Tax Planning for Real Estate Transactions

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Introduction

- Tax consequences when buying and selling real estate should be considered from the beginning of transaction and should be addressed before an agreement of sale is finalized.
- This presentation will address the following issues:
  - Tax allocations for a buyer and seller;
  - Maximizing capital gains treatment;
  - Entity purchases v. asset purchases;
  - Tax elections under IRC Sections 338 and 754; and
  - Like-kind exchanges

Classification of Income

- Many planning decisions are driven by the classification of income as either capital gains or ordinary income.
  - The top capital gain rate is 20% (with exceptions for depreciation recapture) and 39.6% for ordinary income.
- In addition to the capital gains tax, a sale of capital assets will result in a net investment tax of 3.8% for any capital gain equal to the lesser of the statutory threshold amount or AGI.

Tax Rates

- The statutory threshold amounts are:
  - Married filing jointly — $250,000
  - Married filing separately — $125,000
  - Single or head of household — $200,000

Tax Rates

- Certain gains from the sale of capital assets result in higher taxes than the normal capital gains rates. The sale of tangible personal property that has an allocated price in excess of the depreciated book value will result in ordinary income equal to the prior depreciation taken on those assets, known as depreciation recapture.
  - The same rule applies to buildings and improvements, but the recapture rate is only 25%.

Capital Assets

- Examples of capital assets:
  - Investment properties (such as vacant land)
  - Residential rental property
  - Commercial rental property or property used in a trade or business or for rent

Allocation Opportunities

- Best to address the question of allocation before the agreements are signed, but it may not come up until just before closing or even after closing when an accountant is preparing the tax returns.
- As a seller, you want to maximize capital gain treatment and avoid recapture of depreciation.
- As a buyer, you want to get as much depreciation early as possible.

Allocation Opportunities

- There are generally five categories of assets to allocate purchase price, and if the parties agree on allocations and they are reasonable, they will be respected by the IRS.
  - Land – not subject to depreciation
  - Buildings – subject to depreciation over 27.5 years for residential buildings and 39 years for commercial buildings
  - Land improvements (parking lots and other site improvements) - subject to depreciation over 15 years
  - Furniture, equipment, vehicles and software – subject to depreciation over 3-7 years
  - General intangibles (goodwill, trade names, restrictive covenants, going concern value, phone numbers and websites) – amortized over 15 years

Competing Interests

- Buyers
  - Allocate as much as you can to assets that you can write off the quickest, and the tangible personal property (Section 1245 property)
  - Allocate the least amount to land, since there is no depreciation
- Sellers
  - If the price allocated to depreciable property exceeds the adjusted tax basis, it will result in ordinary income taxed as high as 39.6% on the recaptured depreciation, or tax on buildings and improvements at 25% for any recaptured depreciation on those assets.
  - Allocating to assets that result in the recapture of depreciation could create tax problems for the seller.

Example 1

- Suppose your clients bought a motel for $5,000,000 allocated as follows:
  - Land $2,000,000
  - Building $2,000,000
  - Furniture and Equipment $250,000
  - Goodwill/General Intangibles $750,000

Example 1 (cont.)

- Over a period of five years the building has been depreciated by $256,000, furniture and equipment has been fully depreciated and the general intangibles have been amortized by $250,000. They now have an offer for $6,500,000. They have agreed to the following allocations:
  - Land $2,500,000
  - Building $2,750,000
  - Furniture and Equipment $250,000
  - Goodwill/General Intangibles $1,000,000

Example 1- Question 1

- What problems are there for the seller?
  - The net capital gain is the price of $6,500,000 less the adjusted basis of $4,244,000, totaling $2,256,000.
  - Even though it is capital, anything over $250,000 will be subject to the additional 3.8% net investment tax, 250,000 will be taxed as ordinary income and $256,000 will be taxed at 25%.

