

## Federal Tax Compliance for LLCs and Partnerships in Commercial Real Estate

Tackling Tax Challenges in Acquisitions, Financing, Development, Leasing and Dispositions

TUESDAY, AUGUST 13, 2013, 1:00-2:50 pm Eastern

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# Federal Tax Compliance For LLCs And Partnerships In Commercial Real Estate Seminar

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Aug. 13, 2013

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Wray Rives, Rives CPA PLLC  
[wray@rivescpa.com](mailto:wray@rivescpa.com)

Jon Funk, Ernst & Young  
[jon.funk@ey.com](mailto:jon.funk@ey.com)

# Today's Program

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Passive Activity Losses

*[Jon Funk]*

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*[Wray Rives]*

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Jon Funk, Ernst & Young

# **PASSIVE ACTIVITY LOSSES**

# Passive Activity Loss (PAL) Limitations

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“Passive activity income does not include the following: Income from an activity that is not a passive activity.” - quote from instructions for Form 8582

# PAL Limitations

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- I. Income and loss (loss includes credits) from passive activities are netted.
- II. If taxpayer's passive activities net to a loss, passive activity loss is suspended and not currently deductible.
  - I. Individuals, estates and trusts may have to file Form 8582.
  - II. You can find examples at [http://cs.thomsonreuters.com/ua/ut/2012\\_cs\\_us\\_en/pdfs/i\\_pasact.pdf](http://cs.thomsonreuters.com/ua/ut/2012_cs_us_en/pdfs/i_pasact.pdf)
- III. In the year of disposition of an entire interest of a specific passive activity, any previously suspended losses (to the extent they exceed the income or gain for the taxable year from all other passive activities) shall be treated as a loss not from a passive activity (see IRC Sect. 469(g)).

# PAL Limitations (Cont.)

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- I. Passive activity generally includes:
  - A. A trade or business activity in which taxpayer does not materially participate
  - B. Any rental activity
  
- II. For non-rental activities, must meet at least one of seven material participation tests to be a non-passive activity
  - A. Limited partners can qualify for material participation under only three of the seven material participation tests.

# PAL Limitations: Material Participation

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- I. Taxpayer works more than 500 hours during year in activity. \*
- II. Taxpayer does substantially all work in activity.
- III. Taxpayer works more than 100 hours in activity during year, and no one else works more than taxpayer.
- IV. Activity is significant participation activity (SPA) in which taxpayer works more than 100, but not more than 500, hours, and total SPA participation exceeds 500 hours for year.
- V. Taxpayer materially participated in activity in any five of prior 10 years. \*
- VI. Activity is a personal service activity, and taxpayer materially participated in that activity in any three prior years. \*
- VII. Based on all facts and circumstances, taxpayer participates in activity on a regular, continuous and substantial basis during such year.

\* Denotes tests apply to limited partners

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# PAL Limitations: Activity Grouping

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- I. Taxpayers may aggregate multiple activities into a single activity or fragment a single activity into multiple activities.
- II. Activity grouping must be an “appropriate economic unit.”
- III. Facts and circumstances; regulations list five factors:
  - A. Similarities and differences in types of trades or businesses
  - B. Extent of common control
  - C. Extent of common ownership
  - D. Geographical location
  - E. Interdependence between or among activities

# PAL Limitations: Activity Grouping (Cont.)

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- I. Once an activity or grouping is adopted, it cannot be changed in subsequent years unless:
  - A. Original grouping was “clearly inappropriate”, or
  - B. Facts and circumstances have changed materially to make it clearly inappropriate.
  
- II. Proposed regulations permit a one-time “fresh start” in activity grouping for 2013 or any later year in which taxpayer is first subject to net investment income tax under IRC Sect. 1411.

# PAL Limitations: Real Estate Professional

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- I. IRC Sect. 469(c)(7) makes an exception to the *per se* passive activity classification rule of real estate activities if the person:
  - A. Spends more than 750 hours working in real property trades or businesses in which the taxpayer materially participates, and
  - B. More than half of all personal service hours performed are in real property trades or businesses in which the taxpayer materially participates.

# PAL Limitations: Real Estate Professional (Cont.)

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- I. If these two requirements are satisfied, then rental real estate income or loss is non-passive if the taxpayer materially participates in the rental real estate.
  
