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Beware of 2014 tax law changes impacting real estate owners; some are positive, others negative

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As 2014 begins, several changes in real estate tax laws have occurred. These changes will have a considerable effect on how real estate-related taxes are filed this year, with some changes being taxpayer-friendly and others potentially negative. The three most important changes in tax law effecting real estate owners this year are the repair vs. capitalization rules, the Net Investment Income Tax, and the potential for upcoming Congressional action on several extenders.

Repair vs. Capitalization Rules

After ongoing debate since the early 2000s, the IRS has finally set in new repair vs. capitalization rules effective 1/1/14. These new rules will affect virtually every taxpayer and will be vital to the real estate industry. However, the rules are taxpayer friendly and provide a number of opportunities and advantages if applied correctly.

The new rules include several advantages for the taxpayer:

* De minimus Expensing Election - Taxpayers can deduct up to $5,000 per item by preparing an Applicable Financial Statement (AFS) and a capitalization policy.

* Routine Maintenance Safe Harbor - Taxpayers can write off the cost of keeping building property in its ordinary, efficient operating condition, as long as it's expected to be performed more than once in 10 years.

* Disposition rules - Taxpayers can write off building structures that are replaced or destroyed.

* Small Taxpayer Safe Harbor - Taxpayers with gross receipts of $10,000,000 or less can deduct without capitalizing if the repairs do not exceed $10,000

To meet the new requirements and take advantage of the benefits, taxpayers must write and follow a capitalization policy. Additionally, internal accounting should now separate out building structures (such as roof and facade), as well as the nine building systems defined by the IRS in the new rules. Finally, cost segregation studies will become more valuable, since they allow taxpayers to break down the cost, making disposition rules easier to apply.

Net Investment Income Tax

While the Net Investment Income Tax ("NIIT") applies to 2013, taxpayers will start to feel the effect as they finally make the cash payments for it this year. The tax, also known as the Medicare Tax, places a 3.8% tax on the net investment income of individuals, states, and trusts who meet a certain threshold. The threshold is an AGI of $250,000 for couples who are married and filing jointly, or $200,000 for taxpayers filing as single.

The NIIT will be placed on interest, dividends, annuities, royalties, rents, and net passive activities. The tax must be paid on rents other than those derived in a trade or business where the taxpayer is active. Some taxpayers may be able to exempt their rental income and gains from the disposition of rental property by using the Real Estate Professional Safe Harbor. The test for qualifying for this

safe harbor is complex, and requires strong record keeping.

Extenders

As Congress has focused on issues like the fiscal cliff and tax reform, the issue of extenders has been largely pushed to the side. The two most pressing extenders for real estate that have expired are the 50% bonus depreciation and the 15 year recovery life for Qualified Leasehold Improvements (QLHI). Both of these extenders expired on 12/13/13, but there is still hope that they will be extended and made retroactive to 1/1/14.

The 50% bonus depreciation allowed for a 50% deduction on property classed under the Modified Accelerated Cost Recovery System (MACRS) with a life less than 20 years, on QLHI, and on other qualified build-outs. Unless the extenders are set in place again, this deduction will not be available in 2014. The 15 year recovery life for QLHI allowed for a 15-year write-off of QLHI. Without the extenders, this will go to 39 years.

If the extenders are not put back into place, taxpayers can expect to see a negative effect. In particular, the changes could have an impact on how landlords structure Tenant Improvements (TI) and the amount of funding that's used for it, since there would be no immediate cost benefit.

There's a lot of information to take in with these new changes, and it can be difficult to find time to understand and comply with all the details. Consult with your tax advisor to find out how these changes may affect you.

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