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ACCOUNTANTS & ADVISORS

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IRC Section 1231

It's the best of both worlds

Most owners and developers know that the sale of a business asset, including real estate, can have significant tax implications. The tax effects generally come down to whether the sale results in a gain or a loss. Ideally, gains would be treated as long-term capital gains, subject to lower tax rates, and losses would be considered ordinary losses, which could be applied to offset ordinary income. Section 1231 of the Internal Revenue Code (IRC) permits just such advantageous treatment — the best of both worlds — for certain types of property in certain circumstances.

Eligible property

Sec. 1231 generally applies to depreciable property used in a trade or business that's held for more than one year. A sale or exchange of property held mainly for sale to customers isn't a Sec. 1231 transaction. If you get back all, or almost all, of your investment in the property by selling it, rather than by using it up in your business, it's property held mainly for sale to customers. On the other hand, property used to generate rents is considered to be used in a trade or business.

Notably, the IRS has taken the position that real property purchased or constructed for use in a trade or business qualifies for Sec. 1231 treatment even if it was never placed in service but instead was sold — as long as the property was held for more than a year, running from the purchase date to the sale date. In other words, property doesn't have to be placed in service to be considered property used in a trade or business.

Treatment of Sec. 1231 gains and losses

To determine the treatment of Sec. 1231 gains and losses, you combine all of your Sec. 1231 gains and losses for the year. If you have a net Sec. 1231 loss, it's an ordinary loss. Not only can such a loss be used to offset your ordinary income, but you're also not subject to the normal $3,000 limit per year limitation on how much of the loss can be used against ordinary income. Plus, the loss could give rise to a net operating loss that can be carried back or forward

If you have a net gain, it's considered ordinary income up to the amount of your non-recaptured Sec. 1231 losses from previous years. The remainder, if any, is long-term capital gain that can offset other capital losses from sales of non-Sec. 1231 property.

The recapture issue

As suggested above, the benefits of long-term capital gains treatment might not be available if you had a non-recaptured Sec. 1231 loss in the prior five years. That means that, for every year in the last five in which you have a net Sec.1231 gain, you must "look back" to determine whether you had an aggregate net Sec. 1231 loss. You have a non-recaptured loss if the total net Sec. 1231 losses exceed the total Sec. 1231 gains for the prior five years. Real property may also be subject to depreciation recapture under Sec. 1250.

A complicated matter

While the benefits of Sec. 1231 transactions are straightforward and clear, the applicable rules and their potential interaction with other provisions of the tax code are anything but. Your financial advisor can help you decipher the proper timing and planning to get the best of both worlds.

Coming into its Own: LLC Investments

During the last decade, limited liability companies (LLCs) have become one of the most preferred forms of business entities through which to hold title to investment real estate properties. Prior to LLCs, real estate investors seeking limited liability protection were largely limited to using corporations to acquire title — a form of entity that has potential drawbacks.

All 50 states have enacted legislation creating some form of the LLC business structure, although the rules vary from state to state. The insulation from personal risk exposure for real estate investors provided by LLCs, coupled with the relative ease of administration and potential tax benefits, makes ownership of investment property through an LLC a desirable option in most instances. In general, an LLC member's personal liability is limited to his or her equity investment. But investors should be aware that there are some limits to the liability protections afforded by LLCs.

Environmental risks

Environmental liability is a common concern when purchasing property, and use of an LLC to make the purchase doesn't make that concern moot. The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) imposes strict, joint and several liabilities — no showing of negligence or intent is required — for cleanup costs on past and present owners and operators of

facilities where hazardous materials have been released. An LLC member who had the authority to control the operations or decisions involving the disposal of hazardous substances could be held liable for cleanup.

Loan breaches and defaults

LLC members who personally guarantee the company's debts or obligations will be held liable for their nonpayment or breach. This is a true risk when entering contracts or financing agreements before the LLC legally comes into existence because the other party insists on some guarantee.

To minimize the risk of personal liability, always act in the name of the LLC. When you sign contracts, for example, do so solely as an agent of the LLC, making sure to identify the LLC as the principal in the document. Similarly, make sure that the LLC's other agents and employees act as representatives of the entity and not of you personally. For extra protection, members might consider adding a personal umbrella policy to the LLC's traditional business insurance coverage.