- II. “Real property trade or business”
  - A. Includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business

# PAL Limitations: Real Estate Professional (Cont.)

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- I. Aggregation election
  - A. Generally for purposes of the real estate professional exception, all rental real estate activities are treated as separate activities.
    - A. Special rules apply to rental activities group by pass-through entities.
    - B. Taxpayer may elect to aggregate and treat all rental real estate activities as a single activity.
    - C. Consistent with general rules, material participation through limited partnership interests is allowed only under three of the seven tests.
- II. Election is binding for the taxable in which it was made and all future years.
- III. Election may be revoked if there is a material change in the facts.

# PAL Limitations: Net Investment Income Tax (NIIT)

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- I. A passive activity is subject to NIIT if:
  - A. Such activity is a trade or business.
  - B. Such trade or business is a passive activity as defined in Sect. 469.
  - C. Generally, this includes rental real estate activities.
- II. Gross income from a passive activity does not include:
  - A. Portfolio income: Interest, dividends, rents and royalties not derived from a trade or business
  - B. Net gains from disposition of property (not used in trade or business)
  - C. Although not gross income from passive activities, the above items may still be subject to NIIT.

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# **REHABILITATION TAX CREDITS**

# Rehabilitation Tax Credits

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- I. Costs for rehabilitation and reconstruction of buildings
  - A. Excludes enlargement or new construction
  - B. Excludes tax exempt use property
  - C. 10% of cost for buildings placed in service before 1936
  - D. 20% of cost for certified historic structures
  - E. Increased percentage for disaster areas
    - A. 10% increased to 13%
    - B. 20% increased to 26%
- II. Does not offset AMT

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# **INSTALLMENT SALES**

# Installment Sales: General Rules (§453)

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- I. A disposition of property in which at least one payment is to be received after the close of the taxable year in which the disposition occurs
  - A. Escrow to pay subsequent liabilities
  - B. Exceptions
    - A. Dealer property excluding farm property used in the trade or business of farming and timeshares and residential lots if elected by taxpayer
    - B. Marketable securities
    - C. Election out ( §453(d))

# Installment Sales: Installment Method

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- I. Income recognized for any taxable year equals total payments received in such year multiplied by a gross profit ratio.
  - A. Gross profit: Selling price less the adjusted basis
  - B. Contract price: Selling price reduced by that portion of any qualifying indebtedness assumed by buyer
    - A. Qualifying indebtedness includes mortgages or other indebtedness encumbering the property.
  - C. Gross profit ratio: Total gross profit divided by total contract price
  - D. Exceptions:
    - A. Ordinary income depreciation recapture recognized in year one ( 453(i))
    - B. Qualifying indebtedness in excess of seller's basis recognized in year one

# Installment Sales: Reg. §15A.453-1(b)(5), Ex. 2

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- I. C sells Whiteacre to D for \$160.
  - A. \$160 includes assumption by D of \$60 mortgage from C.
  - B. C's basis in Whiteacre is \$90.
- II. D, after assumption of \$60 mortgage, is to make 10 equal annual installments of \$10.
- III. Contract price is \$100 (\$160 less \$60 mortgage).
- IV. Gross profit is \$70 (\$160 less \$90).
- V. Gross profit ratio is 70% (\$70 gross profit/\$100 contract price).
- VI. C is to recognize \$7 of gain upon receipt of each \$10 installment payment.

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# Installment Sales: Reg. §15A.453-1(b)(5), Ex. 3

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- I. C sells Whiteacre to D for \$160.
  - A. \$160 includes assumption by D of \$60 mortgage from C.
  - B. C's basis in Whiteacre is \$40.
- II. D, after assumption of \$60 mortgage, is to make 10 equal annual installments of \$10.
- III. C is to immediately recognize \$20 deemed payment, because \$60 mortgage exceeds \$40 basis by \$20.
- IV. Contract price is \$120 (\$160 less \$40 mortgage not exceeding basis).
- V. Gross profit is \$120 (\$160 less \$40 basis).
- VI. Gross profit ratio is 100% (\$120 gross profit/\$120 contract price).
- VII. C is to recognize \$10 of gain upon receipt of each \$10 installment payment.

