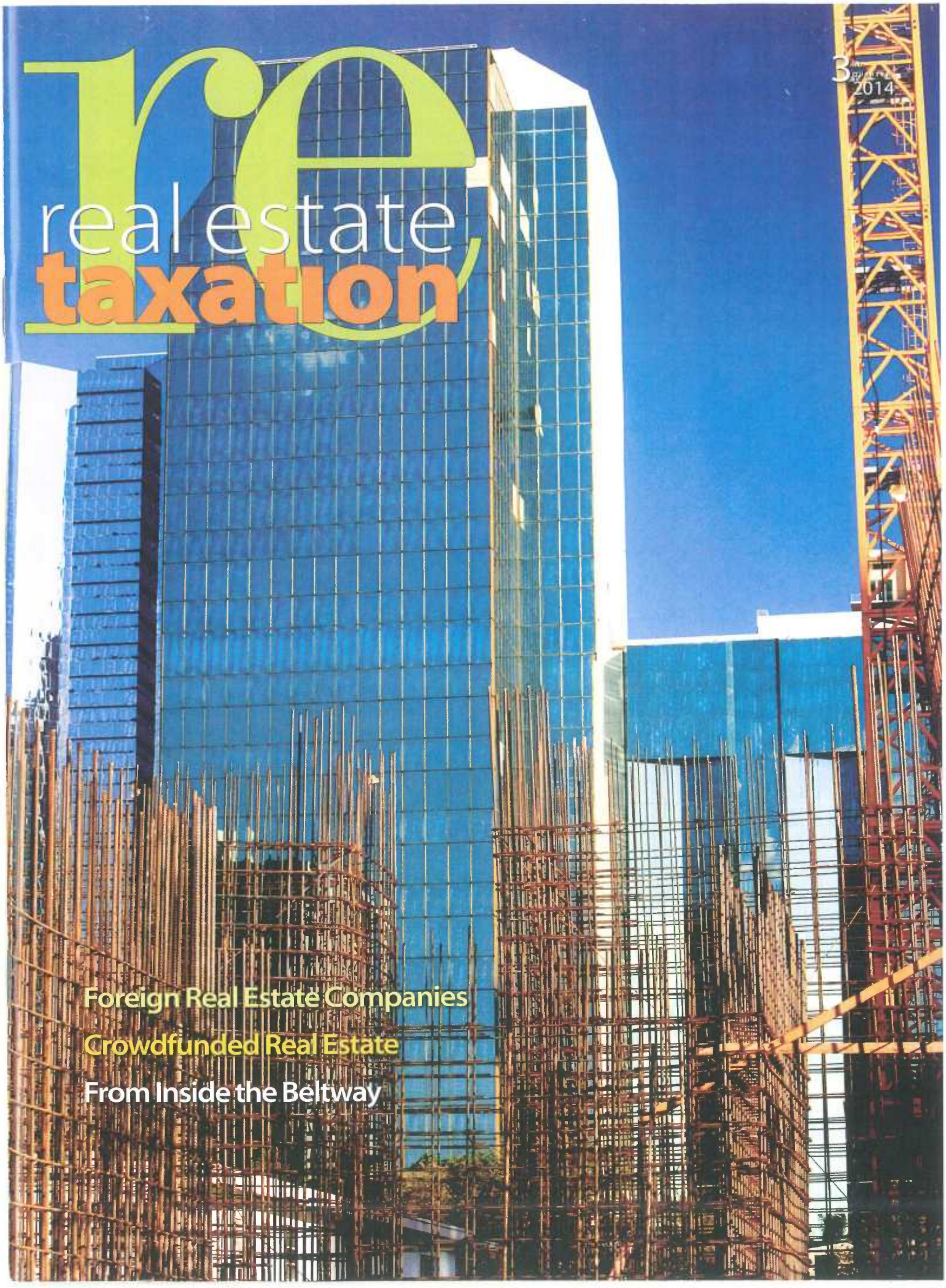

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SAVING TAXES AND ENHANCING THE VALUE OF REAL PROPERTY

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There are a variety of techniques for saving taxes and increasing cash flow/yield associated with real property assets.