Certain loan defaults may also create personal liability. Carefully review all loan documents to make sure you completely understand the consequences of all potential covenant violations.

Vicarious liability

An LLC won't protect a member from liability for his or her own negligent or otherwise wrongful acts that cause injury to another, such as assault or fraud. That could include negligent hiring or supervision of employees if an employee causes some type of injury and the member hired the employee in his or her own name, rather than in the name of the LLC.

Also note that, if an LLC member commits a wrongful act that causes injury while acting as an agent or employee of the LLC, it's not just the member's personal assets that could be targeted by the injured victim. The victim could also go after the assets of the LLC, under a theory of vicarious liability (also known as "respondeat superior liability") for its agent's acts.

On rare occasions, a court will "pierce the corporate veil" to impose liability for an LLC's debts and obligations on its members. This typically occurs when closely held and small businesses fail to observe corporate formalities such as holding regular board meetings, keeping minutes, adopting bylaws and ensuring company finances are separate from those of members. It could also happen if the LLC engaged in reckless conduct or fraud or was inadequately capitalized from the beginning. In all of these circumstances, a court might conclude that the LLC is merely a sham to shield its members from liability.

Go on the defense

A disadvantage of operating an LLC is that the company may automatically end if a member of the company decides to sell his or her portion of the business, or if a member abruptly passes away. In this scenario, the LLC may legally be required to terminate its affairs, pay creditors, file dissolution documents with the LLC's state of formation and distribute the company's remaining assets to the LLC members. So work with your tax and legal advisors to ensure you're covered.

Tax Court Disallows Property Dealer's Bad Debt Deduction

If you've ever had a debt go bad, you may have believed that you could at least get a tax deduction out of the situation. But that's not always the case, as a property dealer in Maryland learned the hard way.

Claim filing is amiss

The taxpayer in this case had been involved for about 30 years in one or more activities involving real property, including buying, selling and renting property and providing management services for rental real property. In early April 2003, he borrowed almost $200,000 from Merrill Lynch Credit Corporation, to be repaid over 30 years. He secured the loan with a rental property.

In April, he transferred about $157,000 of the loan proceeds to another individual. That individual and his mother (the borrowers) signed a document titled "Unsecured Note." The taxpayer didn't secure the repayment in any way, such as by requiring collateral. He also never checked the borrowers' credit ratings or required them to provide financial statements. He further failed to verify the source of funds from which they would be able to comply with their loan terms.

The son made 28 monthly payments before defaulting. At that time, the monthly payments remaining totaled about $153,000. The taxpayer made oral, but not written, requests to the son for payment of the outstanding debt. He never asked the mother to pay all or part of the debt and pursued no legal remedy.

In October 2006, the son filed for bankruptcy. The taxpayer, however, didn't file a claim regarding the outstanding debt. On his 2009 Form 1040, the taxpayer identified his principal business or profession as "property management." He claimed a deduction for the loss on the loan. The IRS disallowed the deduction, and the case ended up in the US Tax Court.

The Tax Court weighs in

The taxpayer asserted that he was entitled to deduct the entire amount of the alleged outstanding debt as a business bad debt because he was in the business of lending money. Business bad debts are generally considered ordinary losses that can be offset immediately against ordinary income.

For all or part of a debt to be deductible as a business bad debt, the debt must be either:

• Created or acquired in connection with a trade or business, or

• Incurred in the taxpayer's trade or business.

The fact that a taxpayer makes a loan for the sole purpose of obtaining interest income doesn't, standing alone, satisfy this requirement.

Moreover, for a taxpayer to be entitled to a bad debt deduction in connection with the business of lending money, the taxpayer's lending activity must be "so extensive and continuous as to elevate that activity to the status of a separate business." During his 30 years in the property business, though, the taxpayer made loans on about six different occasions. He also never advertised himself as a money lender or kept a separate office or books and records relating to any of the loans.