Example 1 – Question 2

- What would you do as a seller to minimize the tax?
  - An installment sale could spread the gain out over a number of years to avoid the net investment tax and reduce the marginal rate on the capital gain from 20% to 15%.
    - ***Note***: The 20% tax rate on net capital gain applies to the extent that a taxpayer's taxable income exceeds the thresholds set for the 39.6% ordinary tax rate ($415,050 for single; $466,950 for married filing jointly; and $233,475 for married filing separately).
    - This could result in significant savings of up to 8.6% of most of the capital gain income.
  - Allocating less to the personal property and building could avoid the recapture of depreciation to ensure the taxation of income at the lower capital gains rates.

Planning Opportunity

- Suppose the real estate was in a limited liability company or in an S corporation that your client owned with two other partners, and your client and one partner was redeeming the interest the other partner.
- What are the planning opportunities from a buyer's standpoint?
  - With the real estate in an LLC, the selling partner will get capital gains treatment with certain exceptions and the buying partners can make a 754 election to step up the basis of the LLC assets, assuming it is taxed as a partnership.

IRC 754 Election

- **IRC Section 754 -** allows you to increase the inside basis of assets by the purchase price for a partnership interest, with certain exceptions.
- **IRC Section 755** says:
  - **(a) General rule**. Any increase or decrease in the adjusted basis of partnership property … in the case of a transfer of an interest in a partnership shall … be allocated—
    - **(1)** in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties, or
    - **(2)** in any other manner permitted by regulations prescribed by the Secretary.
  - You can likely make this allocation per agreement following the guidelines in **IRC Section 1060**.

IRC Section 338(h)(10) Elections

- For a corporation, there is a similar planning alternative.
  - **IRC Section 338(h)(10)**: the parties can agree to treat this as an asset sale for tax purposes, giving the buyer the ability to step up the basis of the assets allocated to the corporation.
  - This will give the corporation additional depreciation and amortization deductions. From the seller's standpoint, however, the only downside is the potential for recapture income for the depreciation of 1245 and 1250 property.

Change Residency

- What if as a seller, you have decided to move out of state and change your residency to Florida?
  - If you sold LLC assets or S Corp assets, the pass-through gain would be subject to the New Jersey State income tax, but if you convince your client's buyer to buy the entities, you would be selling intangible assets that are not taxable to nonresidents of New Jersey, and thus can save your client the State tax on the gain, which could be at a rate of up to 9%.
  - In addition, the buyer saves the mansion tax on the real estate and the seller saves the transfer fee on the real estate.
  - The buyer can still make the 754 election to step up the inside basis of the real estate assets, but the 338(h)(10) election cannot be made since it would force the seller to treat it as an asset sale and thus be subject to the New Jersey tax.

Partnership Split-up

- What if on the split up of a partnership or LLC, you had gain assets that a third party wanted to buy and a partner who wanted to be bought out, but the other partner wished to continue in the business? What are the any planning opportunities?
  - If the partnership sold the asset each partner would pick up his share of the gain, and then the buying partner would have to buy out the selling partner with after-tax money.
- But what if you split up the partnership and distribute the property that the third party wants to purchase to the partner who wants to cash out and then have the third party buy it from that partner?
  - Your client ends up with the remaining company assets without having to buy out the partner with after-tax money, and the selling partner ends up with the same capital gain income he would otherwise have in a two-step transaction.

Real Estate Development

- How do you avoid ordinary income treatment?
  - The determining factor is whether your client is considered a dealer of real property, in which case the land would not be a capital asset but inventory subject to ordinary income treatment.
  - The less work your client does to develop the property, and the less often he or she engages in this type of activity, the more likely that capital gains treatment would apply.
- The general rule is that property held for sale in the ordinary course of business (inventory property) is never a capital asset. This is where real estate developers and agents, other dealers in property (such as art or antique dealers) and, occasionally investors, get into trouble.