Saving taxes tends to drive most discussions between advisors and clients, but enhancing asset performance and principal protection are also worthy of consideration. By maximizing asset-class entities' and equities' performance as well as reviewing the applicability of making Section 1031 elections and using cost segregation, advice in these areas help clients achieve additional economic benefits they might not have considered on their own.

The challenge of wealth

Wealthy families often own large amounts of real estate that may be held by the client, the clients' children, and trusts for family members. These assets are often held for many years, sometimes for generations. Complicating matters is that most real estate ventures are usually owned in multi-tier controlled entities, often formed as limited liability companies (LLCs) or limited partnerships (LPs). Also, the real estate may be subject to third- or related-party liens.

There are a variety of techniques for saving taxes and increasing cash flow/yield associated with real property assets, but taking advantage of them must occur after a thorough review of current laws and each individual situation. Options are available for assets that are highly appreciated and those that have had disappointing results, but there is no "one size fits all" solution.

Using partnerships

The merits of placing real property assets into LLCs or LPs as well as trusts for asset protection have been well documented. What advisors and clients must be aware of is that there must be a legitimate business purpose for any equity transfer; tax avoidance cannot be the primary reason.[1]

Preventing fractionalization of the real estate over years and providing for successor management are common arguments for establishing partnerships, as is protecting the assets from creditors or litigants who might seek to seize property if the assets were directly held. Other reasons could include market and economic risks for given asset classes and lack of diversification.

The terms of an LLC or LP agreement may also suggest the investment philosophy is to buy and hold for a significant time horizon to mitigate short-term ebbs, and may also indicate

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that liquidated asset proceeds may be reinvested to achieve returns common for the partnership's asset category. Therefore, sale or transfer to outside third parties would be restricted and could impair the desired investment outcomes. Consolidated management of otherwise fragmented assets can create a securitization of equity interest in the entity that simplifies the orderly buying and selling of equity between equity holders as well as efficient and economic control to minimize disputes and legal expenses.

Rev. Rul. 93-12,[2] acknowledges IRS acquiescence in asserting discount limitations due to family attribution. This ruling is the primary impetus for the prolific growth of LPs and LLCs as estate and gift tax-planning vehicles.

Trust and estate advisors as well as tax specialists should consider including an investment policy statement as part of the meeting minutes associated with any partnership operating agreement, trust instrument, amendment, or addendum. Such documents are very common for family offices with hundreds of millions if not billions of dollars of investments. These statements are also commonly found as part of closed-end funds, private equity group subscriptions, and other private and syndicated investments. The inclusion an investment policy statement in these minutes helps in establishing a legitimate business purpose by indicating investor return and holding period expectations. It also provides greater support for the valuation expert's level of investor value concessions ("discounts" and "premiums").

Value determination

The valuation of asset holding companies can be performed using either the distributable cash flow (DCF) or net asset value (NAV) methods.[3]

Under the DCF method, because such entities do not usually have the unilateral right to liquidate, the analyst capitalizes the net earnings of the "structure," assuming any are distributed to derive a value.

The NAV method, the most commonly used, gives an aggregate (total) value of all assets held in the "structure." This adjusted net asset value is reduced by any existing liabilities to determine NAV and assumes the willing buyer is interested primarily in the assets after discounts, for lack of marketability as recognized by Rev. Rul. 77-287,[4] lack of control (interest has no decision-making authority) as recognized by Rev. Rul. 59-604[5] and Rev. Rul. 93-12.[6] Valuation under the NAV method also includes portfolio mix (what are the assets in the structure). In addition, restrictions (obstacles placed on interest holders), blockage (the possibility that size could depress market value if sold at once), loss of a key person, absorption (time required to sell), and embedded capital gains (taxable appreciation of assets held) are considered.

