

# Real Estate *advisor*

September • October 2011

## **A GRAT can be a great way to transfer a business**

Year end is fast approaching:  
Tax strategies to consider

*Sec. 179 expensing*  
You may qualify for extra expense deductions

### **Ask the Advisor**

What type of due diligence is necessary in today's market?



# A GRAT can be a great way to transfer a business

Succession planning for your real estate business can be daunting. Along with selecting the right family member or other individual to carry on the business, you must weigh a variety of tax and financial planning issues. Some closely held business owners have found it pays to use a grantor retained annuity trust (GRAT).

A GRAT can help you minimize gift and estate tax liability associated with transferring ownership interests while retaining an income stream for a specified period of time. And it may be particularly powerful in the current economic environment, where the lifetime gift tax exemption is high and the value of your business may be lower than it was a few years ago.

## The nuts and bolts

A GRAT is an irrevocable trust funded by a one-time contribution of assets by the “grantor.” For example, if you’re the owner of a real estate development company, you can transfer some or all of your ownership interests in the business to the GRAT. The GRAT pays you, as the grantor, an annuity for a specific term.

The amount of the annuity payment is a fixed percentage of the initial contribution’s value or a fixed dollar amount; either way, the payment must be made at least annually. You maintain the right to the payments regardless of how much income the trust actually produces.

When the GRAT’s term expires, the assets remaining in the trust (known as the “remainder”) transfer to designated beneficiaries. But



your gift tax is assessed when the GRAT is funded, based on the value of the beneficiaries’ remainder interest.

*With the lifetime gift tax exemption increased from \$1 million to \$5 million for 2011 and 2012, your gift tax obligation when funding a GRAT may be significantly lower than it would have been in the past.*

The remainder interest’s value hinges in part on an IRS interest rate, known as the Section 7520 rate, at the time of the GRAT’s creation. An asset such as an ownership interest in a closely held real estate business must undergo a valuation before the Sec. 7520 rate can be applied to calculate the remainder interest’s value.

If the Sec. 7520 rate is low (as it has been recently) and the trust assets can generate a

higher rate of return, the assets will be worth more when the trust terminates than the remainder interest's gift tax value. So, the excess asset appreciation over the term of the trust passes to the beneficiaries free of gift and estate taxes.

Furthermore, with the lifetime gift tax exemption increased from \$1 million to \$5 million for 2011 and 2012, your gift tax obligation when funding a GRAT may be significantly lower than it would have been in the past or stands to be in 2013, when the exemption, absent additional Congressional action, will drop back down to \$1 million.

In addition, if your business's value is currently lower than it has been, the interests will have a lower value for gift tax purposes. And GRATs work particularly well with interests in closely held businesses because valuation discounts can reduce a gift's value for tax purposes even more.

You must report the income, gains and losses from the trust assets on your individual income tax return. Paying income tax on the trust asset income and gains is actually beneficial for estate planning purposes. Why? By you paying the tax (rather than the GRAT paying them), you're preserving the trust's assets for the beneficiaries — essentially making additional tax-free gifts to them — and further reducing the size of your taxable estate.

### IRS rules

While the IRS accepts GRATs as valid vehicles for transferring assets, it does impose some rules on the trust instrument used to create a GRAT. The instrument must prohibit:

- Additional contributions to the GRAT,
- Commutation (prepayment of the grantor's annuity interest by the trustee), and
- Payments to benefit anyone other than the grantor before the grantor's retained interest expires.

Moreover, issuing a note, other debt instrument, option or similar financial arrangement to satisfy the annuity obligation is not allowed.

### Act now

If a GRAT sounds right for you, now is the time to contact your tax advisor. First, you can potentially take advantage of a low business value, a low Sec. 7520 rate and a high gift tax exemption.

Second, Congress has introduced several bills that would limit the benefits of GRATs by, for example, requiring a minimum term of 10 years. Why does the term of the GRAT make a difference?

If the grantor doesn't survive to the end of the GRAT term, the gift is effectively "undone" for tax purposes, and the GRAT assets are included in the grantor's estate at their current value. The benefit of transferring the appreciation out of the grantor's estate will be lost. It's likely that any successful legislation would apply only *prospectively*, though, leaving existing GRATs intact. ■

## GRATs, GRUTs and GRITs, oh my!

GRATs aren't the only type of grantor trusts available for estate planning. You might also want to consider a grantor retained unitrust (GRUT) or grantor retained income trust (GRIT). Like a GRAT, both are irrevocable trusts created by the transfer of assets and followed by the gift of remainder interests, but there are some key differences.