Real Estate Development

- Sometimes it's clear that the property is inventory.
  - Example: A real estate developer who purchases 100 acres of land and promptly subdivides and begins advertising and selling either bare land or lots with houses constructed.
- But other times it's not so obvious.
  - Example: A real estate professional owns a number of rental properties and sells one or more.
    - Were the properties held for use in a trade or business or as inventory for sale? If held primarily as rental properties in the business of renting real estate the property could be a capital asset.
- The outcome turns on whether the property was held primarily for sale or for rent.

Malat v. Riddle, 383 U.S. 569 (1966)

- In *Malat,* the Supreme Court defined "primarily" to mean "principally" or "of first importance."
- Some of the tests that have been applied to determine whether the property is held for investment or primarily for sale include:
  - the purpose of the acquisition of the property and the duration of ownership;
  - the nature and extent of the taxpayer's efforts to sell the property;
  - the number, extent, continuity and substantiality of the sales;
  - the extent of subdividing, developing, and advertising to increase sales;
  - the nature and extent of the taxpayer's everyday business; and
  - the time and effort the taxpayer devoted to sales.

Real Property Subdivided for Sale IRC Section 1237

- There is a safe harbor in the IRC for determining whether a taxpayer holds real property primarily for sale to customers in the ordinary course of business.
- **IRC Section 1237**

  (a) General. Any lot or parcel which is part of a tract of real property in the hands of a taxpayer other than a C corporation shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because of the taxpayer having subdivided such tract for purposes of sale or because of any activity incident to such subdivision or sale, if [certain conditions are met] —

IRC Section 1237

- This provision permits taxpayers qualifying under it to sell real estate from a single tract held for investment without the gain being treated as ordinary income merely as a result of subdividing the tract or of active efforts to sell it.
- The rule is not applicable to dealers in real estate or C corporations. In addition, if there is other substantial evidence to show that the taxpayer held real property for sale to customers in the ordinary course of business, activities in connection with the subdivision and sale of the property will be taken into account.

IRC Section 1237

- Three conditions must be met:
  - The tract, or any parcel, can not previously have been held for sale to customers in the ordinary course of a trade or business, and in the same taxable year in which the sale occurs, the taxpayer does not hold any other real property, and
  - No substantial improvement that substantially enhances the value of the lot is made by the taxpayer, and
  - The lot or parcel, except in the case of real property acquired by inheritance or devise, is held by the taxpayer for a period of 5 years.

IRC Section 1237

- If more than 5 lots or parcels contained in the same tract of real property are sold or exchanged, gain from any sale or exchange (which occurs in or after the taxable year in which the sixth lot or parcel is sold) of any lot or parcel which meets the requirements on the previous slide will be treated as capital gain except that up to 5 percent of the selling price will be considered ordinary income.
- If you don't satisfy the requirements of the rule you will not be given a free pass, but can still maintain that your client is not a dealer under the case law.
- While this provision may not be useful for all taxpayers attempting to subdivide real property, you should know that it is out there and may in limited circumstances be helpful for part-time real estate developers.

Bruce A. Rice et ux. T.C. Memo. 2009-142

- In a 2009 taxpayers bought a 14 acre parcel of undeveloped property in a desirable location on which to build their dream home. While the property was much larger than desired, it was cheaper per acre than other properties they had looked at. The property could only be purchased as a single unit. The taxpayers initially wanted to keep the entire property, but the wife changed her mind and they decided to subdivide.
- The taxpayers had never engaged in the sale of real estate other than sales of their own personal residences before they purchased this property, nor have they engaged in it since. They first identified the portion of the property they wanted for their lot. This lot was the largest and was in a desirable place on the property.

Bruce A. Rice et ux. T.C. Memo. 2009-142

- They had to hire consultants for zoning, access, water and wastewater service, construction, and environmental issues. They applied for and received a zoning change to subdivide and develop the property. The taxpayers divided the property into ten smaller lots, reserving eight lots for homes and two lots for environmental purposes.
- The taxpayers registered the subdivision for a homeowner's association and executed a declaration of covenants, conditions and restrictions, which applied to all the lots in the subdivision (other than Lots 9 and 10 that fell outside the subdivision).
- They took two years to construct their dream home. The taxpayers devoted a significant amount of their spare time to building their home, and their home was the focus of their attention.