As an example, one court indicated that base value, holding period, growth rate, dividends, and required return should be considered in determining appropriate marketability discounts. The court also examined holding period, dividends paid, local economy, management continuity, potential capital gain tax (24%), stock transfer restrictions (3%) and transaction costs (6%) to achieve a combined discount for lack of marketability (DLOM) of 33%.[7]

Converting assets into cash

There is a flaw in thinking that an equity interest can instantaneously be converted into cash or cash equivalent once its value has been determined. The purpose of applying adjustments ("investor concessions") to the value of a closely held interest is that value does not reflect market realities. Even if it is priced correctly, a business or other asset will sell at its highest price only after a certain "optimal" period of pre-listing preparation, listing, and funding. Moreover, a sale at the asset's highest price assumes there is a ready market and an adequate pool of well-financed buyers that most likely consists of sophisticated "value" or even "vulture" investors. Unless these investors can acquire assets or debt at significant discounts, they will not be interested in a portfolio of assets or the interests holding them.

During and following the optimal period there are opportunity costs, and after this period the pool of buyers customarily declines. Without an adequate pricing incentive/concession sufficient to affect investor return ex-

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1 See Section 2036, regarding the includability in the gross estate of a transferred property with a retained life estate.
2 1993-1 CB 202.
3 See Section 2512(a) involving the valuation of gifts/transfers.
4 1977-2 CB 319, *amplifying* Rev. Rul. 59-60, 1959-1 CB 237.
5 1959-1 CB 237 (defining fair market value and the factors to consider in rendering the opinion).
6 1993-1 CB 202 (recognizing the application of investor concessions ("discounts") for minority equity).
7 Estate of Borgatello, TCM 2000-264.

pectations, there is no guarantee a sale will even occur.

Even so, the seller will ultimately have to be qualified, and only a very small pool of buyers have sufficient capital for a mostly or all-cash purchase. Consider a 35% equity interest valued at $2,500,000. Based on reasonable asset allocation to diversify risk, an investor would likely possess a net worth of $25 million plus. There simply are not that many investors of this level of wealth who would be eligible and likely to acquire a minority interest.

One court stated the following relating to marketability discounts: "It seems clear ... that an unlisted closely held stock of a corporation ... in which trading is infrequent and which therefore lacks marketability, is less attractive than a similar stock which is listed on an exchange and has ready access to the investing public."[8] This implies the pool of potential buyers is considerably smaller based on the limited awareness of closely held investment opportunities as well as lack of ready transferability.

The valuation of asset holding companies can be performed using either the distributable cash flow or net asset value methods.

The above being said, it is important to be aware of the special valuation rules of Chapter 14 of the Code (Sections 2701-2704).

In general, the Chapter 14 rules attack traditional "estate freeze" techniques, as well as a number of other intra-family transactions, in which the value of a transferred interest is considered by the IRS to be undervalued for gift and estate tax purposes. The mechanics of Chapter 14 generally involve ignoring certain rights, restrictions, or retained interests when valuing a transferred interest. Despite these rules, however, gifts of interests in family business entities can still be eligible for valuation discounts if the entity is properly structured, the interest is a minority or non-controlling interest, and the interest has the same economic rights as other interests in the entity.

A district court has held that the taxpayer's retention of the right to vote transferred shares was not a retention of the entire value of the shares for estate tax purposes.[9] The IRS had asserted that retaining the right to vote was an impermissible retained interest under Section 2036(a). In response to this decision, Congress enacted Section 2036(b), which provides that retention of the right to vote shares in a controlled corporation (defined in Section 2036(b)(2) as ownership by the decedent of at least 20% of the voting stock) will be considered a retained interest that causes the value of the shares to be included in the transferor's estate.

