NJPA Real Estate Journal

Friday, April 28, 2006 Covering the States of New Jersey, Pennsylvania and Delaware

Commercial Tax Issues 2005

By Edward Mendlowitz, CPA, WithumSmith+Brown

Choosing the right entity for a real estate investment

Real estate presents many opportunities for tax benefits. However, choosing the wrong form of entity could cancel out some of the tax benefits.

The basic rule is that $25,000 in real estate losses are deductible in provided the adjusted gross income is not over $100,000; and phased out until the AGI reaches $150,000. Thereafter no losses are deductible. Un-deducted losses get carried forward and can offset future profits, or can be deducted in full when the property is disposed of. Trap: Unused (or suspended) losses cease upon death. Because of this, it is essential that real estate be owned either personally or in a pass through entity – not in C corporate form.

Edward Mendlowitz

Losses are deducted to the extent of basis, which can include the owner's share of nonrecourse mortgages if the property is owned in an unincorporated entity, such as individually, in an LLC, or in either a general or limited partnership. Mortgages cannot be used for basis in S corporations. That is one reason why real estate should not be owned in an S corporation.

When an interest in real estate that is owned in LLC or partnership form is acquired, the excess over book value that is paid can be depreciated provided the entity make an election under IRC Section 754. This is a great benefit since the excess over book value that was paid can provide current additional depreciation deductions. Extra: This also applies to real estate that was inherited even though no money changed hands. The 754 election provides for a separate calculation of depreciation that applies only to the individuals it relates to.

Using a partnership or LLC

In addition to the two previous benefits, these forms of entities permit special allocations of profits and losses to different partners. Ownership percentages in an S corporation are much more rigid and inflexible.

Not a tax reason, but an asset protection benefit is for real estate owners to transfer their property into an LLC, limiting their liability from operating the property. These transfers can be done tax free. Use a one person LLC to own your real property. Tax returns do not have to be filed, with the income and expenses are reported on an individual income tax return. Note that there is no separate federal tax on LLCs, but some States will tax the LLC, so consult with an attorney in the State where you will own the property.

Edward Mendlowitz, CPAis a shareholder in WithumSmith+Brown in New Brunswick, NJ. ■