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Real Estate Financial Accounting and Tax Developments

Certain enacted and proposed changes to the financial accounting and tax treatment of various real estate transactions may have a significant impact on the way that various real estate transactions are structured. This alert will highlight some key developments.

Financial Accounting Treatment of Leases

The International Financial Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have recently issued proposed rules in an "Exposure Draft" that would change the way that leases are reported on financial statements of both lessors and lessees. The current distinctions between capital leases (essentially treated as financing transactions) and operating leases (so-called "true leases" that are respected as leases for these purposes) would generally be eliminated under these proposed rules.

If these rules are finalized in their current form, lessees would be required (beginning in 2013) to book their lease rights (i.e., right to use) as assets and show their future lease payment obligations as liabilities on their balance sheets, regardless of whether the leases would otherwise constitute operating (so-called "true") leases for financial accounting purposes. This change would essentially eliminate in most cases the ability of lessees to obtain "off-balance sheet" financing with respect to operating leases. Under current rules, lessees are generally required to show only their current lease rent payment obligations with respect to operating leases on their balance sheets.

If this fundamental change is implemented in its current form, then the treatment of long term lease obligations as debt may, among other items, cause many lessees to be in violation of their debt covenants—which will have to be carefully reviewed as a result of these potential rules. Moreover, due to the unavailability of off-balance sheet financing, tenants may seek to purchase rather than lease real estate (perhaps by purchasing real estate condominium units)—in that tax benefits associated with ownership such as depreciation and interest deductions may make ownership more attractive now that lease obligations will be required to be shown as debt on their balance sheets. Alternatively, lessees may attempt to negotiate shorter term leases in order to mitigate the negative impact of showing their lease obligations as a liability on their financial statements. It should be noted, however, that lease extension options are generally treated as part of the lease term for these purposes provided that it is "more likely than not" that the options will be exercised.

Depending upon whether or not lessors retain substantial risks or benefits with respect to the underlying leased property, lessors are generally required either: (a) to split the leased property into two separate assets on their balance sheets as follows: (i) the present value of the lease payments, and (ii) a separate asset representing the residual value of the leased property at the end of the lease term; or (b) to show the value of the lease receivable as an asset, and its obligations with respect to the lessee's right to use the property as a corresponding liability on their balance sheets.

3.8% Surcharge on Investment Income

Under the "ObamaCare" health care legislation enacted into law earlier this year (the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010), various types of investment income from passive investment sources (such as certain rents from real property and capital gains from the sale of real property) earned by individuals earning over $200,000 (and married couples earning over $250,000 and married persons filing separately earning over $125,000) will generally become subject to an additional federal surtax of 3.8% beginning in 2013. This new surtax is intended to offset the cost of the health care reform package. Given the increase to a 20% federal tax return long-term capital gains scheduled to occur next year, long-term capital gains rates will increase from their current level of 15% to 23.8%, a whopping 58.7% increase in the federal long-term capital gains rate. Income otherwise excluded from income tax as gain from the sale of a primary personal residence (i.e., $250,000 for individuals and $500,000 for married couples filing joint returns) will generally not be subject to this 3.8% tax surcharge.

As a result of these significant future tax increases, real estate owners and operators should consider a number of potential tax saving strategies in connection with property dispositions, such as (among other items) whether to accelerate the sale of property in 2010 in order to take advantage of the current low (15%) federal long-term capital gains income tax rates, and the potential availability of tax advantaged disposition strategies (such as like-kind exchanges, and property contributions to Up-REITs, etc.). Our Business Tax Group can provide a number of tax planning alternatives to mitigate the impact of these new taxes.

Carried Interest Proposals

A variety of proposals have recently been put forth in Congress to tax so-called carried interests issued to service providing partners (including real estate advisors) in partnerships and limited liability companies as ordinary compensation income rather than capital gains. Thus far, these proposals have repeatedly died in the Senate. In light of the ongoing revenue/spending gap faced by the federal government, these provisions may be revisited as possible revenue raisers in the near future. If enacted in their current form, this potential legislation would carry a potential "double whammy" for real estate advisors in that not only would their profits from property appreciation be taxed at ordinary income rates (and subject to employment taxes as compensation) but, upon death, they likely would not be eligible to obtain a tax basis "step-up" to the fair market value of their ownership interests —in which case, their estates would be left to pay income tax on the inherent appreciation with respect to their interests at ordinary income rates. In light of this potentially significant change in tax treatment, our Business Tax Group has been closely monitoring developments and is available to discuss potential strategies in order to preserve capital gains treatment for real estate advisors. ■

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