Special attention to Section 2703 is appropriate, as it applies to agreements among family members involving (1) rights to acquire or use property at a price less than its fair market value or (2) restrictions on the right to sell or use property. The rights or restrictions may be contained in options; buy-sell agreements; partnership, operating, or shareholders' agreements; or any other agreement. These rights or restrictions will be disregarded in valuing the transferred property for transfer tax purposes unless the option, agreement, right, or restriction meets the following requirements:[10]

- It is a bona fide business arrangement.
- It is not a device to pass on wealth to members of the decedent's family at a reduced value.
- Its terms are comparable to similar agreements among unrelated persons in arm's-length transactions.

For example, a court held that transfer restrictions on a parcel of undeveloped real property in a family limited liability company (FLLC) should be disregarded because the FLLC did not have a bona fide business purpose.[11] The court determined the FLLC was not engaged in the business of real estate investment or development because there was no evidence either that its members made any investment in the property to increase its commercial value or that they tried to acquire additional real property as an investment for the FLLC.

Another IRS argument is that a family limited partnership (FLP) should be disregarded for federal tax purposes because it lacks economic substance. The Tax Court agreed with the IRS and disallowed a minority interest discount for lack of economic substance.[12] The court referred to several writings from the donor's professional advisors, exhorting her to make the gift to reduce her interest for the purpose of obtaining a minority interest discount.

In another case, the Eight Circuit, too, found that buy-sell provisions of an LP agreement operated to restrict the ability of the limited partners (the taxpayers' children) to reach their proportionate share of the underlying value of the partnership.[13] Therefore, the court deemed the buy-sell provisions to be a device to pass

wealth to other family members, even though the buyback provisions required the units to be priced at fair market value, and held that the IRS properly ignored the restrictions when valuing the limited partnership units because the values of the interests of the remaining partners would increase if the partnership purchased LP units transferred in violation of the agreement.

The IRS has achieved the most success in the courts using Section 2036(a),[14] which provides that a decedent's gross estate includes any property transferred by the decedent, excluding transfers by bona fide sale for full and adequate consideration, in which the decedent retained either (1) the possession or enjoyment of the property/right to income of the property, or (2) the right, alone or in conjunction with any other person, to designate the persons who could possess or enjoy the property or its income. Most planners are now convinced that partnerships should have a legitimate and significant business or nontax purpose. In addition, planners may have to take other measures to lessen the impact of these cases in any partnership in which discounts are desired or gifts are made.

Further, it has always been clear that Section 2036(a)(1) applies if the decedent had either an express or implied agreement to retain the enjoyment of property.[15] Generally, Section 2036(a)(2) was thought to be more limited in scope than Section 2036(a)(1). It was believed previously that a general partner's duty to control and manage a partnership was insufficient to cause inclusion, because of the fiduciary duties owed to the limited partners.[16] Also, one court has cited the general partner's fiduciary duties under Maryland law as a reason why Section 2036(a)(2) did not apply to gifts of limited partnership units made to trusts for the decedent's daughters.[17] It appears relatively clear that if a taxpayer establishes a significant nontax or business purpose for the formation of the business entity, Section 2036 will not apply.[18] Also, limiting liability should be a legitimate nontax purpose for these types of assets.[19]

These courts have held that if a taxpayer has a legitimate nontax purpose, such a transfer is a bona fide transfer for adequate consideration on formation of the partnership, thereby precluding the operation of Section 2036. However, the purpose must be real, not theoretical, and not simply recited in the partnership agreement. Legitimate nontax purposes may include:

- *Avoiding disproportionate distributions.* Pro-rata distributions show that all partners have a stake in the partnership. Disproportionate distributions, especially going back to the original transferor, are strong evidence of an implied agreement that the transferor may retain use of the assets.
- *Retaining funds outside partnership for personal use.* Clients should retain sufficient assets to completely fund their lifestyles. If clients have to rely on the partnership for living expenses, a court may find it very easy to infer that there was an agreement that the funds would be available for that purpose and are therefore an impermissible retained interest.
- *Respecting partnership formalities.* Obviously, separate partnership accounts and records should be kept. Holding meetings and taking minutes is also probably a good idea. Again, careful advisors will admonish clients to operate the partnership as a business (even if the business is investing in passive assets) and avoid using partnership assets for any purpose that does not benefit the partnership.
- *Documenting business purpose and economic substance.* The partnership's investment policies and activities should be documented. The investment policy should be tailored to the partnership as a whole and not to the original owner, although the continuation of certain family investment values can be a significant

[8] Central Trust Co., 305 F. 2d 393 (Ct. Cl. 1962).

