

Real e-State

An electronic newsletter for real estate professionals ©2004

From the desk of
The Real e-ditor

April 15th! If you're like me, this date doesn't conjure up images of Opening Day, or the arrival of robins at the bird feeder. You immediately think Taxes (with a capital "T"). The day on which most of us pay and file our income taxes, or at least file an extension. Since the publication deadline for this, our second issue of the *Maddin, Hauser Real e-State Newsletter* falls on this date, it seemed appropriate to us to devote this issue to the subject of taxation, as it affects real estate professionals.

In writing the articles that follow, we have tried very hard to follow the **KISS** (Keep It Simple, Stupid) method. However, there isn't much about taxation, at any level, that one could ever call simple. So our objective is limited to providing you some useful information without getting overly technical. A challenging goal to be sure, but I hope that you will find in the pages that follow that we were successful. In this issue you will find articles covering federal income taxation of the profits on the sale of real estate, as well as State of Michigan transfer taxes and the confusing subject of uncapping property tax assessments after sale or transfer.

So, on this April 15th, I remember the words of comedian Arthur Godfrey, who said, "I'm proud to be paying taxes in the United States. The only thing is -- I could be just as happy for half the money."



Steven D. Sallen
Shareholder

FEDERAL TAX ISSUES AFFECTING REAL ESTATE

The following is a discussion between the **Real Editor** and **Robert D. Kaplow**, senior tax partner at Maddin, Hauser.

RE: Rob, its April 15th. Let's talk about some of the big picture tax concepts that real estate professionals should be familiar with. First, what is the tax rate on capital gains?

RDK: For taxpayers in the upper income tax bracket, the current tax rate on ordinary income is 35%. On sales of real estate held for less than one year, the **short term capital gain** is taxed as ordinary income.

RE: What about property held longer than one year?

RDK: For sales of real estate after May 5, 2003 the federal income tax rate on **long-term capital gain** is now **15%**. For sales prior to May 6, the rate was 20%.

RE: Obviously there is a major incentive for a taxpayer to hold investment property for at least one year.

RDK: True, but unless current law is changed, the long-term capital gain tax rate will return to 20% on January 1, 2009, or maybe sooner if there is a significant policy change in Washington

next year.

RE: Can't we avoid paying tax on sales of real estate when the money is re-invested in an exchange transaction?

RDK: Yes. Federal income taxes on many profitable commercial real estate sales can be *deferred* (although not avoided altogether) by means of a **§1031 Exchange**, provided that replacement property is formally identified within 45 days, and the proceeds of sale are reinvested in like-kind property within six months, after the sale of the relinquished property, and continue to be held for a business or investment purpose.

RE: Is it difficult or expensive to do this?

RDK: Usually, no. So long as you follow the safe harbor process set out in the IRS regulations. Successful exchanges under §1031 require thoughtful advance planning, but can provide a significant tax savings!

RE: What about depreciation?

RDK: **Commercial real estate can be depreciated** over 39 years. In other words, 2.56% of original historical cost can be deducted annually.

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STATE TAX CONSIDERATIONS AFFECTING MICHIGAN PROPERTIES

Taxes are levied on real property in Michigan in different ways. For example, the General Property Tax Act levies an annual tax, based upon the value of the property. The Real Estate Transfer Tax Act levies a value-based tax on certain "transfers" of real estate. The applicability and amount of each tax depends, in large part, on what constitutes a "transfer" of real property. Certain types of transactions are exempt from these taxes. Unfortunately, the exemptions are sometimes inconsistent with one another.

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Eleventh Annual Real Estate Law Symposium

Maddin Hauser will host its eleventh annual Real Estate Law Symposium, at the Novi Sheraton (formerly the Novi Hilton) 21111 Hagerty Road, Novi, MI on May 4, 2004, from 8:00 a.m. until 10:30 a.m.

The Real Estate Law Symposium program will feature **David Littman**, Chief Economist at Comerica Bank, who will provide his economic outlook. Individual presentations on legal techniques of interest to real estate professionals will follow.

Maddin Hauser will also host its annual Tax Symposium in the fall. Please watch for further announcements in upcoming newsletters.

If you are interested in attending our Real Estate Law Symposium or would like more information, please contact Gregory J. Gamalski at 248-827-1893 or Danielle M. Spehar at 248-827-1892.

MICHIGAN (CONTINUED FROM PAGE 1)

General Property Tax

The general property tax is levied by applying a millage rate to the taxable value of the property. The taxable value of the property is the lesser of the state equalized value (50% of fair market value) and a capped value (taxable value for the previous year, minus any losses, adjusted for inflation, plus additions). If the property is "transferred", the taxable value is increased (uncapped) to the state equalized value for the next year. Therefore, even though the general property tax is levied on the ownership of the property as opposed to the transfer of the property, determining when or if a "transfer" occurs is crucial with respect to the *amount* of the tax.

The General Property Tax Act provides that a "transfer of ownership" means the conveyance of title to or a present interest in property, including the beneficial use of the property. "Transfers" include conveyances by deed, by land contract, and certain conveyances to a trust, by distribution from a trust, certain changes in the sole present beneficiary of a trust, certain conveyances by distribution under a will, certain long term leases, certain conveyances of ownership interests in entities (e.g., corporation, LLCs, etc.), certain transfers of property held as tenants in common, and others.