Rice Factors

- The Court looked at the factors cited in *Malat* and noted the following:
  - They sold the excess lots to dispose of unwanted property, not that they purchased the property primarily for sale to customers in the ordinary course of business.
  - The taxpayer looked at other properties, but the one they purchased was in the right school district, provided them with enough space to build their dream home, and was much cheaper than the other properties. They did not have the option to buy a smaller portion of the property.
  - Although the taxpayers made significant improvements to develop and sell the excess lots (generally, a negative), many of those improvements would have been necessary even had they not subdivided.

Rice Factors (continued)

- Solicitation and advertising efforts and brokerage activities are also significant factors in analyzing whether property sales are eligible for capital gains or ordinary treatment. The taxpayers devoted very little time to the sale of the excess lots; the solicitation and advertising efforts are more characteristic of those of investors than of dealers.
- Taxpayers had full-time jobs and devoted little time to the sale of the excess lots. Lot sales accounted for a small percentage of their income each year, and they retained the proceeds rather than buying additional inventory.

Rice (continued)

- The Court of Appeals for the Fifth Circuit, which is the court that would hear an appeal of this case, previously held that substantiality and frequency of sales is among the most important factors.
  - Factors to determine whether property is held for investment or for sale: (1) The nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales. *United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969).

Rice (continued)

- The Court concluded that they purchased the property as an investment and not as property held for customers in the ordinary course of business.
- The interesting issue here is not that the taxpayers won, but that the IRS challenged them at all. It would have appeared that there was little support for the claim that the taxpayers were in the business of selling real estate, but it shows that many taxpayers could be at risk.

Plan in Advance

- Knowing that in advance you can minimize your risk by setting a fact pattern early on that would indicate you're not in the business of selling real property.
- For example, keep improvements to a minimum, avoid advertising the property (use word of mouth as much as possible), keep the number of sales per year to a minimum, etc. While not advertising may limit sales potential, you may be able to overcome that by pricing the land under the market. A price somewhat below will make the property more attractive.
- While you may get less, the gain you retain is likely to be higher if you're only paying tax at long-term capital gains rate on the gain. Get good advice and work through the numbers

Additional Planning Opportunities

- During the last real estate boom, several business owners holding valuable real property in their business, such as beachfront motels, decided to become real estate developers. Many of these properties were bought at a low price and the buildings were fully depreciated.
- There was much more value in the land and many of these buildings were demolished and replaced with residential dwelling units. Although the market has changed drastically since then, there are still opportunities for the development and sale of residential housing along the shore.
- The worst thing you can do is take all of the land appreciation which is capital in nature and turn it into ordinary income.

Additional Planning Opportunities

- Planning opportunities available for this type of business:
  - If your client has children who are active in the business, you can structure this as a sale of the property to a new corporation owned by your children or by a trust in which your children are the beneficiaries, and your client can still own a small percentage with all of the voting rights.
  - There are related party rules which prevent the use of a partnership/ LLC.
  - There are also estate planning opportunities with this – shifting all of the development profits outside of your estate.

Additional Planning Opportunities

- This can be an installment sale based on a note that gets paid from the proceeds of each residential unit sale.
- If the beachfront property is worth $5,000,000 and has a basis of $1,000,000, you have converted $4,000,000 of what would otherwise be ordinary income to capital gain income at a savings of about $1,000,000, which is 25% on the rate if the payments are structured properly

Like-Kind Exchanges

- A 1031 Exchange, also known as a "Like Kind Exchange", is set forth in **IRC Section 1031**.
- A 1031 exchange allows an investor to "defer" paying capital gains taxes on property held for investment or for productive use in a trade or business as long as other "like-kind property" is purchased with the proceeds received from the sale of the first property.
- A 1031 Exchange allows a taxpayer to continue his/her investment in like kind business assets without reducing the investment by the tax on the gain on the relinquished asset.

