Narrative – Income Tax Planning and Like-Kind Exchanges (presentation delivered 3-16-16)

Presented by
Scott T. Wait, CPA, AEP

This article summarizes the educational event which focused on general income tax issues and planning for Like-Kind Exchanges:

The presentation discussed the following topics:

Notice to the audience
Tax Planning
Exit Strategies for like-kind exchanges

Scott was introduced to the audience by Kandas Myer, Nevada Regional Manager of Starker Exchange Services / Coldwell Banker. Scott began discussion by stating that the goal of the discussion is to inform attendees to better understand the impact of income tax on real estate and especially the impact on real estate like-kind exchanges.

Notice to the audience

Scott informed the audience as follows:
This material is provided for informational purposes only and is not to be construed as tax advice. The readers and audience are strongly advised to speak with their tax consultant before attempting to employ any of the concepts stated herein

Introduction

Scott provided introduction that he will provide the following discussion:

An overview of the 1) federal income tax system and 2) 7 like-kind exchange exit strategy examples

Tax Planning

Ordinary Income Tax: Ordinary income tax includes seven different income tax brackets – 10%, 15%, 25%, 28%, 33%, 35% and 39.6% - and three different capital gains tax brackets – 0%, 15%, and 20%. If you combine these tax brackets with the new 3.8% net investment income tax (NIIT), there are seven more possible tax brackets. For high income taxpayers, they will be subject to 43.4% tax rate on ordinary income and 23.8% tax rate on long-term capital gains. The U.S. has shifted from a two dimensional tax system to a five dimensional tax system which includes1) regular income taxes on ordinary income and capital gains rates; 2) the alternative minimum tax; 3) “super-tax” (i.e. the new 39.6% ordinary income tax rate and the 20% long-term capital gains rate); 4) the NIIT; and 5) the PEP and Pease limitations – these are limitations on personal exemptions and itemized deductions based on high income taxpayers.

Capital Gains Tax also include a depreciation recapture tax. This is a flat 25% tax on depreciation deducted in prior tax years by the tax payer. The tax is charged when the property is sold.

Capital Gains Tax may be spread out over time using Installment Sale rules that allow the sale proceeds to be received and tax over a period of years. The payments received include a capital gain portion and an interest income portion. The capital gain tax is charged at the 0%, 15%, or 20% rate based on the taxpayer’s tax bracket, and the interest income is taxed at the taxpayer’s ordinary income tax rate.

The Principal Residence is subject to the capital gain tax rate after allowing for an exclusion of $250,000 for single and $500,000 for married filing jointly taxpayers. As was mentioned in earlier discussion, the rules to allow for the exclusion described above is to own and reside in the principal residence for 2 of 5 years.

The Net Investment Income Tax (NIIT) is charged to individuals with adjusted gross income over $200,000 and married filing jointly taxpayers with adjusted gross income over $250,000. The definition of NIIT income is the following: interest, dividends, annuities, royalties, rents, substitute interest and dividend payments, other passive gross income not described above, net gain, capital gain or otherwise, attributable to the disposition of property, real estate or other property, but not to the extent held in an active trade or business.

Exclusions of NIIT includes income derived in the ordinary course of an active trade or business. Examples include trade or business income from an active S Corporation or C Corporation, or salary or wages from compensation as an employee.
Entities & Tax planning for exchanges: Transactions that involve taxpayers who are owners of the following entities may include Sole Proprietorships, LLC's or Partnerships, C Corporations, S Corporations, or Irrevocable Trusts.

Sole Proprietorships, LLC's taxed as Partnerships, and Partnerships are considered disregarded entities. A disregarded entity is not taxed normally at the entity level. The income is passed through to the owners and taxed to the owners. With disregarded entities such as a single member LLC or a husband and wife LLC which is categorized as a single member LLC, like kind exchanges have flexibility in exiting the like-kind exchange. With Partnerships, S Corporations, C Corporations and Trusts, the entity in many cases need to be the entity exchanging the property of the old for the new. If the property is exchanged outside the entity, the like-kind exchange may not be qualified under IRS rules. It is critical to make sure the like-kind exchange is structured properly with entities involved.

There are a few IRS exceptions with regard to partnership that can be considered in like-kind exchanges, but that discussion is beyond the scope of our presentation today.

Exit Strategies for like-kind exchanges

Traditional Like-Kind Exchange Exit:

Under the IRS like-kind exchange rules, they are permitted for property that is used for investment and income purposes which include undeveloped land, residential or commercial rental property. The benefit is that the exchange is 100% tax deferred as long as the taxpayer abides by the IRS rules in full.