[9] Byrum, 440 F.2d 949, 27 AFTR2d 71-1744 (CA-6, 1971), *aff'd* 408 U.S. 125, 30 AFTR2d 72-5811 (1972).

[10] Section 2703(b).

[11] Fisher, 106 AFTR2d 2010-6144 (DC Ind., 2010).

[12] Estate of Murphy, TCM 1990-472.

[13] Holman, 601 F3.d 763, 105 AFTR2d 2010-1802 (CA-8, 2010).

[14] See Estate of Strangi, TCM 2003-145, *aff'd* 417 F.3d 468, 96 AFTR2d 2005-5230 (CA-5, 2005) (Strangi II); Estate of Bongard, 124 TC 95 (2005).

[15] Estate of Malkin, TCM 2009-212; Estate of Jorgensen, TCM 2009-66; Estate of Bongard, *supra* note 14; Estate of Miller, TCM 2009-119; Estate of Erickson, TCM 2007-107.

[16] Byrum, *supra* note 9.

[17] Estate of Mirowski, TCM 2008-74. See also Kimbell, 371 F.3d 257, 93 AFTR2d 2004-2400 (CA-5, 2004) (decedent's 50% interest in general partner not sufficient to make Section 2036(a)(2) apply).

[18] Estate of Shurtz, TCM 2010-21 (legitimate nontax reasons included protection from risks associated with litigious environment family believed existed in Mississippi and centralization of management for decedent's timber interests); Estate of Black, 133 TC 340 (2009) (protecting family stock is legitimate nontax motivation).

[19] Estate of Bongard, *supra* note 14 (liability should be a legitimate nontax purpose for these types of assets).

nontax purpose. In some cases, the underlying activities will be ongoing businesses, which should easily satisfy the business purpose requirement, especially if the original business was not otherwise in an entity.

- *Isolating control.* The partnership can be structured so that control over distributions is held by someone other than the original owner. For example, in a partnership with two general partners, the second general partner, who should not be the client, could be given exclusive authority over distributions.
- *Having all partners contribute.* Having a number of partners contribute more than a minimal amount at the initial formation of the partnership may help the partnership qualify for the full and adequate consideration exception to Section 2036(a)(2). From a practical standpoint, having each partner risk some capital should also help indicate that the economic arrangement was a true partnership.

In drafting the agreement, two other points should be kept in mind.

There is a flaw in thinking that an equity interest can instantaneously be converted into cash or cash equivalent once its value has been determined.

- *Consider transferring all interests.* Although some of the initial appeal of the partnership may have been the ability to retain control, it could make sense for existing partnerships to consider a transfer of all the donor's interest in the partnership because Section 2036(a) is an estate tax statute and has no application for gift tax purposes. Advisors should be careful in these situations, however, to consider the three-year rule of Section 2035, which generally applies to gifts of retained interests under Section 2036(a). As a result, it may be preferable to sell, rather than give, remaining partnership interests.
- *Consider formula transfers.* One taxpayer made a transfer that was defined by a formula clause that limited the value of gifts of LLC interests to individuals and caused a larger share of the property to pass to charity if the transferred property was worth more than was reported on the gift tax return.[20] Another taxpayer used a similar approach, a formula disclaimer to prevent increases in the value of an estate on audit.[21] In both cases, the defined value formula was upheld.

Value and real estate appraisal reports

Do not simply read the real estate appraisal report's transmittal page. While not commonly considered, examining the real estate appraisal reports of the underlying assets and tax returns can yield several clues for likely investor concessions off the pro rata amount. Items of particular interest include an unusually long duration of market exposure prior to the property being sold, which tends to omit the preparation of the property and the process of proceeds being received by the partnership. These items get omitted because the real estate appraisers almost always assume direct investment ownership. In addition, discussion of the tax assessment may reveal that the appraised value is lower than the assessed value, which suggests partnership management may be inadequate.