The General Property Tax Act also provides exemptions that are not deemed to constitute a "transfer". Exempt transactions include the conveyance of property between spouses, conveyances where the consideration is less than \$100.00, certain conveyances to a trust by spouses if one of them is the sole present beneficiary, and a conveyance of real property or other ownership interests among members of an "affiliated group".

A "transfer" of property for purposes of the general property tax is reported to the local assessor on a Property Transfer Affidavit form. Failure to file the Property Transfer Affidavit within 45 days after transfer will subject the owner to a penalty not to exceed \$200.00. If the assessor determines that there was an unreported transfer, the property value can be retroactively uncapped back to the date of the transfer. The buyer would then be liable for any additional taxes that would have been levied, plus interest and penalties. However, if there is a transfer of ownership of the real property to a new owner (after an unreported transfer), the liability for taxes, interest and

Effort:

"Things may come to those who wait, but only the things left by those who hustle."

Abraham Lincoln

penalties stays with the seller, (i.e. the buyer who initially failed to report the transfer).

State Real Estate Transfer Tax

Most real estate professionals are also familiar with the State Real Estate Transfer Tax. This state tax is collected upon the recording of certain written instruments in the State of Michigan. These instruments include: (a) contracts for the sale or exchange of property or any interest in the property or any combination of sales or exchanges or any assignment or transfer of property or any interest in the property, and (b) deeds or instruments of conveyance of property or any interest in property, for consideration. The State Transfer Tax is imposed at the rate of \$3.75 for each \$500.00 (or fraction thereof) of the value of the property being transferred. Under the Act, the seller is liable for the tax, but the burden can be shifted by agreement of the parties. A separate County Transfer Tax is imposed at the rate of \$0.55 for each \$500.00 (or fraction thereof) of the value of the property being transferred.

The Real Estate Property Tax Act also exempts certain transactions. These include conveyances where the consideration is less than \$100.00, a conveyance from a husband and wife creating or disjoining a tenancy by the entirety, a conveyance to a child or grandchild, certain land contracts, and a conveyance where the transferor and transferee are considered a "single employer" (as defined in Section 414 of the Internal Revenue Code).

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Success:

"The secret to success is to start from scratch and keep on scratching."

Dennis Green, football coach

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Definition:

"Capital Punishment:
The income tax."

Jeff Hayes

FEDERAL (CONTINUED FROM PAGE 1)

RE: But the concept of depreciating real estate seems counter intuitive, since real estate tends (we hope!) to *appreciate* over time.

RDK: That is why the difference between historical cost basis and net book value (i.e., after depreciation) is taxed upon sale. The **depreciation recapture tax rate is 25%** (subject to certain exceptions).

RE: What about **depreciation of leasehold improvements?**

RDK: Persons constructing certain leasehold improvements can depreciate their cost over the same 39 year depreciation period.

RE: Even where the lease term is just a few years?

RDK: Yes, but in addition to normal depreciation, special **bonus depreciation** of 30% (§168(k)(2)) or 50% (§168(k)(4)) can be taken for certain types of leasehold improvements (§168(k)(2)) or personal property (§168(k)(4)) used in buildings more than three years old, where the items are placed in service by December 31, 2004.

RE: That's great. Are there any other incentives worth noting?

RDK: Yes. There may also be an available **\$100,000 expense deduction** for up to \$400,000 of personal property placed in service prior to December 31, 2005. So a taxpayer investing in qualifying leasehold improvements or personal property totaling, say \$250,000, can deduct up to \$100,000 in the first year. The remaining \$150,000 could also be eligible for up to a 50% bonus depreciation in the first year, or \$75,000.

RE: What about the remaining basis of \$75,000; can we still depreciate that?

RDK: That amount would be depreciated over the usual 39 year recovery period, including 2.56% in the first year.

RE: Rob, those are great insights. Thanks.

Death & Taxes:

"Our Constitution is in actual operation; everything appears to promise that it will last; but nothing in this world is certain but death and taxes."

Benjamin Franklin

MICHIGAN (CONTINUED FROM PAGE 2)

A simple comparison of the transactions that are included as a "transfer" under both statutes (either under the inclusionary rules or by lack of an exemption) reveals that some transactions are not treated the same under the two acts. For example, if a person transfers an ownership interest of more than 50% in a corporation or LLC, the taxable value is uncapped. However, this same conveyance is generally not a "transfer" for purposes of the real estate transfer tax. Interestingly, however, the Michigan Tax Tribunal recently issued an Opinion that in-kind distributions of real estate to members of a limited liability company requires payment of transfer taxes (See [Hansen Plaza, LLC v Michigan Dept. of Treasury](#), MTT Docket No. 263743 (December 2003)).

Determining when a "transfer" has occurred is critical in determining the amount of the general property tax and the applicability of the real estate transfer tax. Although many conveyances will result in a "transfer" for purposes of both taxes, some will not. In each circumstance, one must consider the facts surrounding the conveyance, understand whether a "transfer" has occurred for purposes of each of the two taxes, and determine if any exemptions apply. The law might result in a "transfer" occurring for one of the taxes but not for the other.

While the analysis under the General Property Tax Act and the State Real Estate Transfer Tax Act can be complicated, the potential impact on real estate transactions and the parties involved can be significant.

More Information: www.michiganlegislature.org

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