The Tax Court found that the taxpayer didn't establish that his lending constituted a separate business. Notably, it also pointed out that, in a previous case, the court had held that making eight or nine loans in the course of four years didn't elevate the lending activity to the status of a separate business.

Don't take the deduction for granted

Unless you engage in enough lending activity to establish a separate business, you'll be able to claim a business bad debt deduction only on loans that are connected to your business. Consult with your financial advisor to determine the best way to increase your odds of securing the deduction.

Langert v. Commissioner of Internal Revenue, T.C. Memo. 2014-210

Sidebar: Don't overlook the personal bad debt deduction

If you find yourself with a bad debt that doesn't qualify for the business bad debt deduction, you may qualify for the nonbusiness bad debt deduction. A nonbusiness bad debt is basically any debt that doesn't qualify as business debt.

Unfortunately, nonbusiness bad debts receive less favorable tax treatment than business bad debts. Rather than being treated as immediately deductible ordinary losses, they're deductible as a short-term capital loss and only in the year the debt becomes totally worthless. "Totally worthless" means there's no reasonable expectation of payment. In such cases, the deduction can be used to offset capital gains.

If a net capital loss results, the taxpayer can use it to offset up to $3,000 ($1,500 if married and filing separately) of other income. Any balance remaining will be carried over as a short-term capital loss.

The court in the Langert v. Commissioner of Internal Revenue case (see main article) found the taxpayer couldn't use this deduction, though. He failed to show any events that established the debt was totally worthless.

Leaser Option…or Sales? It Matters to the IRS

Lease options are often used in real estate transactions, especially when property owners run into difficulty finding a buyer. If you're not careful, though, the IRS might re-characterize the arrangement as a sale in the form of a contract for deed.

Lease option vs. contract for deed

A lease option is a traditional lease with a purchase option that gives the tenant the exclusive right to buy the property at the price typically set from the beginning. The tenant can exercise the option at any time during the option period, which usually runs concurrently with the lease period. The seller benefits from market appreciation or, alternatively, can claim depreciation as a tax deduction as long as the option isn't exercised. In addition, the IRS doesn't deem the arrangement a sale until the option is exercised, so the seller can defer its gains.

With a contract for deed, the buyer makes installment payments and receives equitable title in the property, while the seller holds legal title as security for the payments. Legal title is transferred after the final payment. Because the IRS considers a contract for deed to be a sale, the buyer reaps the tax benefits of ownership, such as mortgage interest deductions. When the buyer makes the final payment, the entire balance paid constitutes capital gains for the seller, and the seller also must pay any transfer tax.

Signs of a sale

When determining whether a transaction is a lease option or a sale, the IRS looks at the "economic reality." For example, if the circumstances when the agreement is executed suggest the buyer is very likely to exercise the option, it may be considered a sale.

Another indicator of a sale is an arrangement with artificially high rents and a below-market option price. These features can lead to the conclusion that the buyer is acquiring equity in the property during the lease term (equity = rent paid less fair market value rent). In such circumstances, the option price may be seen as a down payment. The low-priced option alone won't establish a sale, though, if the price is a substantial percentage of the property's fair market value and the rent payments aren't applied to the purchase price.

A lease that requires the tenant to make substantial improvements may also evidence a sale. As in the case of inflated rents, the theory is that the only way the tenant can recover its investment is by exercising the option.

Proceed with caution

A lease option can provide strategic value for both buyers and sellers, but you must take care to avoid IRS re-characterization. An appraiser can help you set the payments and option price at market values to boost the odds of surviving scrutiny.

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Joseph (Joe) Klein is a Partner with the firm's Real Estate Group. He provides tax and consulting services to commercial and residential real estate clients including real estate investment trusts (REITs), real estate management firms and high-net-worth individuals. In addition, Joe specializes in preparing financial projections and operating escalations, as well as performing due diligence on real estate acquisitions.

In addition to his professional activities, Joe plays an active role in the not-for-profit community. He serves on the board of directors of the Auditory/Oral School of New York, which was founded to offer an auditory-oral education to hearing-impaired and deaf children in New York.

Joe enjoys kayaking and pitching at his son's little league games. He resides with his family in Woodmere, New York.

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For Further Information

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