Maddin Hauser Wartell Roth & Heller PC
attorneys and counselors

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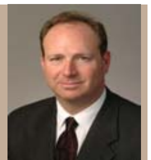
From the desk of: The Real e-ditor



I spent a recent Sunday preparing my tax records for my CPA. Afterwards, I felt low. Not only had I spent a lovely Sunday morning locked indoors, in that annual, depressing ritual of scrounging for records and receipts that held the key to my keeping more of my hard earned money, but also because preparing my taxes focused my attention on things I have no control over. For 2004, the time for planning is long gone. Now, all I could do was compile the information, send it to my CPA, and hope that when he returns my 1040, I will have planned well. Otherwise, my penalty will be writing a check to Uncle Sam.

The very next day, I attended Opening Day at Comerica Park. This annual Spring ritual usually consists of shivering in a cold and damp stadium, only to watch our Tigers take the first of what will surely be many beatings on their home field. But this year was different! High clear skies shone over the diamond. Our seats were bathed in warm sunshine. The crowd was festive with the hopefulness that is Opening Day in Detroit.

Attending Opening Day this year felt like time-travel to mid-Summer to see a (dare I say it?) Pennant-bound team. Suddenly, the worry of my taxes, of "the economy", the general pressures of life all melted away. Gone. A mere memory, like the snow of just a few days ago. Afterwards, a hopefulness that only a trip to Comerica Park on Opening Day can create, lingers. Realizing that "next year" is now, but that it's not too late to make plans, even changes to have a more successful year than last, is what Opening Day is all about. And, isn't that a wonderful metaphor for us, in our jobs here, as we start the second quarter of 2005?

In that spirit then, we bring you this issue of *Real* e-*State*. Articles on cost segregation and property tax uncapping may prove useful to you or your clients in future tax planning. We have also included an article on Industrial Revenue bond financing, for those of you looking for below market interest rate financing. So now, with April 15th behind us, we are surely "in the swing of things" for 2005.

> "What are we out at the park for except to win?"
>
> **— Leo Durocher,** *baseball player, manager*

Commercial Property Owners May Lose Under Governor's Proposed Jobs and Investment Act

BY: GEOFFREY N. TAYLOR

Michigan imposes an annual tax on real property equal to the product of taxable value multiplied by the appropriate millage rate. Taxable value equals the lesser of (i) the State Equalized Value (SEV), which is approximately 50% of the property's assessed true cash value (i.e., fair market value), or (ii) the capped value of the property. The capped value equals the taxable value of the property in the immediately preceding year minus any "losses," multiplied by the lesser of (i) 1.05 or (ii) the increase in the immediately preceding year in the consumer price index plus any "additions." Therefore, absent "additions" and/or "losses," taxable value cannot increase in any year by more than the lesser of 5% or the rate of inflation. However, if ownership of the property is transferred, the cap is eliminated and the taxable value may increase up to the property's SEV for the year following the year in which ownership is transferred.

While "additions" increase taxable value and "losses" reduce taxable value, they do not uncap taxable value. "Additions" include new construction, remodeling, and the physical addition of equipment or furnishings (whether by the landlord or tenant). "Losses" include removal or destruction of real or personal property and environmental contamination.

For "additions" to real property, case law provides that an "addition" does not permit the assessor to uncap the entire property's taxable value. The assessor may average the value of the "addition." The remainder of the parcel remains subject to the annual cap.

> **"...commercial real estate owners may lose the benefit of reduced taxable value resulting from a decrease in the property's occupancy."**

Changes in a property's occupancy rate can also change taxable value. MCL 211.34d(1)(h)(iii) provides that a reduction in mar-

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Low Interest Opportunity for Industrial Development

BY: LINDA E. BLOCH

In today's competitive marketplace, your clients are constantly searching for ways to reduce their costs. They should be aware of the Small Issue Industrial Development Revenue Bond ("IRB") Program. The IRB program has been the cornerstone of government efforts to provide affordable, long term capital for the acquisition, construction and improvement of manufacturing facilities.

> **"Cost savings can be dramatic… The average variable tax-exempt bond rate... [for the first months of 2005] was 1.83%."**

An IRB is a tax-exempt obligation issued by a public entity (an "Issuer") to provide funds to a local business. The bonds, which are secured by a letter of credit obtained by the borrower, are sold by an underwriting firm to investors. The bonds are sold by the underwriter on the basis of the credit of the issuing bank rather than the borrower. The proceeds of the bonds are then loaned to the borrower to finance a specific capital project.

Cost savings can be dramatic. The average prime interest rate for the first months of 2005 was **5.25%**. The average variable tax-exempt bond rate for the same period was **1.83%**.