Examining whether the deed is properly recorded is often overlooked. In the absence of proper recording, the legal risk and possibility of a reassessment of property taxes can be real. Tax returns may or may not report the same equity amount and ownership as recorded in the operating agreement, which is more common than one might think. Determine the basis of the underlying property as the equity interests may be exposed to significant capital gains as well as supporting holding periods.

Limiting conditions of the appraisal report are a treasure trove of information. This is so because the real estate appraiser may assume market rents, whereas the leases may be long term and below market rates. Therefore, the equity holder of the partnership would not realize the implied dividends from the net operating income forecast by the real estate appraiser. The property may have easement issues and/or environmental contamination, but real estate appraisers will often assume that the property is free of such impairments.

Finally, the real estate appraiser may opine a debt-to-equity mix that results in a market capitalization rate that may not be available to the current owner, due to either a decline in property value or creditworthiness, to name a few issues.

These risk and economic issues bring the discussion back to the equity interest reflecting an investor expectation. The greatest area of contention between investors and tax authorities is on impairments, ubiquitously referred to as "discounts," that drive down the pro rata value of equity. Most common is the discount for DLOM. Many advisors select a roughly 30% discount for real estate partnership equity interests and roughly 20% for undivided interests in directly owned real estate.

At first glance, why this is done is understandable. One judge suggested that the starting point is a discount between 30% and 35%.[22]

Another supported the Service's position that direct ownership interest impairments may be discounted by about 15%, but generally did not favor applying discounts.[23] This position fails to consider notional investors under the fair market value standard. What drives investor concessions is benchmarked performance over various periods to establish risk and return expectations.

In other words, if common real estate investment in multi-unit apartments generates annual yields of 5% and growth of 7%, for a 12% return, and the asset held by the partnership provides a 3% yield and a 5% growth rate, for an 8% return, investors will likely seek no less than a 33.4% concession to achieve the 12% return and likely will seek more (because they would not have direct access to the asset, but hold only an interest—likely a non-controlling one—in a partnership that holds the asset). The issue of what published study to use misses the point. These studies generally prove that illiquidity impairments exist but not how best to quantify them. (This issue does not begin to scratch the surface of the various provision restrictions found with partnership operating agreements.)

Another key issue for undivided interests is the belief the impairments are lower because a direct interest is held. Partnership agreements are almost always written to outline interest holder voting and economic rights. The holders of undivided interests seldom have such agreements. As such, regardless of the size of the interest held, interest holders are given one vote and can sue for partition, which is seldom permitted in a partnership. Investor concessions for undivided interests can often exceed 30% to 50% for partnership interests, depending on economic realities.

An equity valuation can save thousands and sometimes millions of dollars in taxes. It can assist in identifying ways to minimize risk within the real estate investment that elevates cash flow and lowers the capitalization/discount (risk) rate, which in turn raises asset value.

Using Section 1031 exchanges

Just a few years ago, the real estate industry was seen as illiquid with little hope for recovery. Families with these investments found some properties had poor recovery prospects and, as a result, the wrong properties were sometimes held by the wrong entity. For example, properties expected to rapidly appreciate might be in clients' estates, subjecting them to higher taxes, whereas stagnant properties or those decreasing in value were held in trusts outside estates, providing limited benefit.

Clients' goals should be to restructure their real estate holding structures so the properties expected to appreciate are held by trusts or entities outside of their estate. Conversely, real estate that is expected to depreciate in value or remain flat should be held in the estate. While there may be other goals, such as addressing negative capital accounts, such issues are assumed to be secondary.

Do not simply read the real estate appraisal report's transmittal page.