Like Kind Exchanges

- Technically applies to any type of asset, but traditionally has been in real estate since most non-real estate assets depreciate in value and there is often little or no gain, and gains from intangible assets, such as goodwill, can never work because of the inability to find a like kind replacement asset.
- Under **IRC Section 1031**, Like Kind Exchanges are not available for exchanges of securities, including interests in closely held corporations, partnerships and limited liability companies.

Like-Kind Exchanges (Deferred)

- Technically, a Like Kind Exchange is where one property is literally swapped for another property of like-kind. However, the likelihood that the property you want is owned by someone who wants your property is unlikely.
- This is why the vast majority of exchanges are delayed exchanges, and before the changes to the Internal Revenue Code in the 1990s that codified delayed exchanges. They were done under the precedent set by a case know as *Starker v. Commissioner*, and they are still sometimes referred to as Starker Exchanges.
- They have now been blessed by the government in **IRC Section 1031** based on specific requirements.

Like-Kind Exchanges (Deferred)

- *Intermediary*. There needs to be an unrelated party acting as the intermediary in the exchange. It can't be the taxpayer's agent.
- *Escrow*. The sales proceeds must be held in escrow by the intermediary and not be accessible to the taxpayer other than for the purchase of replacement property.
  - In essence, the taxpayer conveys his property to the intermediary, never receives the cash, the intermediary then sells it to the buyer (the original sales contract is assigned to the intermediary). The taxpayer then identifies the replacement property and when a purchase contract is reached he assigns it to the intermediary, who completes the purchase and then transfers title to the taxpayer. So the taxpayer is deemed to have swapped properties with the intermediary.

Deferred Exchanges – Direct Deeding

- The IRS has also made this easier than it was in the Starker days by allowing the direct deeding of property from the taxpayer to the buyer and then from the seller to the taxpayer so that the intermediary never takes ownership, avoiding transfer taxes as well as title issues.
- Even though by contract the taxpayer transfers to the intermediary and the intermediary transfers to the buyer, the deed goes directly from the seller to the buyer.
- The same thing occurs when buying the replacement property.

When to suggest a 1031 Exchange

- When values are rising, so are capital gains and thus an increase in the use of 1031 Exchanges occurs to defer and sometimes avoid the capital gains tax.
- When you sell property held for investment or used in a trade or business, such as a rental property, which could be a vacation home that you use for not more than two weeks during the year and make available for rentals during the rest of the year, you have the ability to use the proceeds from the sale to acquire replacement property which would carry the same tax basis as the property you sell.

Like Kind Exchange – Basic Rule

- The general rule is that you should acquire property of equal or greater value than the property you sold.
- If you are paying off debt, you can offset that debt with new debt on the replacement property or additional cash in the transaction. However, you can't offset cash with new debt.
- Any cash that you walk away with will be taxed to the extent of the gain.

1031 Exchange - Tax avoided or deferred?

- In most cases the gain is deferred until you cash out of the replacement property, but in some cases the gain can also be avoided.
- If you die before you cash out, your heirs will received what is called a stepped up basis in the property, meaning that all of the gain goes away and if they sell the property and cash out, they will only have gain on the appreciation since the date of death.
- If you sell property in New Jersey and buy replacement property in Florida, and then you move to Florida, you would avoid the New Jersey tax since the sale of the replacement property would no longer be subject to New Jersey tax and Florida has no income tax.

Types of 1031 Exchanges

- *Simultaneous Exchange*
  - This allows investors to relinquish and close on a replacement property in the same day. Originally, this is what a 1031 Exchange was–a direct exchange between two parties. Today, this type of exchange isn’t very common, primarily because the chances are slim that the person who owns the exact property you want also wants the exact property you own.
- *Delayed Exchange*
  - This type of 1031 Exchange is the most common. It allows the investor to sell their investment property first, and find a replacement property within a certain amount of time, which was addressed earlier.