# Installment Sales: Interest Charge

## §453A

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- I. Installment sales require additional interest charges if:
  - A. Sales price exceeds \$150,000
  - B. Installment sale obligation is outstanding at the end of the taxable year, and
  - C. Face amount of taxpayer's installment sale obligations exceeds \$5M/
- II. Exceptions
  - A. Personal use property
  - B. Property used in the trade or business of farming
  - C. Timeshares and residential lots, if taxpayer elects under 453(l)(3)

# Installment Sales: Related Parties

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- I. If installment sale is to a related party, and purchasing related party sells to third party prior to paying off original installment note, then the original seller may not continue to defer the gain ( § 453(e)).
  
- II. If installment sale of depreciable property is to a related party, then installment sale treatment is not applicable, and all payments are treated as received in year of sale and taxed as ordinary income ( § 453(g)).
  - A. Related party includes related entities as defined in 1239(b), and related partnerships as defined in 707(b)(1)(B).

# Installment Sales: Like-Kind Exchanges

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- I. If sale and receipt of cash from qualified intermediary straddle two taxable years, then Reg. 1.1031(k)-1(j) permits taxpayer to report taxable gain under 453 installment method.
  - A. See Rev. Rul. 2003-56
  - B. Assumes taxpayer transfers property through a QI and still has a bona fide intention to complete a like-kind exchange at end of year one

# Installment Sales: Reporting

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- I. Form 6252
  - A. Complete Parts I and II in year of sale
    - A. Part I shows the calculation of the gross profit ratio.
    - B. Part II shows payments received and gain recognized in the current year.
  - B. For any future year in which the taxpayer receives payments, only Part II is required to be completed.
    - A. Would indicate that the IRS doesn't want the gross profit ratio to change in future years
  - C. If installment sale to a related party, in addition to the items above, then Part III is required to be completed in the year of sale and any future year in which the taxpayer receives a payment.

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# **INVOLUNTARY CONVERSIONS**

# Involuntary Conversions

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- I. Involuntary conversion occurs when property is destroyed, stolen, condemned or disposed of under threat of condemnation, AND you receive other property or money in payment.
  
- II. Defer gain
  - A. Defer gain if you receive property that is similar or related in service to the converted property
  - B. Basis of old property carries over to the new property.

# Involuntary Conversions (Cont.)

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- I. Postpone gain or loss if you purchase replacement property
  - A. Must spend as much as the net award received
  - B. Two-year replacement period
    - A. Three years for property used in a trade or business or held for investment
    - B. Five years for property in qualified disaster areas
  - C. Purchase of 80% interest in a corporation owning replacement property
  - D. Attach a statement to your tax return to report election to postpone gain

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# Involuntary Conversions (Cont.)

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- I. Recognize gain or loss if you receive money or unlike property
  - A. Condemnation award includes:
    - A. Money you receive
    - B. Your debts that are paid
    - C. Net out expenses to obtain the award
  - B. Condemnation award does not include:
    - A. Interest due to delay in paying
    - B. Payments to relocate
    - C. Severance damages

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# **LIKE-KIND EXCHANGES**

# LKE: General Rules

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- I. To qualify as tax-free under 1031:
  - A. Relinquished (“old”) property must be exchanged for
  - B. Replacement (“new”) property of “like kind” held for investment or use in a trade or business.
  
- II. Can be viewed as three separate requirements:
  - A. Exchange
  - B. Like kind
  - C. Held for investment or use in a trade or business

# LKE: Computation Of Gain And Basis

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- I. Gain realized in a like-kind exchange is still recognized (taxable) to the extent taxpayer receives cash or other property that is not of a like kind (“boot”).
  - A. Any excess of debt on relinquished property over debt on replacement property is boot.
- II. Replacement property takes a substituted basis.
  - A. Adjusted for difference in debt on relinquished property vs. debt on replacement property and other boot
- III. Loss is disallowed in a Sect. 1031 exchange.
  - A. Sect. 1031 is not elective.
  - B. *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652 (5th Cir. 1968)

# LKE: Exchange Requirement

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- I. An “exchange” is a direct exchange with one party.
  - A. Sale for cash followed by reinvestment of cash in like-kind property does not qualify under 1031.
    - 1. *Crandall v. Commissioner*, T.C. Summary Opinion 2011-14 (failure to use qualified intermediary or qualified escrow, discussed below, resulted in actual receipt)
  - B. Buyer of relinquished property is unlikely to hold property that taxpayer wishes to acquire.