Some of the other advantages of IRB Financing include:

- IRB financing allows private companies access to the low rate, tax-exempt marketplace.
- Fixed or variable rate financing is available.
- Choices in amortization of principal: straight-line (equal principal), balloon, bullet, or customized schedules.
- IRB financing can be used to meet not

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Using Cost Segregation to Achieve Tax Savings

by: Michael K. Hauser

Brokers and other real estate professionals can help clients who are buying real estate for investment purposes or for use in a business to enhance depreciation write-offs through cost segregation. Owners can generally write off ("depreciate") the building's cost over its "tax life" (39 years for commercial property, 27.5 years for residential property). Further, part of the building's cost can be allocated to land improvements (such as parking lots), depreciable over 15 years, or to personal property within the building (such as carpeting or appliances), depreciable over 5-7 years. Yet, part of the purchase price must be allocated to the land, which does not "wear out" and thus cannot be depreciated.

There is no set formula for how to allocate costs between land, land improvements, personal property and the building itself. Taxpayers must make their own allocations, which need to be justified in the event of an IRS audit. Thus, taxpayers should collect as much documentation as possible to evidence that the allocation to land should be relatively low (since it is non-depreciable) and that the allocation to land improvements and personal property should be high (since their depreciation periods are shorter and deductions come sooner). A mere allocation of the purchase price between the different components, as reflected in the purchase agreement, would not be determinative of the values as the IRS would likely view such an allocation as being self-serving.

> **"A real estate professional looking to add value can help a purchaser collect documentation for such cost segregation, so that the client's tax professional is not left to guess the following April."**

When a tax professional bases a tax allocation on documentary evidence, rather than mere guess-work, the allocation is more likely to survive an IRS audit. Further, a tax professional likely will end up making a more aggressive tax allocation if provided with extensive documentation. The professional might also suggest certain transactional techniques to enhance deductions, discussed below, most notably a land lease.

Land:

Any documentary evidence justifying a minimal land allocation is helpful. So, get the local tax assessor's property value break-down, find out the appraiser's land-building allocation (or ask him to make one); and find evidence of comparable vacant land. Whichever one of these valuation methods puts the least value on the land, that's probably going to be the tax professional's starting point. Alternatively, recommend a ground-lease for the land, preserving title to the land in the seller or a third-party. Structured properly, land lease payments will be deductible.

Land Improvements:

Land improvements are non-depreciable if they permanently improve the land (e.g. clearing and leveling), but are depreciable over 15 years if they improve the land only while a particular building is present. For example, sidewalks, parking lots, drainage facilities, fences, bridges, and shrubbery are typically depreciable. Land-preparation costs are depreciable only if they enhance the land for a specific use, such as concrete pads in a mobile home park.

Personal Property:

Generally, structural components of a building must be depreciated over the life of the building (27.5-39 years). However, if property is movable, or if it is not permanently attached to the buildings, or if it is not inherently destined to remain with the building, then it is probably personal property which can be depreciated over 5-7 years. Examples of 5-7 year property include: floor coverings; wall partitions; signs; window treatments; appliances / kitchen; and back-up generators, as well as plumbing, electrical, and HVAC, to the extent needed for specialized equipment (rather than for the whole building). Design and installation costs related to 5-7 year property can also be depreciated over a like period.

For recent construction, the best proof of the cost breakdown comes from construction documents like blueprints, sworn statements, builder draw requests, cost worksheets, and invoices. For older buildings, the task is more challenging. One can try to obtain these original documents, retain an expert to perform a detailed cost-estimate analysis, or ask the appraiser to account for at least the major personal property items. One can also calculate the replacement cost of specifically identified 5-7 year items, although the value would need to be adjusted based on the age of the assets. Ordering an expert-prepared estimated cost breakdown based on a sample of similar buildings is another possibility.

Intangible Allocation

Generally, one cannot allocate any portion of a purchase price to intangible assets like the value of leases or tenant relationships. Still, in appropriate settings, one could reduce a purchase price by, say, 5%, and execute a side contract for that 5% wherein the buyer acquires intangibles which can be clearly separated from the property, such as: a covenant not to compete; use of the building's trade name; workforce-in-place (preventing the seller from re-locating the building's employees); information base (tenant payment histories and computer records); and future tenant waiting lists. Such intangibles can be depreciated over 15 years.

A real estate professional looking to add value can help a purchaser collect documentation for the foregoing "cost segregation" techniques so that the client's tax professional is not left to guess the following April. The tax professional may even suggest the client obtain a specialized cost segregation analysis or a standard appraisal with cost-segregation in mind. Of course, the costs of such an analysis or appraisal may be prohibitive, depending on the extent of the possible tax benefit.

For example, assume that a taxpayer purchases a commercial building for $2 million. If the taxpayer merely allocates 20% to land ($400,000), 5% to the parking lot ($100,000) and 75% to the building ($1.5 million), his annual depreciation deduction will be about $48,000 in the initial few years. However, if the taxpayer assembles sufficient documentation to justify a 15% land allocation ($300,000), a 10% allocation to land improvements ($200,000), a 10% allocation to personal property in the building ($200,000) and a 65% allocation to the building itself ($1.3 million), his annual depreciation deduction will be about $103,000 in the initial few years. The enhanced deductions in the latter case will wear off over time, but not before significant tax savings have been achieved, thereby justifying the expense of a cost-segregation analysis.

