which you're a trustee. Be sure you're meeting your fiduciary obligations and document it.

Evaluate property and casualty coverage. Consider real replacement cost of your valuables.

Buy a fire proof safe for key personal records for your home.

Inventory your safe deposit box.

Photograph every room in your home and office and save the photographs and negatives or CD/DVD in a safe deposit box and another set with family or a trusted friend.

Don't forget Fido. Does your power of attorney, emergency letter of instruction and will assure protection for your fury friends? PP

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PRACTICAL PLANNER

Martin M. Shenkman, CPA, MBA, JD

Tenant Improvements & Costs: Tax Benefits

Summary: You're renting a new office or store and are negotiating an allowance for improvements, and planning for the costs you'll incur on fitting out the space. How can you maximize deductions from leasehold improvements and other costs you're likely to incur? This get's really complex, so put on your hip-waders and call your CPA to translate, the savings will be worth the struggle.

<u>Costs to Acquire Your Lease</u>

Brokerage commissions, legal fees, and other costs incurred by you as a tenant in negotiating and acquiring a lease are generally treated as an asset (capitalized), not deducted currently. Treas. Reg. Sec. 1.263(a)-4(c) and (d). These costs, once capitalized, are then deducted ratably (amortized) over the lease term. Treas. Reg. Sec. 1.162-11(a); 1.263(a)-4. You have to determine the length of the lease term. This is not always obvious with the many possible renewal provisions and other lease terms. Generally, you must include a renewal option in the "lease term" for amortization purposes if less than 75% of the costs are attributable to the base lease term. Treas. Reg. Sec. 1.1.78-1. Since this is a facts and circumstances determination, the results are unclear. Tip: Have a broker give you a written opinion that based on market conditions it is unlikely that you will exercise the options.

Costs of obtaining a sub-lease are capitalized and then amortized over the lease term. If you purchase a lease, the payments will generally have to be amortized over the term remaining in the lease purchased. However, it may be possible to argue that you can allocate some of the costs to improvements and depreciate (recover) that portion of the payments according to those rules discussed below. Rev. Rul. 61-217. If you purchase the lease along with the property the cost allocable to the lease becomes part of the cost of the realty and must be depreciated over what is usually a longer period. Treas. Reg. Sec. 1.197-2(c)(8).

<u>Tax Consequences of Tenant Improvements and Allowances</u>

Landlords often will provide building standard improvements and then you, as the tenant, will pay for any above standard finishes, e.g., better carpet, a kitchen, and more. You must depreciate (recover) these improvements over the time periods required for depreciating real estate. Tenants can no longer amortize improvements over the lease term. IRC Sec. 168(i)(8). Improvements the landlord pays for and owns must be capitalized and depreciated under rules called the "Modified Accelerated Cost Recovery System" or MACRs. If instead the landlord structures the payment as a lease acquisition cost, with you owning the improvements, the landlord will amortize the costs over the lease term, but you'll recognize income, and depreciate the improvements. This is the worst tax result.

<u>Avoid Income on Receipt of an Allowance</u>

If you as the tenant expend the allowance on improvements which are owned by the landlord, the allowance is not taxable income to you. Another approach which has also been used by tenants to avoid income taxation of allowances is to argue that landlord payments are non-taxable contributions to capital and excluded from income. IRC Sec. 118; *Elder-Berman Stores, Corp*. Finally, the tax laws include a provision to assure retail tenants that an allow-

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Checklist: 179 Expensing

Summary: The cost of a real property leasehold improvement generally has to be depreciated over a 39 year recovery period. However, if expenditures can be properly classified as tangible, personal, movable, non-real estate property, they may qualify to be deducted currently. This can provide a tremendous tax benefits.