# LKE: Qualified Intermediary

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- I. The exchange party cannot be the “agent” of the taxpayer.
  - A. If property is exchanged through an agent, then the agent’s receipt of cash from sale of relinquished property is imputed to the taxpayer.
    - 1. Taxpayer’s receipt of cash will generally bust the exchange.
  - B. Regulations issued in 1991 provide a “safe harbor” for exchanges through a qualified intermediary (QI).
    - 1. Certain security or guarantee arrangements, a qualified escrow account or qualified trust are also permitted and can be combined with QI arrangement; Reg. 1.1031(k)-1(g).
    - 2. Taxpayer’s receipt of cash may bust the exchange.
      - a. But, see *Peter Morton v. U.S.*, 98 Fed. Cl. 596 (Ct. Fed. Cl. 2011) (accidental actual receipt by taxpayer through no fault of taxpayer)
      - b. Taxpayer could not prove like-kind exchange. *Zurn v. Commissioner*, T.C. Memo 2012-132
      - c. Program exchange; non-docketed service advice review (NSAR) 20124801F

# LKE: Qualified Intermediary

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- I. Under the “safe harbor” regulations, the QI cannot be a “disqualified person.”
  - A. Reg. 1.1031(k)-1(k): A disqualified person is one who:
    1. Has been taxpayer’s employee, attorney, accountant, investment banker or broker, or real estate agent or broker in the two years before transfer of first relinquished property; or
    2. Is related to the taxpayer or any service provider prohibited above, using 10% test under 267(b) or 707(b).

# LKE: Qualified Intermediary (Cont.)

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- I. Rulings on “disqualified person”
  - A. Intermediary LLC is not a disqualified person, although managed by another LLC in which exchanging taxpayer’s son is an individual manager.
    - 1. PLR 200338001
  - B. Bank is not a disqualified person by reason of QI and controlled group members providing investment advisory, brokerage, private planning, insurance, trust and retail banking services.
    - 1. PLRs 200803003 and 200803014
    - 2. PLR 201030020
  - C. Subsidiary activities as manager of operations of a financing company or commercial paper issuance and shareholder loan program
    - 1. PLR 201234018
  - D. Provision of software designed to assist in like-kind exchanges
    - 1. PLR 201308020

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# LKE: Like-Kind Real Estate

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- I. Definition of “like kind” for real estate is very broad.
  - A. In general, real estate is of “like kind” to all other real estate.
    - 1. E.g., vacant rural land for office building
    - 2. Generally look to state law definition
      - a. Compare with federal tax definition: 48, 512, 856
    - 3. State law property classification does not control whether exchanged properties are considered of “like kind,” for purposes of Sect. 1031.
      - a. Rather, federal income tax law controls, and requires consideration of all facts and circumstances including state law and federal tax law classifications, as appropriate.
      - b. ILM 201238027.

# LKE: Like-Kind Real Estate (Cont.)

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- I. Lease exchanges
  - A. Fee title for 30-year leasehold
    - 1. Reg. 1.1031(a)-1(c); example in PLR 8453034
    - 2. Renewal options count toward 30 years.
      - a. Rev. Rul. 78-72, 1978-1 CB 258
    - 3. Exchange of tenant's interest in lease with remaining term of less than 30 years can be exchanged for tenant's interest in another lease with remaining term of less than 30 years.
      - a. Rev. Rul. 76-301, 1976-2 CB 241
  - B. Other examples of lease exchanges:
    - 1. Tenant's interest in building on land already owned by taxpayer was replacement property of like kind under 1033.
      - a. Rev. Rul. 68-394, 1968-2 CB 338
    - 2. Tenant's interest in newly-issued lease may qualify as replacement property.
      - a. PLR 200842019
      - b. See also Rev. Rul. 66-209, 1966-2 CB 299
      - c. Consider impact of 467

# LKE: Like-Kind Real Estate (Cont.)

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- I. Other examples of “like kind” for real estate
  1. Coal supply contracts were covenants running with real property under New Mexico law; coal mine (subject to the supply contracts) is “like-kind” to gold mining property.
    1. *Peabody Natural Resources Co. v. Commissioner*, 126 TC 261 (2006)
  2. Exchange of old-growth timberlands for reproduction timberlands
    1. Approved in PLR 200541037
    2. Citing Rev. Rul. 72-515, age, quality and species of timber do not change class or kind of property being exchanged.
  3. Development rights for fee interest in real property
    - a. Approved in PLR 200805012
    - b. Approved again in PLR 200901020
    - c. Development rights vary widely under state and local law.