Twelfth Annual Real Estate Law Symposium

Maddin Hauser will host its twelfth annual Real Estate Law Symposium at the Novi Sheraton (formerly the Novi Hilton), 21111 Haggerty Road, Novi, MI on Wednesday, June 1, 2005 from 8:00 a.m. until 11:00 a.m.

The Real Estate Law Symposium program will feature individual presentations by members of the firm on topical issues for real estate professionals.

If you are interested in attending our Real Estate Law Symposium or would like more information, please contact George A. Contis at 248-827-1886 or Danielle M. Spehar at 248-827-1892. Or e-mail your reservation to 2005Real@maddinhauser.com.

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"Never let fear of striking out get in your way."

— Babe Ruth

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ket value resulting from a decrease in a property's occupancy rate is a "loss" for assessment purposes. Conversely, MCL 211.34d(1)(b)(vii) provides that an increase in market value resulting from a recovery in a property's occupancy rate is an "addition" for assessment purposes. However, in May 2002, the Michigan Supreme Court invalidated MCL 211.34d(1)(b)(vii) as unconstitutional. Therefore, under current law, taxable value can decrease substantially due to a reduction in occupancy but can increase only by the lesser of 5% or the rate of inflation when occupancy is recovered.

Commercial real estate owners may soon lose the benefit of reduced taxable value resulting from a decrease in the property's occupancy. In January 2005, Governor Granholm introduced the Jobs & Investment Act (the "Act"). The proposed Act would restructure Michigan's single business tax purportedly to make Michigan more attractive for job providers. If passed, the Act would be effective starting January 1, 2006. A summary of the Act circulated by the Governor's office provides that in order to make business tax structure fairer, the Act will eliminate the special property tax treatment of commercial rental property by treating changes in value like all other changes in value are treated for assessment purposes. No one knows exactly what this means because the Governor's office has not provided any further information with respect to this provision. An official at the Michigan Department of Treasury, who spoke on the condition of anonymity, strongly suspects that the Act may eliminate the treatment of a reduction in the occupancy rate of commercial rental property as a "loss" for property tax assessment purposes.

If the Act voids MCL 211.34d(1)(h)(iii), taxable value would not be affected by a decrease in a property's occupancy rate. The following scenario could arise: assume that (i) the taxable value of commercial rental property that was purchased in Year 1 is $1 million in Year 2, (ii) the rate of inflation is 2%, and (iii) by the end of Year 4 occupancy of the property is 50% of the Year 1 level. Under current law, the taxable value of the property in Year 5 would be considerably less than $1 million because the taxable value would reflect the decrease in the fair market value of the property resulting from the reduction in occupancy. However, if MCL 211.34d(1)(h)(iii) were eliminated by the Act, the taxable value of the property in Year 5 would equal approximately $1,061,000 ($1 million increased by 2% annually from Year 2 through Year 5). Unfortunately, since the Governor's office has not generated any new information on the Act, its intended effect on commercial rental property is mere speculation. Until more information is provided about the mechanics of the Act, commercial rental property owners will have to wait and see if they will be the losers under the proposed Act.

IRB (Continued from Page 1)

only present capital needs but those reasonably anticipated over the next three years as well.

- Registration under the Securities Act of 1933 is generally <u>not</u> required.
- Issuance costs of up to **2%** of bond proceeds may be financed under the bond issue.
- Bonds in the variable rate mode may be prepaid at any time, in whole or in part, without premium.

"Progress always involves risks. You can't steal second base and keep your foot on first."

— Frederick B. Wilcox

Of course, the IRB program is not without restrictions. Some significant restrictions imposed by the Internal Revenue Code include:

- At least 95% of bond proceeds must be spent on acquisition or improvement of real estate and depreciable property; no more than 25% may be used for the acquisition of land.
- At least 95% of bond proceeds must be spent for manufacturing facilities. At least 70% must be allocable to "core" manufacturing facilities (*i.e.*, property used in the production of the product) and no more than 25% to related and ancillary purposes (i.e., office space, storage space, parking lots, sales showrooms, loading docks, forklifts, rail spurs etc.).
- No more than 2% of bond proceeds may be used to pay bond issuance costs.
- Bond proceeds cannot be used to purchase used property unless, in the case of a used building, at least 15% of the cost of the building will be spent after the purchase for rehabilitation. In general, the cost of used equipment alone may not be financed with bond proceeds.
- Real estate and equipment financed with bond proceeds must be depreciated on a straight-line basis over the useful life set by the Internal Revenue Code.
- Bond proceeds must be spent within defined time periods (generally 6 months to 2 years after bond issuance).

Other requirements may apply and determination as to whether all requirements of the Internal Revenue Code can be met is made by bond counsel.

IRB financing is restricted to the acquisition of land, buildings and equipment for *manufacturing* facilities. In general, small to medium size companies should investigate the possibility of IRB financing if they are considering capital improvements or acquisitions in excess of $1 million but under $10 million. So if your manufacturer or industrial developer client is seeking long term low interest rate financing, IRB's may be the ideal vehicle.