One way to accomplish these restructuring goals is with a series of real property transfers intended to qualify as like-kind exchanges under Section 1031. A like-kind exchange is a reciprocal transfer of property, as distinguished from a transfer of property for money as provided by Reg. 1.1002-1(b). An exchange can occur even where cash ("boot") is part of the consideration if the transaction otherwise qualifies as a like-kind exchange.

Boot is the part of the exchange that gives rise to an income benefit to the seller. This benefit can take many forms, such as cash directly withdrawn by the seller in the transaction, the exchange of property that is not like-kind, unsecured liabilities that might not be related to the otherwise qualified exchanged property, seller financing, or the transfer of a "hot asset" that would give rise to ordinary income to the seller in the normal course of business. An example of a hot asset is the assumption of a rent receivable in the transaction.

To qualify for non-recognition treatment under Section 1031 there must be an exchange for like-kind property as provided under Section 1031(a)(1), with "like-kind" referring to the nature of the property rather than its quality. Thus, transferring a rundown partially abandoned building may qualify as a like-kind exchange for an office building that has 100% occupancy. One kind or class of

[20] Estate of Petter, TCM 2009-280.

[21] Estate of Christiansen, 586 F.3d 1061, 104 AFTR2d 2009-7352 (CA-8, 2009).

[22] Mandelbaum, TCM 1995-255, *aff'd* 91 F.3d 124, 78 AFTR2d 96-5159 (CA-3, 1996).

[23] Propstra, 680 F.2d 1248, 50 AFTR2d 82-6153 (CA-9, 1982).

property may not be exchanged for property of a different kind or class according to Sections 10311(a) and (b), however. Thus an office building cannot be exchanged tax free for machinery.

In Section 1031 exchanges, care must be taken to ensure that both the real property interest and the associated debt securing it are transferred as well, even if the property's debt exceeds its market value.[24] In addition, the values being exchanged must be nearly the same to avoid a significant gain on the transfers. Boot occurs whenever property received is not of like kind or if cash is received.[25]

Cost segregation studies are not necessarily for everyone.

It may be difficult to find family-held properties that are roughly equal in value, so it may make sense to consider a Section 1031 exchange of a fee interest for several tenant-in-common interests instead.

Be aware that the exchange will subject both parties to a taxable event if the real estate is disposed of within two years, a reality that necessitates careful coordination between the related parties. The taxpayer must not have any access to the funds from the sale during the process, otherwise the Section 1031 exchange will fail and the original sale will be taxable. The process also comes with a time constraint. Replacement property must be identified within 45 days of the date of the sale of the relinquished property. The replacement property must be acquired within 180 days. A taxpayer can do a true exchange with another seller, or the taxpayer can do a third-party exchange using a qualified escrow agent.[26]

The equity that taxpayers have in the new property must be the same as or greater than what they have in the property they are giving up. This means they must put all the cash proceeds into the new property, and have debt on the new property equal or greater than the debt they had on the relinquished property. If they do not, a portion of the original sale could be taxed. The amount of reduced debt or cash not reinvested is considered boot, treated as taxable income and as though a portion of the property transferred was sold. It is always taxed first. While there are various ways to limit boot on a transaction, including receiving installment notes, their complexity puts them beyond the scope of this article.

Using cost segregation studies

One area of real estate acquisition that all accountants are asked to record is the allocation, for tax purposes, between land, land improvements, Section 1245 property,[27] and buildings. A qualified cost segregation specialist can be retained to conduct a study of this question. However, these studies are not necessarily for everyone. The cost of the property, anticipated holding period, and the owner's tax situation and general business goals may cause the owner to forgo this potential tax-savings technique.