# LKE: Not Like-Kind Real Estate

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- I. Not all real estate is of “like kind.”
  - A. Construction of new building on land already owned by taxpayer
    - 1. *Bloomington Coca-Cola Bottling Co. v. Commissioner*, 189 F.2d (7<sup>th</sup> Cir. 1951)
    - 2. Rev. Rul. 67-255
  - B. Fee title for 50-year water rights not of like kind.
    - 1. *Wiechens v U.S.*, 228 F.Supp. 2d 1080 (D.C. Arizona 2002)
  - C. U.S. and foreign real property are not of like kind.
    - 1. 1031(h)(1)

# LKE: “Held for” Requirement

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- I. Sect. 1031 also requires that both relinquished and replacement properties are:
  - A. Held for investment, or
  - B. Used in a trade or business.
- II. Thus, “held for” requirement is violated either if relinquished or if replacement property is:
  - A. Ordinary income (dealer) property.
  - B. Personal use property.
- III. “Held for” requirement may be jeopardized if relinquished or replacement property is transferred to an affiliate or unrelated party soon before or after the exchange.

# LKE: Dealer Real Property

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- I. Dealer property does not qualify for like-kind exchange treatment.
  - A. Definition of dealer property is somewhat broader under 1031 than with standard definition under 1221(a).
    1. *Neal T. Baker Enterprises, Inc. v. Commissioner*, T.C. Memo 1998-302
    2. See also ILM 201025049 (dual use property held for rental and for sale ruled held primarily for sale)

# LKE: Timing Of Exchanges

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- I. Simultaneous exchange
- II. Deferred exchange: Old property transferred first, new property received later; 1031(a), enacted in response to *Starker v U.S.*
  - A. 45-day identification requirement
  - B. 180-day closing requirement
- III. Reverse exchange
  - A. New property is received before old property is transferred.
  - B. Case law is generally unfavorable.
  - C. Alternative in parking transactions under safe harbor in Rev. Proc. 2000-37

# LKE: Typical Steps In A Deferred Exchange

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- I. Taxpayer enters into a contract to sell relinquished property.
- II. Taxpayer enters into an exchange agreement with a QI, pursuant to which the QI agrees to facilitate an exchange of the relinquished property for other replacement property pursuant to the QI safe harbor in Treas. Reg. 1.1031(k)-1(g)(4).
- III. On or before the closing on the sale of the relinquished property, taxpayer assigns its rights in the sale contract to the QI and notifies the buyer in writing of the assignment.

# LKE: Typical Steps In A Deferred Exchange (Cont.)

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- I. At the closing on the sale of the relinquished property, taxpayer deeds the relinquished property directly to the buyer, and the proceeds of the sale (net of any paydown of relinquished property debt) are transferred by the buyer directly to the QI.
- II. Within 45 days after the closing on the sale of the relinquished property, taxpayer identifies potential replacement properties in a written document that is delivered to the QI.
- III. Taxpayer enters into a contract to purchase replacement property.

# LKE: Typical Steps In A Deferred Exchange (Cont.)

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- I. On or before the closing on the purchase of the replacement property, taxpayer assigns its rights in the purchase contract to the QI and notifies the seller in writing of the assignment.

# LKE: Typical Steps In A Deferred Exchange (Cont.)

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- I. No later than 180 days after closing on the sale of the relinquished property (and before the expiration of the due date, including valid extensions, of the taxpayer's tax return for the year in which the relinquished property was transferred), taxpayer closes on the purchase of the replacement property.
  
- II. At the closing on the purchase of the replacement property, the QI transfers the balance of the exchange funds (supplemented, as necessary by proceeds from new debt incurred to acquire the replacement property or other cash provided by the taxpayer) to the seller, and the seller directly deeds the replacement property to taxpayer.