There are critical components to abide by the like-kind exchange rules:
1) There needs to be a qualified intermediary/ an Accommodator.

2) IRS timeline- exchange rules must be followed including the 45 day identification of new properties and the 180 day purchase of the new property.
3) New property purchase for old property must be equitable and net boot received must be $0.00 to qualify for nontaxable impact. Boot is cash or debt cancellation upon closing of new property purchase. Equitable definition is in effect the purchase is of equal or greater value and that there is no cancellation of debt in the exchange of the properties.

Other exchange rules include: The sequence of transactions with a traditional like-kind exchange is to exchange (sell) one investment / income property before buying a new investment / income property. In order to qualify, the owner of the property needs to hire a Qualified Intermediary who handles the sale and purchase process.

Also, to be conservative under the IRS rules, the holding period of the exchanged (sold) property must be held for 12 or more months before sold. As a reminder: The new property or prospective properties need to be identified within 45 days of the exchanged (sold) property and the new property must be purchased within 180 days of the exchanged (sold) property.

There are other critical rules to qualify the like-kind exchange that are outside the scope of this presentation. Scott urged the attendees to seek tax advice from their tax professionals for more details.

The Reverse Exchange: The reverse exchange sequence of events is the opposite as described above. The new property is purchased before the old property is sold. There are advantages to the reverse exchange in that the 45 day and 180 day IRS rules are met immediately. If the property is not sold in a reasonable time, the taxpayer may consider making the old property more attractive by lowering the price or making other terms of the sale more attractive to a buyer to speed up the process to sell. The like-kind exchange fails in this case, and there are no IRS penalties. The issue is that you may have a cash flow issue, and if you desire to exchange the old property, you will need to go through a new like-kind process with traditional or reverse exchange.

Conversion to Principal Residence (PR) from Investment / Income property is allowed by the IRS regulations. In order to qualify as a PR and its tax benefits, the taxpayer must meet the 2 of 5 year owner/ residence rules as described above.

Please note: Also, if the Investment Income property was part of one or more like-kind exchanges in the past, the IRS rules require that the converted property be held a minimum of 5 years.

Conversion from Principal Residence to Investment/ Income property: IRS allows taxpayers to convert to investment / income property, and taxpayers lose the Principal Residence exclusion, $250,000 single taxpayer and $500,000 for married joint filing taxpayers, if they do not meet the 2 of 5 year owner / residence rule after conversion.

Vacation home/ 2nd home exchange for Vacation home / 2nd home is allowed:
There is a safe harbor rule that requires the old and new homes be held 2 years for the exchange to be allowed. Also, the taxpayer must meet the 14 day minimum rental rule and abide by the 14 day personal use / 10% personal use to rental use rules.

Related Party Exchanges: For related parties to exchange old for new properties both properties of each exchanger must hold their respective properties for a minimum of 2 years to qualify. As was noted by Kandas Myer, these exchanges are very rare, and currently the IRS is not allowing these like-kind exchanges even though the IRS regulations technically allow them.

California exchange reporting rules:
As of January 1, 2014, the California legislature passed a law that allows the California Franchise Tax Board to enforce reporting rules of like-kind exchanges. The law requires that exchangors report on an annual basis the exchanged property using form 3840 even though the exchangors / taxpayers may not be required to file California tax returns. The purpose of the form 3840 is to keep track of the deferred gain on the California property exchanged. When the property is sold in the future, the California taxing authority will charge the appropriate tax on the sale. If the taxpayers do not file the form, the California Franchise Tax Board is allowed to issue a notice

of tax due to the taxpayer and potentially file liens to enforce the reporting of form 3840.

Estate / Gift strategies:
For estate tax purposes, with regard to exchanged property, the deferred gain upon death of the taxpayer is adjusted and is described as stepped up (presuming that the value of the exchanged property has increased in value compared to the adjusted basis of the property). The deferred gain becomes partially or fully permanent which depends on the property' value at death.

If the property is gifted to an individual unrelated or related party, the deferred gain remain same status. If the donee sells the property, they will pay the deferred gain.

If the property is donated to a qualified charity, the deferred gain becomes permanent given that the charity is not subject to tax on the sale.

Scott appreciated the attendees for their time and attention with these topics and returned control of the meeting to Kandas Myer.

Contact information:

Scott T. Wait, CPA, AEP
scott@rswait.com

RS Wait, Chtd. (775)825-7337