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Newsletter August 2019

Tax Filing Reminders

September 16 -

- Third quarter installment of 2019 individual and corporation estimated income tax is due.
- S corporations: Filing deadline for 2018 tax returns for S corporations that requested/received a six-month extension.
- Partnerships: Filing deadline for 2018 tax returns for partnerships that requested/received an automatic six-month extension.

September 30 -

- Trusts and Estates: Filing deadline for 2018 fiduciary income tax returns for calendar year end trusts and states.

Facing a Huge Gain from a Realty Sale?

Article Highlights:

- Adjusted Basis
- Passive Loss Carryovers
- Installment Sale
- Tax-Deferred Exchange
- Tax on Net Investment Income
- Qualified Opportunity Fund
- Home Sale Exclusion

If you are contemplating selling real estate property, there are a number of issues that could impact the taxes that you might owe, and there are steps you can take to minimize the gain, defer the gain, or spread it over a number of years.

The first and possibly most important issue is adjusted basis. When computing the gain or loss from the sale of property, your gain or loss is measured from your adjusted basis in the property. Thus, your gain or loss would be the sales price minus the sales expenses and minus the adjusted basis.

Adjusted Basis - So, what is adjusted basis? Determining adjusted basis can sometimes be complicated, but in a simplified overview, it is a dollar amount that starts with your acquisition value and is then adjusted up for improvements to the property, down for depreciation taken on the property, and down for any casualty losses claimed on the property. The acquisition value could be the price you paid for the property, the fair market value of an inheritance at the date of the decedent's death, or, in the case of a gift, the donor's adjusted basis at the time of making the gift.

As you can see, it is extremely important that you keep track of your basis, since it is a key factor in determining gain or loss upon the sale of the property. Failure to keep a record and substantiating documentation could cost you dearly in income tax.

Passive Loss Carryover - If the property was a rental and the rental operated at a loss, there is a chance that the losses were not fully deductible in the year(s) of the loss because of the passive loss limitation rules; in this case, you might have a passive loss carryover that can be used to offset some of the gain. In addition, current year passive losses and passive loss carryovers you may have from other properties might also be used to offset any gain from selling a rental property.

Next, you have to decide whether you want to take (i.e., report on your tax return) all the income in one year or whether to attempt to spread the income over a period of years with an installment sale (by carrying back a loan) or defer the income into a replacement property through a tax-deferred Section 1031 exchange.

Installment Sale - In an installment sale, the seller acts as the lender to the buyer. That can entail holding the first trust deed or taking back a second trust deed for only a portion of the loan amount. However, second trust deeds are as the name implies: They are second in line to be paid if the buyer defaults on the loan and thus are riskier. When set up as an installment sale, part of the gain is reported for each year that payments are received. In addition, the interest that the buyer pays the seller is taxable as ordinary income to the seller. Installment sales can be structured as short- or long-term loans, but remember, the buyer can always pay off the loan early or refinance. Either of these actions would make the balance of the profit from the sale taxable at that time.

Tax Deferred Section 1031 Exchange - Another option if the property is held for investment or used in a trade or business is to defer the gain down the road. This is accomplished by using the rules of IRS Code Section 1031, which allows the taxpayer to acquire like-kind property and defer the gain into the replacement property, which also must be used for business or be held for investment. However, the rules for like-kind exchanges are complicated, have strict timing issues, and require advance planning with a professional familiar with Section 1031 rules.

Net Investment Income Tax - Adding complications to the sale-planning issue is the surtax on net investment income. This 3.8% additional tax kicks in when a taxpayer's modified adjusted gross income (MAGI) exceeds $200,000 ($250,000 for married joint filers and $125,000 for married individuals filing separately). Gain from the realty sale is included in the MAGI and could cause the MAGI threshold to be exceeded, resulting in this surtax applying to some or all of the realty gain. However, it may be minimized, or possibly eliminated, by using an installment sale and spreading the gain over a number of years or deferring down the road with a tax-deferred exchange.

Qualified Opportunity Fund (QOF) – Taxpayers who have a capital gain from selling or exchanging any property to an unrelated party may elect to defer that gain if it is reinvested in a QOF within 180 days of the sale or exchange. One exception is that the gain from the subsequent sale of the QOF cannot be deferred into another QOF. Only one election may be made with respect to a given sale or exchange. If the taxpayer reinvests less than the full amount of the gain in the QOF, the remainder is taxable in the sale year, as usual. Only the gain need be reinvested in a QOF, not the entire proceeds from the sale. This is in sharp contrast to a 1031 exchange where the entire proceeds must be reinvested to defer the gain.