# LKE: 45-Day Identification Requirement

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- I. Replacement property must be identified within 45 days of transfer of the relinquished property.
  - A. No extension for weekends or holidays
  - B. Number and value of replacement property identification
    - 1. Three replacement properties with any value
    - 2. Unlimited number, but fair market value no more than 200% of relinquished property
    - 3. Unlimited number and value; taxpayer actually acquires 95% by value.
    - 4. Property acquired within 45-day identification period
  - C. Unambiguous description of each replacement property
  - D. Notice must be delivered to seller or certain other non-disqualified parties to the transaction.
  - E. Reg. 1.1031(k)-1(c)

# LKE: 180-Day Closing Requirement

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- I. Replacement property must be acquired by the taxpayer within 180 days of transfer of the relinquished property.
  - A. If sooner, extended due date for tax return
  - B. No extension for weekends or holidays
  - C. Taxpayer must acquire replacement property that is “substantially the same” as identified.
    - 1. Reg example: Acquisition of only 75% of vacant land that was identified
  - D. Reg. 1.1031(k)-1(d)

# LKE: Reporting

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## I. Form 8824

Wray Rives, Rives CPA PLLC

# **ENVIRONMENTAL CLEAN-UP COSTS**

# Environmental Clean-up Costs

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- I. IRC Sect. 198
  - A. Sunset Dec. 31, 2011
  - B. Efforts to resurrect have died in committee.
- II. Repair vs. capitalization regulations
  - A. Generally favors capitalization
  - B. Unit of property
  - C. Restore property to previous condition
    - A. Plainfield Union Tex appropriate again?
  - D. Restores property to "like new" condition

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# **ENERGY EFFICIENCY TAX DEDUCTIONS**

# §179D Deduction: Overview

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- I. Federal tax deduction of \$0.30 to \$1.80 per square foot of the building, up to the total basis of the energy efficient property placed in service
- II. Energy efficient commercial building property includes:
  - A. Light fixtures and controls, not light bulbs
  - B. New or replacement HVAC systems and controls
  - C. New buildings or replacements windows, roofs and doors
- III. Property must meet energy efficiency targets (compared with ASHRAE 90.1-2001) and prescriptive requirements.
- IV. Effective Jan. 1, 2006 through Dec. 31, 2013

# §179D Deduction: Value And Benefit

Property	Energy Efficiency (Compared to ASHRAE 90.1-2001)	Benefit (per sq. ft.)
Lighting	25 – 40% LPD reduction	\$0.30 - \$0.60
HVAC/HW	16 2/3% energy cost reduction	\$0.60
Building Envelope	16 2/3% energy cost reduction	\$0.60
Lighting + HVAC/HW	33 1/3% energy cost reduction	\$1.20
Lighting + Envelope	30% energy cost reduction	\$1.20
HVAC/HW + Envelope	30% energy cost reduction	\$1.20
Lighting + HVAC/HW + Envelope	50% energy cost reduction	\$1.80

Value of 179D deduction @ 35% ETR	Lighting Only	HVAC, Building Envelope, Lighting
200,000 s.f building	\$21,000 - \$42,000	\$126,000
500,000 sq. ft. building	\$52,500 - \$105,000	\$315,000
1,000,000 sq. ft. building	\$105,000 - \$210,000	\$630,000
2,000,000 sq. ft. building	\$210,000 - \$420,000	\$1,260,000

# §179D Deduction: Certification Requirements

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- I. Energy modeling
  - A. Model the building with the minimum requirements of ASHRAE Std 90.1-2001, then compare to actual installation to calculate % reduction in energy costs
  
- II. Third-party site inspection
  - A. After the property has been placed in service
  - B. Confirming that the building has met, or will meet, the energy saving targets and prescriptive measures contained in the design plans and specifications
  
- III. Letter of certification
  - A. By “an engineer or contractor that is properly licensed in the jurisdiction in which the building is located”

# §179D Deduction: Reporting

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- I. Form 1065 instructions
  - A. If trade or business deduction, page 1 line 20 - other deductions
  - B. If rental real estate activity, presumably reported on Form 8825 in other deductions
  
- II. 179D deductions reduce a partner's outside basis (AM 2010-007).