When you create a GRUT, you retain an annual right to receive a fixed percentage of the net fair market value (FMV) of the trust assets, as determined on an annual basis, for a specified term. If the FMV increases, the amount of your payment also increases. Just as with a GRAT, if you survive the term, the remaining value of the trust passes to the named beneficiaries.

With a GRIT, you retain the right to receive all of the income the trust generates for either 1) the earlier of a specified term or at your death, or 2) a specified term. If you outlive the specified term, any principal left in the trust passes to the beneficiaries named in the trust instrument. However, the beneficiaries can't be members of your family.

# Year end is fast approaching: Tax strategies to consider

If you're like many business owners, you're always looking for ways to save tax dollars. Fortunately, there are several ways you can do just that. Here's how.

## Get a bonus

A 2010 tax law change significantly enhanced bonus depreciation by temporarily increasing this additional first-year depreciation allowance to 100% for 2011 and providing a 50% allowance for 2012. This is a huge boon if you're considering purchasing certain business assets. Qualified assets include new tangible property with a recovery period of 20 years or less (such as qualified leasehold-improvement property, office furniture, equipment and company-owned vehicles).

If you're anticipating major purchases of assets in the next year or two that would qualify, you

might want to time them so you can benefit from 100% bonus depreciation. (For information on another depreciation-related break that's been enhanced for 2011, see "You may qualify for extra expense deductions" on page 5.)

*If you're anticipating major purchases of assets in the next year or two that would qualify, you might want to time them so you can benefit from 100% bonus depreciation.*

## Don't forget the MACRS

The Modified Accelerated Cost Recovery System can save you tax because it divides business assets into classes and specifies shorter time periods over which they can be depreciated than under the straight-line method. For example, business equipment is depreciated over three, five or seven years; land improvements over 15 years; residential rental property over 27.5 years; and nonresidential rental property over 39 years. Most of these assets have useful lives that extend well beyond their MACRS recovery periods.

Another tip: If you've recently purchased or built a building or are remodeling existing space, consider a cost segregation study. It identifies property components and related costs that can be depreciated much faster, dramatically increasing your current deductions.

## It's all in the timing

Typically, it's best to pay taxes later rather than sooner, so deferring taxable income to next year and accelerating deductions to this year may be beneficial. Try to put off sales of property that will result in taxable income until after the first of the year.



If you have an asset that's been declining in value, realizing losses on a sale could be a good strategy to offset taxable gains. If you can sell these holdings, you may be able to reduce your tax burden. Also work with your tax advisor to determine which tax credits are available to you and take steps before year end so you can qualify.

### Save yourself a buck or two

There are also some tax-saving strategies that will help lower your personal tax bill. First, make sure you fully fund your retirement accounts. You may be able to make *pretax* contributions of up to \$16,500 (\$22,000 if you're age 50 or older) to your 401(k), or make *tax-deductible* contributions up to \$5,000 (\$6,000 if you're 50 or older) to your traditional IRA and enjoy *tax-deferred* growth.

If you like the idea of *tax-free* growth, contribute to a Roth IRA or Roth 401(k). The contribution limits are the same as those of their non-Roth versions. However, your eligibility to deduct contributions to a traditional IRA or make contributions to a Roth IRA may be reduced or eliminated based on your income and other factors.



Also consider making donations to a qualified charity. Such gifts are generally fully deductible. Finally, as a business owner, you can hire your children and deduct their pay. Keep in mind, though, that your children must perform actual work for wages and be paid in line with what you'd pay nonfamily employees.

### The clock is ticking

Because many of these tax-saving strategies must be employed before year end, contact your tax advisor right away. Together, you can work out a plan that helps you save taxes for 2011 and beyond. ■

## Sec. 179 expensing

# You may qualify for extra expense deductions

**T**ax law changes passed last year opened the doors for some major tax savings on 2011 business purchases. Under the temporary modifications to Section 179 expensing rules, you might be able to deduct — rather than depreciate over a number of years — costs related to qualified leasehold-improvement, restaurant and retail-improvement property. Interested? Read on.