The analysis used to determine which costs can be classified as personal property rather than real property is referred to as "component depreciation" analysis. The foundation for this is based on the law that had applied years ago for the determination of what property qualified for the investment tax credit under prior law Code Section 48. *Hospital Corp. of America & Subs. v. Comr*., 109 T.C. 21 (1997). Structural components of a building don't qualify for more rapid depreciation or Section 179 expensing. Structural components relate to the operation and maintenance of a building. Treas. Reg. Sec. 1.48-1(e). These include:

√ Land; √ Inherently permanent structures; √Walls; √Doors and door locks. Treas. Reg. Sec. 1.48-1(e)(2); FSA 200203009; √ Windows; √ Floors, such as permanent

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...TENANT IMPROVEMENTS & COSTS: TAX BENEFITS

(Continued from page 1)

ance will not be taxable. IRC Sec. 110. When a retail tenant receives rent concessions or a cash allowance to use to pay for improvements, for a short term lease (15 years or less) for retail space (broadly defined so that professional offices of a CPA or attorney are deemed retail), the amount is excluded from tenant income to the extent paid in that tax year for improvements. The cost of the improvements is treated as non-residential real property improvements owned by the landlord that the landlord then depreciates (recovers). Treas. Reg. Sec. 110-1(b)(5). The IRS view is that payments not spent on improvements are income to the tenant. AM 2007-003 1/24/07. The tenant and landlord must each attach a statement to their income tax returns for the years involved. Treas. Reg. Sec. 1.110-1(c). This must include: name, address and tax ID number of landlord and tenant, amount of the allowance, amount of the allowance that is qualified, and the location.

15 Year Special Depreciation.
The general rule is that you must depreciate (recover) leasehold improvements over 39 years, using the rules for real estate. However, qualifying leasehold improvements completed before 2008 qualify for a special favorable 15-year recovery period. IRC Sec. 168(e)(6). These improvements must be to an interior of a nonresidential building, made by an unrelated landlord or tenant under a lease, to a building that had been completed at least 3 years earlier. Costs to enlarge a building, or for an elevator or structural component doesn't qualify.

Distinguishing Real from Personal Property.
A key to maximizing deductions for tenant improvements is to properly characterize the property purchased as to whether it is personal property (e.g., equipment) that qualifies for more favorable tax benefits (faster depreciation over 5 or 7 years), or real property (walls and structural components) that must generally be recovered over the 39 years (or longer) recovery period (unless the special 15 year rule above applies). See Checklist article.

Code Sec. 179 Deduction.
If you purchase business property that will last for a number of years, such as equipment, it generally has to be written off over a specified period, such as 5-7 years. However, these costs may qualify to be deducted immediately under a special tax rule contained in Code Section 179. The holy grail of leasehold improvement tax planning is to qualify expenditures for this benefit instead of the 39 year recovery for real property.

The maximum amount of property you can deduct in any year is $125,000. This limit is reduced to $25,000 in 2010. Your deduction is also reduced by expenditures in excess of $500,000 for qualifying property. The amount you can deduct is also limited to your taxable income for the year, before the Section 179 deduction. When a partnership, limited liability company or S corporation incur qualifying expenses the entity must file a statement with the IRS to claim the deduction. This is done on Form 4562. The property cannot be purchased from a related person, and it must be used more than 50% in an active business.

Trusts and estates are not eligible for the Section 179 benefit. So if a trust or estate is a partner in a partnership (or a member in a limited liability company) the amount of Section 179 deduction that would pass through to the trust or estate will have to be capitalized and then depreciated. It might be possible to avoid this adverse result by allocating 179 deductions to partners who are not trusts or estates, and allocating depreciation deductions to the partners who are trusts or estates.

Conclusion.
Planning for tenant improvements can substantially enhance tax deductions. This requires a coordination of tenant allowances, documenting expenditures to corroborate the maximum amounts that can be treated as depreciable personal property instead of real estate, obtaining proper bills, and taking advantage of the Section 179 deduction. PP

Terms in red defined in the glossary at www.laweasy.com. For e-newsletter sign up at www.laweasy.com.

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...CHECKLIST: 179 EXPENSING

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tiling; √Acoustical ceilings. *Metro Nat'l Corp. v. Comr*., 52 T.C.M. 1440 (1987); √ Central air conditioning and heating systems; √ Fire escapes; √ Stairs; √ Sprinkler systems; √ Basic affixed electrical wiring, wall outlets and general lighting; √ General Lighting; √ General plumbing.