Home Sale Exclusion - If the real estate is your home (primary residence), there are special rules. Generally, if you own and occupy the home in two out of the five years prior to the sale, you will be able to exclude a substantial portion of your gain. The tax-deferred exchange rules do not apply to personal-residence sales. The amount of the home exclusion can be as much $250,000 ($500,000 for married couples filing jointly). There are even special rules that allow a reduced exclusion under certain special circumstances.

As you can see, the result of selling real estate property can include a number of tax issues, and minimizing current taxes requires some careful planning. Please give this office a call for assistance in planning your real estate transactions.

How to File Taxes After Saying "I Do"

Article Summary:

- Filing Options
- Married Filing Jointly
- Unpleasant Consequences
- Pleasant Consequences
- Married Filing Separately
- Notifying SSA, IRS, employers
- Other Issues to Consider

A taxpayer's filing status for the year is based upon his or her marital status at the close of the tax year. Thus, if you get married on the last day of the tax year, you are treated as married for the entire year. The options for married couples are to file jointly or separately. Both statuses can result in surprises – some pleasant and some unpleasant – for individuals who previously filed as unmarried.

Individuals filing jointly must combine their incomes, and if both spouses are working, combining income can trigger a number of unpleasant surprises, as many tax benefits are eliminated or reduced for higher-income taxpayers. The following are some of the more frequently encountered issues created by higher incomes:

- Being pushed into a higher tax bracket
- Causing capital gains to be taxed at higher rates
- Reducing the child care credit
- Limiting the deductible IRA amount
- Triggering a tax on net investment income that only applies to higher-income taxpayers
- Causing Social Security income to be taxed
- Reducing the Earned Income Tax Credit
- Reducing or eliminating medical deductions

Filing separately generally will not alleviate the aforementioned issues because the tax code includes provisions to prevent married taxpayers from circumventing the loss of tax benefits that apply to jointly filing higher-income taxpayers by filing separately.

On the other hand, if only one spouse has income, filing jointly will generally result in a lower tax because of the lower joint tax brackets and a higher standard deduction, double the amount for single individuals ($24,400 for 2019), if the couple does not itemize deductions. In addition, some of the higher-income limitations that might have applied to an unmarried individual with the same amount of income may be reduced or eliminated on a joint return.

Filing as married but separate will generally result in a higher combined income tax for married taxpayers. For instance, if a couple files separately, the tax code requires both to itemize their deductions if either does so, meaning that if one itemizes, the other cannot take the standard deduction. Another example relates to how a married couple's Social Security (SS) benefits are taxed: on a joint return, none of the SS income is taxed until half of the SS benefits plus other income exceeds $32,000. On a married-but-separate return, and where the spouses have lived together at any time during the year, the taxable threshold is reduced to zero.

Aside from the amount of tax, another consideration that married couples need to be aware of when deciding on their filing status is that when married taxpayers file jointly, they become jointly and individually responsible (often referred to as *"jointly and severally liable"*) for the tax and interest or penalty due on their returns. This is true even if they later divorce. When using the married-but-separate filing status, each spouse is only responsible for his or her own tax liability.

Once a couple files as married filing jointly they cannot undo that. However, if they file separately, they can later amend that filing status to married filing jointly.

Once the knot is tied, the Social Security Administration should be notified of any name changes, and if they've moved, the IRS needs to be notified of the couple's new address.

If either or both of the newlyweds purchased their health insurance through a government marketplace, the marketplace should be advised of the couple's marriage so that any advance premium tax credit (APTC) being applied to pay the insurance premiums can be adjusted when necessary. Doing so could prevent having to repay some or all of the APTC when filing their federal return(s) for the year of the marriage.

Of course the couple needs to notify their employers of their new marital status so any affected benefits can be updated. Usually new W-4 forms should be prepared and given to their employers so income tax withholding can be revised for the new filing status.

Other issues that may come into play and should be considered are

- If one of the spouses has an outstanding liability with the IRS or state taxing authority, that situation could jeopardize any future refund on a jointly filed return.
- It may be appropriate not to commingle income from assets a spouse wants to maintain as separate property or where the spouses want to name separate beneficiaries.
- Individuals marrying later in life may wish to keep their incomes separate or only pay the tax on their own income.

If you have questions or would like an appointment to evaluate the impact of marriage on your tax liability before saying "I do," please give this office a call.

Thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time.

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