Whether or not a cost segregation study is ordered, it is very important to properly allocate acquisition costs between land and building. This is best done using a qualified appraiser or cost segregation specialist. The term "qualified appraiser" means an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in the regulations, (2) regularly performs appraisals for which the individual receives compensation (as opposed to "dabbles," which is a breach of the AICPA's Code of Conduct under the competency provisions), and (3) meets such other requirements as may be prescribed by the regulations or other guidance.[28] An individual will not be treated as a qualified appraiser unless that individual (1) demonstrates verifiable education and experience in valuing the type of property subject to the appraisal, and (2) has not been prohibited from practicing before the IRS under 31 U.S.C. 330(c) at any time during the three-year period ending on the date of the appraisal.[29]

A penalty provision added in 2006 applies to valuation of real estate as well as to valuations of direct and indirect equity interests. If the claimed value of property based on an appraisal results in a substantial or gross valuation misstatement under Section 6662, a penalty is imposed by Section 6695A on any person who prepared the appraisal and who knew, or reasonably should have known, the appraisal

[24] Ltr. Rul. 201302009.

[25] Section 1031(c); Reg. 1.1031(b)-1(a); Reg. 1.1031(c)-1.

[26] More information about this strategy is available at www.irs.gov/uac/Like-Kind-Exchanges-Under-IRC-Code-Section-1031.

[27] Section 1245 property is any property subject to the allowance for depreciation provided in Section 167.

[28] Section 170(f)(11)(E).

[29] *Id.*

[30] Section 1250 depreciation applies to all real property that is (1) subject to an allowance for depreciation and (2) is not and never has been Section 1245 property.

would be used in connection with a return or claim for refund.

Despite these admonitions, many accountants will allocate property by gut, applying 75% or 80% of value to the building, with the balance to land. They might also use municipal data to apply a breakdown between land and building. The risk is an unfavorable allocation.

Commercial real estate is commonly purchased based on capitalization rates. If the property is acquired based on the cash flow from very favorable leases, the property value could substantially exceed the true value of the land and building.

As an example, suppose a client acquires a property under very favorable circumstances. The adjacent land is on a highly trafficked road at an intersection. The client's property was generally less accessible than the two properties it abutted. The land was appraised for assessment by the municipality at an equal per acre value, which undervalued it for tax purposes. This made a considerable difference in the land-to-building allocation. When combined with a cost segregation study, it was a home run.

When an investor who owns a very profitable building and attempts to maximize long-term cash flow and enhance value must nevertheless think of an exit strategy. Based on the property's increase in value, the investor may believe it is the right time to sell, only to find out from the accountant that the taxes will be murder. If a taxpayer has income in excess of $450,000 including the gain, the federal tax will be 20% on the capital gain portion and 25% on the recapture of Section 1250 depreciation.[30] Plus, for all net investment income in excess of $200,000, the new tax of 3.8% to fund the Affordable Care Act is added. Add to this a hypothetical state tax of 5%. All told, the investor can conservatively expect a 30% tax on the paper gain that is not in cash—a reality that makes the use of the Section 1031 exchange so attractive.

Conclusion

Tax minimization and asset protection of real property holdings are key roles of accounting and legal advisors. Clients have come to expect this wisdom when investing in real estate and when considering the entity structure options. Owners of real estate want more, however. They want to know their options to optimize the human and fungible capital investment to achieve higher returns and higher values while minimizing tax authority challenges. They also want advisors to glean more information found within real estate appraisal reports that may uncover improperly recorded titles or the need for a tax assessment appeal, to name but a few legal and tax reporting opportunities. Real estate investors may require advisors to consider including a draft of an investment policy statement in their clients files.

It seems clear that returns are improved when distributable cash flow is considered in assessing the risk and economic benefit of equity interests. This tends to provide further substantiation of any investment impairments that require the concessions ubiquitously referred to as "discounts." However, while cost segregation may be a good idea, the effect it can have on the taxable basis of the property means it is not for everyone. Moreover, simply selecting adjustments to the pro rata adjusted book value under the net asset value method when income is often the primary investment motivation is insufficient. Issues of illiquidity and lack of marketability go beyond application of discounts. Determining the size of the adjustments must be supported with empirical justification of how entity provisions and holding periods may defer actual distributions of capital accounts upon the sale of part or all of the assets held. Working together, attorneys, accountants, and real estate and business appraisers can achieve superior financial and legal results. ■