### Sec. 179 modifications

For 2011, the maximum Sec. 179 expense deduction is \$500,000. The deduction is subject to a dollar-for-dollar phaseout after the cost of all Sec. 179 property placed in service during the tax year exceeds \$2 million.

The definition of Sec. 179 property has been expanded to include, for tax years starting in



2010 and 2011, “qualified real property.” Up to \$250,000 of the \$500,000 expense deduction can be attributable to such property.

### Qualified real property

The definition of “qualified real property” covers:

**1. Qualified leasehold-improvement property.** This generally includes improvements made to the interior of a nonresidential building by the lessor, lessee or sublessee, under or according to a lease. The premises must be occupied exclusively by the lessee or sublessee and the improvements must be made more than three years after the building was placed in service. Building enlargements, elevators, escalators, structural components benefiting a common area or interior structural components don’t qualify.

Note that leasehold-improvement property, if *new*, may be eligible for 100% bonus depreciation,

which isn’t subject to a phaseout. See “Year end is fast approaching: Tax strategies to consider” on page 4.

**2. Qualified restaurant property.** Generally, this involves improvements to a building with more than 50% of its square footage used for the preparation of, and seating for on-site consumption of, meals.

**3. Qualified retail-improvement property.** This generally includes improvements to an interior portion of a nonresidential building if that portion is open to the public and used in the retail trade or business of selling tangible personal property to the general public. The improvement must be placed in service more than three years after the building was placed in service and may not be a building enlargement, elevator, escalator, structural component benefiting a common area or interior structural component.

You can claim the Sec. 179 expense deduction only to offset net income, not to reduce it below zero. Although any excess expense deductions can generally be carried over to subsequent tax years, you can’t carry over any unused portion attributable to qualified real property.

*You can claim the Sec. 179 expense deduction only to offset net income, not to reduce it below zero.*

### Don’t delay

In the absence of additional legislation, the maximum Sec. 179 expense deduction will drop to \$125,000 for 2012, with a phaseout starting at \$500,000 of investment (both amounts subject to inflation indexing), and qualified real property will no longer be eligible. Work with your tax advisor to determine whether you can take advantage of the expanded break while it’s available. ■

# Ask the Advisor

## What type of due diligence is necessary in today's market?

The commercial real estate market remains rocky. Historical assumptions about rent growth, lease renewals, and similar issues are less reliable than in the past. That means due diligence for new transactions will require more intensive effort and a broader, more conservative focus.

### Which information *must* be reviewed?

Examine these categories of information:

- 1. Financial data.** Request at least three years' financial statements, all loan documents, tax returns and bills, and any information on capital improvements. Consider how you could operate the property more efficiently, but don't be overly optimistic when estimating economies of scale and synergies with other properties.
- 2. Tenants and leases.** Obtain a certificate of occupancy for the property, lease agreements and data on tenant mixes. Compile rent rolls to assess future rental income and lease terms. For leases nearing expiration, consider whether to renegotiate terms or replace undesirable tenants.
- 3. Insurance and title policies.** Scrutinize policies and riders as well as related risk assessments and claims history. If the policy hasn't been updated to reflect current market values, the property may be overinsured.

### Should you go beyond traditional due diligence?

Qualitative assessments of the property are as important as quantitative data. Always visit the property, focusing on competing properties, traffic patterns and any neighborhood characteristics that could change your assumptions. For example, if a competitor has recently renovated, it might affect market rents or force you to improve your property.

Know the comparables in the area, including *current* rental rates, selling prices, market saturation and vacancy rates. Outdated or dissimilar comps can lead to poor investing decisions.

Then inspect individual units. Look for attributes that make a unit hard to lease, such as an unusual layout. Or you might discover that a tenant business is struggling. Can you count on that business to renew its lease or keep up with rent payments and maintenance?

Finally, talk with tenants to find out if they're satisfied with the property and management, or if they have complaints that could affect renewal decisions.

### What else should due diligence cover?

Due diligence should also extend to zoning and land use issues, such as judgments, claims and liens; third-party contractual obligations (such as construction warranties); and environmental issues. More due diligence is required if the property's distressed. Neglected properties risk tenant default and might not comply with building and other codes. You can still land a good deal — just work with your real estate and financial professionals to identify and reduce the risks. ■