Non-structural components and personal property can qualify for more favorable tax benefits. Structural components that don't relate to the operation and maintenance of a building as a building may qualify. These include 5 or 7 year recovery periods, rather than 39 years, and the potential for immediate deduction under Section 179. These can include:

√ Movable partitions. Rev. Rul. 75-178, 1975-1 C.B. 9; √ Equipment and machinery used to maintain temperature or humidity requirements (e.g., for food preparation); √ Removable air-conditioning equipment. *Scott Paper Co*., 74 T.C. 137; √ Computers and peripheral equipment and wiring; √ Smart board and related wiring and equipment; √ Special removable lighting; √Removable kitchen equipment and furnishings; √ Telephone equipment and wiring, including wiring related to intercom, dictation and call systems. *Hospital Crop. Of America v. Comr.*; √ Special electrical wiring and plumbing hook-ups relating to particular equipment or function. This would include electrical loads for particular items of business equipment; √ Kitchen piping, plumbing connections, dishwashers, etc.; √ Costs that relate to the provision of services rather than building functions; √ Removable carpeting. Rev. Rul. 67-349; √ Vinyl wall covering; √ Removable floor tiles, or other floor coverings that are not an integral part of the floor itself; √ Removable ceiling treatments; √ Signs and ornamentation; √ Furniture and equipment; √ Removable shelving.

A number of factors can be considered in determining whether property qualifies for the more favorable treatment:

√ Manner in which the property is attached to the building. It should not be permanently attached; √ The property is inherently moveable; √ Size, weight and construction of the property; √ The type of equipment and number of people required to move the property; √ The property or similar property has been moved in the past; √ Facts support that the property may not stay in place permanently; √ The property was not designed to stay in place permanently. *L.L. Bean, Inc. v. Comr*., T.C. Memo 1997-175, aff'd 145 F.3d 53 (1st Cir. 1998); √ The cost, time and difficulty of moving the property; √ Little damage will be done to the property when moved; √ Little damage will be done to the building when the property is removed; √ The property could readily be re-used if moved.

To secure your write-offs, corroborate the allocations. Use an engineering and cost analysis, survey contractor data, and/or facts. PP

RECENT DEVELOPMENTS

Wash Sale Rules: These rules prevent you from claiming a tax loss on selling a stock (like Maytag) if shortly before or after that sale you've acquired substantially the same stock. The rationale is you haven't really realized a loss for tax purposes if you still own the same stock. The IRS has just expanded the reach of the Wash Sale Rules under Code Section 1091. The general rule is that you cannot deduct a tax loss on the sale of any security if, within the period from 30 days before the sale through 30 days after the sale, you acquire a substantially identical security. A recent ruling has held that if you sell securities for a loss and have your IRA or Roth IRA purchase substantially identical securities within 30 days before or after the sale, you will not be able to claim the tax loss on the sale of the securities. Rev. Rul. 2008-5, 2008-3 IRB. Further, your tax basis in your IRA or Roth IRA will not be increased under IRC Sec. 1091(d) .

Innocent Spouse Relief: A husband and wife are jointly liable for the tax on any joint income tax return. However, if you can demonstrate that you did not know, or have reason to know, of your spouse's tax hanky panky, you can get off the tax hook. This "out" is known as innocent spouse relief. IRC Sec. 6015. Innocent spouse relief is an issue in divorces when one spouse seeks to avoid the tax liability for the misdeeds of an ex-spouse. Unfortunately, it's not easy to qualify for relief. You have to demonstrate that you filed a joint income tax return and the tax understatement was due to the erroneous items of your spouse. You must show that you did not know, or have reason to know, of the problem. Finally, it must be unfair to hold you responsible. In a recent case the wife, who was college educated, had access to joint financial accounts, balanced the couple's checkbook, and was aware of the couple's ownership of limited partnership interests that trigged the tax understatement, didn't qualify. The court felt she did not meet her duty to inquire into the transactions. *Robert Golden, et ux.*