RESTAURANT FINANCE MONITOR®

Volume 26, Number 7 • Restaurant Finance Monitor, 2808 Anthony Lane South, Minneapolis, MN 55418 • ISSN #1061-382X

July 16, 2015

Tax Ideas for Real Estate and Business Sales

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The Monitor's focus on real estate this month gives me the opportunity to discuss two tax items: allocation of purchase price and like-kind exchanges. These are sometimes overlooked in real estate transactions even though they can set the stage for significant tax savings.

Allocation of Purchase Price

There is always a need for an allocation of the purchase price upon an acquisition or sale involving personal property, real estate or intangibles. It is important to look at each asset of the transaction. In fact, the form required by the IRS (Form 8594) has six classes of assets for which the purchase price needs to be allocated:

1. Cash
2. Traded investments
3. Inventory
4. Accounts receivable
5. Furniture, fixtures, buildings, land, vehicles and equipment
6. Intangibles

This is just an outline of what the IRS requires; a good allocation process involves a much closer, detailed scrutiny of the assets, particularly those in Class 5.

The purchase price allocated to the assets is based on fair market value. If the allocation agreed to in an arm's-length transaction between unrelated buyers and sellers is reasonable, the IRS generally will accept this allocation. It is important to have the buyer and seller agree to the same allocation so there can be consistent reporting to the IRS.

One of the major areas of disagreement is usually the allocation to personal property (FF&E). The reason for this is the seller wants to minimize the depreciation recapture and the buyer wants to maximize future depreciation. This is particularly the case in the restaurant world, where these assets have little value but buyers always want to get a stepped-up basis.

The personal property associated with the real estate (such as portions of a drive-thru or other fixture-type items that have a faster write-off than the actual building) is often overlooked. If a leasehold interest is being acquired, these assets have a different type of useful life and should have a specific allocation. Many of the specifically allocated items that are not pure building may qualify for accelerated depreciation and/or Section 179 expensing.

There is normally little disagreement as to the allocation of intangibles. By and large, the seller gets to treat the gain on intangibles as a capital gain and the buyer gets to amortize the intangibles over 15 years.

There are always closing costs associated with the transaction and expensed. Most closing costs are allocated to the assets being acquired and capitalized. Items like pro-rated taxes, rent and CAM can be expensed if a leasehold is being purchased. Legal and accounting fees associated with an acquisition should be divided between tax and ongoing services, which should be correctly deductible, and the pure acquisition services, which need to be capitalized.

Keep these thoughts in mind when negotiating a sale or purchase.

Like-Kind Exchanges

Even though the tax rates for capital gains are fairly low, there still may be a desire to reinvest in like-kind assets and delay payment of tax on the gain. A like-kind exchange must be provided for in the purchase agreement to keep this option open. There are a number of issues to be aware of:

• **Do not take cash at closing.** A seller can always break the like-kind exchange and then pay the tax if the cash is needed. In all cases, a qualified exchanger should be utilized, and a title company usually offers this service.

• **A like-kind exchange for real estate has to be for real estate;** it cannot be for a partnership interest in real estate. Also, it does not mean the exact same kind of real estate. Improved real estate for unimproved real estate or investment rental or even a partial fee interest can be exchanged; but, in all cases, the real estate has to be held for investment, trade or business, or productive purposes.

• **There are important rules that need to be followed** for a like-kind exchange. Some of these are well known and some less.

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1) The replacement properties need to be identified within 45 days. This is not as simple as one might think. The identification should be in writing and sent to the title company holding the proceeds in escrow. A seller can identify multiple properties up to 200% of the value of the exchange property or three properties.

2) The seller needs to exchange the full sale price regardless of the cash proceeds.

3) Closing needs to be within 180 days of the sale date. The seller can do a parking transaction where the replacement property is held by a third party and is acquired before the relinquished property is transferred.

4) Even when the replacement properties have been identified, closing can still be a little tricky if the property being sold is encumbered by debt. As stated above, the seller has to roll over the total purchase price.

For example, if the seller has a property with a $5 million sale price and an underlying mortgage of $3 million, the mortgage has to be paid off at closing to provide free and clear property to the buyer. But in order to qualify for replacement property and a full like-kind exchange, the seller has to acquire properties with a $5 million purchase price.

In most cases, the seller will need to leverage the replacement property by $3 million or provide the cash from some other source. Often we pre-arrange with a bank for the debt money with the lender's pre-authorization for certain approved like-kind properties.

Recently we did a transaction with 30 real estate properties. We secured a line of credit for like-kind properties prior to finding the like-kind properties. We were able to enter into a purchase agreement for these properties knowing we had financing lined up and could cover the full sale price to qualify for a full like-kind exchange.

• **There may be some properties in a sale** that have a very high basis and should not be exchanged.

• **There may be some suspended losses that cannot be used** in a like-kind exchange because they are classified as passive for tax purposes, particularly within partnerships and LLCs, In these cases, the seller may simply want to take advantage of the losses instead of engaging in a like-kind exchange.

• **The seller needs to make separate allocations** to the actual real estate, equipment, furniture, fixtures and intangibles if the like-kind exchange property is a restaurant building.

Each of these asset classifications needs to be exchanged for a like-kind item. For instance, if the building is sold for $500,000, the seller needs to find a building worth $500,000. If equipment is being sold for $200,000, the seller needs to find equipment that has a purchase price of at least $200,000. If the seller is allocating to intangibles (such as franchise rights), he wants to make sure he is specifically trading for other franchise rights. Allocations and descriptions are very important.

In general, a like-kind exchange can be a wonderful tax savings technique but it needs to be carefully analyzed. Questions to keep in mind:

• Is a like-kind exchange really the best approach with our current low tax rates?
• Are there other tax savings opportunities that may be precluded by a like-kind exchange?

It's worth to keep in mind allocation of purchase price and like-kind exchanges when embarking on complex real estate transactions. Properly executed, both techniques can yield appreciable tax advantages.

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