Reverse 1031 Exhange

- *Reverse Exchange*
  - In theory, the reverse 1031 exchange is very simple: you buy first and you pay later. What makes it difficult, however, is that this type of exchange must be an all cash purchase since financing in advance of an exchange is extremely difficult. The bank is in essence loaning money to the taxpayer secured by a mortgage on property owned by the intermediary. But if you have the funds to purchase the replacement property, it can be a very useful tool.

Reverse 1031 Exchange (cont.)

- A reverse 1031 Exchange enables an investor to purchase a new investment property through an Exchange Accommodation Titleholder and postpone the sale of the existing investment property for up to 180 days.
- Allows taxpayer to also make improvements to the investment property with the proceeds from the relinquished property.
- Also eliminates the pressure of finding a replacement property by the 45 day identification deadline of a forward 1031 exchange.
- You can also use it to buy raw land and build your replacement property.

Basis Rules - Like-Kind Property

- To qualify as a 1031 Exchange, the property being sold and the property being acquired must be "like-kind." This is a very broad term, meaning that both of the properties must be "the same nature or character, even if they differ in grade or quality."
- You can't exchange manufacturing equipment for rental real estate, because they're not the same asset. And goodwill is never like kind. In terms of real estate, you can exchange almost any type of property, as long as it's not personal property.

Basis Rules - Investment or Business Property Only

- A 1031 Exchange is only applicable for investment or business property, not personal use property. In other words, you can't swap one primary residence for another.
- Vacation and second homes:
  - Follow the 14 day rule, that is you don't occupy it for more than 14 days per year.
  - What was the use at the time the replacement property was acquired or the relinquished property sold? If your use changes after you purchased the property and you decide to occupy it as a primary home or second home, as long as that was not your intent when you acquired it, it should be okay.

Taxpayer's Intent

- The key is intent. If you change your mind two months after you buy it this is evidence that your intent was to occupy the property for personal use, but if you change your mind two years after you acquire it, you should be safe.

Basis Rules - Greater of Equal Value

- In order to completely avoid paying any taxes upon the sale of your property, the IRS requires the net market value and equity of the property purchased must be the same as, or greater than the property sold. Otherwise, you will not be able to defer 100% of the tax.
- If the cost of the replacement property is less, you will pay tax on the lesser of the actual realized gain or the excess value. This brings in the concept of boot.

Basis Rules - Must Not Receive "Boot"

- The taxpayer must not receive "boot" from an exchange in order for a Section 1031 exchange to be completely tax-free. Any boot received is taxable to the extent of gain realized on the exchange.
  - In other words, you can carry out a partial 1031 exchange, in which the new property is of lesser value, but this will not be 100% tax free.
- So what is boot?
  - It is anything other than like kind property received in the transaction. Even if you buy for equal or greater value, if you walk away with cash you have boot. In other words, if you had no debt on the relinquished property but finance the replacement, this will result in boot. New debt can always offset your cancelled debt, but can never offset cash.

Basis Rules - Same Taxpayer

- The tax return, and name appearing on the title of the property being sold, must be the same as the tax return and title holder that buys the new property.
- However, as an exception to this rule occurs in the case of a single member limited liability company, which is considered a pass-through to the member and a disregarded entity for tax purposes. Therefore, the single member LLC may sell the original property, and that sole member may purchase the new property in his/her individual name.

Basis Rules - 45 Day Identification Window

- The property owner has 45 calendar days after closing of the first property, to identify up to three potential properties of like-kind. This can be really difficult because the deal still needs to make sense from a cash perspective.
  - This is true especially in today's market because people tend to overprice their properties when there are low-interest rates, so finding all the properties you need can be a challenge.
- An exception to this is known as the 200% rule. In this situation, you can identify four or more properties as long as the value of those four combined does not exceed 200% of the value of the property sold.

Basis Rules - 180 Day Purchase Window

- To qualify under a 1031 Exchange, you must also purchase all new properties within the earlier of 180 calendar days (6 months) following the closing of the original property or the due date (determined with regard to extension) for the transferor’s return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.