2012 Real Estate Topics - Continued from Slides

Mary Geong and Greg Wilson

March 15, 2012

I. Commercial COD Issues on Workouts/Foreclosures, Inc.

A. Similar issues to residential workouts/foreclosures but cannot use 1) Qualified Personal Residence Indebtedness Exclusion, 2) CA law which sometimes cause loan to be characterized as non-recourse does not apply to commercial debt and 3) Section 121 does not apply to exclude gain in same cases.

B. Points to consider in commercial loan workout area when attempting to minimize COD income problem.

1) Acquisition of debt by other party.

As with residential properties, if lender agrees to reduce principal balance of loan, COD income results - which may be excludable or deferred if exception applies.

In prior real estate downturns, it was possible that borrower or another party could acquire the debt at discounted price and avoid triggering the COD income. This is no longer possible if borrower or related party acquires the debt. However, if unrelated party acquires the debt at discount, COD will not result.

2) Reduction of interest rate as possible solution.

Instead of the bank agreeing to reduce principal which causes COD income, the parties could agree to change some of the loan terms which might have the same economic impact but not the same tax impact. For example, principal would not be reduced but the terms changed to a 9 year loan, interest only at 1.08% (lowest mid-term AFR rate). Caution must be exercised to avoid triggering the material modification rules here but it should be possible to achieve this if lender will cooperate. Possible to avoid COD income entirely and still economically reduce the debt service burden in the same manner.

3) Section 108(i) - For 2009 and 2010 Events Only - Allowed COD realized in 2009 and 2010 on certain business debt to be deferred for five years and recognized ratably over the following five years.

Debt must have been entered into as part of trade or business. If a taxpayer was taking the position that he was only an investor in real estate does he meet this trade or business requirement? What about just an owner of raw land?

4) QRPBI - Qualified Real Property Business Indebtedness - Another Section 108 COD exclusion that taxpayers can use in certain cases but difficult to qualify for. To use this exception, the entity must not be insolvent and the taxpayer is usually insolvent if going through a debt workout. There are other requirements and limitations that restrict the use of this COD exception but it still is available and works in limited cases.

5) Insolvency and Bankruptcy

Like with residential properties, COD income is excludable if realized when the taxpayer is insolvent or in bankruptcy. Insolvency is determined immediately before the debt discharge and taxpayer can exclude up to the amount he is insolvent. Applying this test nonrecourse loans in excess of the value of the securing assets are ignored.

Most COD exceptions act much like a deferral - either directly as with the Section 108(i) exception or by way of attribute reduction. But in some cases where there are no attributes to reduce, the exclusion is more of a true exclusion.

Most commercial properties are held by entities. If the owner is an LLC or partnership, the insolvency and bankruptcy exceptions are applied at the member/partner level. So the members/partners must be insolvent or in bankruptcy to exclude the COD income. If the owner is a corporation - including an S corporation - the insolvency/bankruptcy exception is applied at the entity level.

6) Planning Point

Do not wait until after the transaction is complete to determine the COD income consequences to the taxpayer. Plan ahead as such planning can reduce the tax consequences.

II. 2012 Estate/Gift Tax Planning

A. $5,120,000 Estate/Gift Tax Exemption until 12/31/12

B. If Congress fails to act, exemption reduced to $1,000,000 on 1/1/13

C. Likely scenario?

Election year - Congress unlikely to do anything sensible or thoughtful. Most likely will do nothing or just pass patch to extend current exemption for another year.

D. Planning

Larger estates should not wait until late in 2012 to see what happens before considering planning - planning might take some time and must be done by 12/31/12

Give away $5,000,000 now?

Loss of control

Loss of step-up in basis

Gift added back into estate later anyway and Estate Tax applies

Example:

Commercial building

Adjusted Basis = $1,000,000

Market Value = $5,000,000

Gift on 12/31/12 - no Gift Tax

Congress lets Estate Tax law expire, goes back to old law with $1,000,000 exemption

Donor dies in 2015 with $1,000,000 in assets

$5,000,000 gift is added back so total transferred is $6,000,000 less $1,000,000 exemption = $5,000,000 taxable estate = tax of about $2,500,000

So did not save Estate/Gift Tax yet still lost the step up in basis on the asset

Debate among estate planners if they will bring back in 2012 gifts if exemption goes back to $1,000,000. Mechanically this is how law works unless Congress acts

So planning must be carefully considered.

Still in certain situations, ability to gift $5,000,000 in 2012 is tremendous planning opportunity that should be used. If the family has non-appreciated property to gift now they do not have to worry about losing step-up in basis on making gift now. If donor is young, losing the step up may still be worth gifting the asset now since appreciation will be out of the estate. Plus, asset prices are generally depressed right now so good time to gift.

Example:

Commercial building

Adjusted Basis = $4,000,000

Market Value = $5,000,000

Gift on 12/31/12 - no Gift Tax

Congress lets Estate Tax law expire, goes back to old law with $1,000,000 exemption

Donor dies in 2017 with $1,000,000 in assets

$5,000,000 gift is added back so total transferred is $6,000,000 less $1,000,000 exemption = $5,000,000 taxable estate = tax of about $2,500,000

But building has by then appreciated to $7,500,000. So removed the appreciation of $2,500,000 from the estate which was worth losing the step up in basis

But should get planning done and gift ready to be made now so can pull trigger on 12/31/12 in the event Congress does not extend $5,000,000 exemption.

III. Foreign Asset Reporting Rules

A. U.S. taxpayers have for years been required to report foreign bank accounts in which they have an interest in or control of if the accounts held at least $10,000 during the year. These are reported on what are commonly referred to as FBAR forms each year and on the Form 1040, Schedule B.

B. New Requirement - FACTA- effective for most taxpayers staring in 2011 requires additional foreign assets to be disclosed on their U.S. tax returns. This new disclosure is due, for the first time for most taxpayers on 4/15/12. Intent is to require reporting of foreign assets in addition to bank accounts.

C. FACTA requires taxpayers to disclose certain foreign "financial" assets if they exceed $50,000 in value such as financial accounts, foreign stock/securities and interests in foreign entities. Thus, it does not cover foreign real estate if such real estate is owned outright by the taxpayer. However, if the real estate is owned through a foreign entity, reporting under FACTA is likely required. Similarly, this or other reporting may be required if the foreign real estate is held through a trust. Many countries require foreigners to hold real estate through entities or trusts - the owners might see themselves as owning the real estate outright but legally that may not be the case.

Penalties here are draconian and there is no new tax here - so error on the side of over-disclosure of foreign assets if there is any question about reporting them. Outright ownership of foreign real estate, however, does not appear to require reporting. Of course, all income from such property must be included on the U.S. owners tax return.

IV. Carry Taxation

A. Hot Topic - The taxation of carried interests (aka carry aka profits interest)

B. How it works

LLC/Partnership can pay manager as bonus for managing property

Deductible to the LLC/Partnership - reduces members/partners gain allocation. Taxed as ordinary income to manager

Alternative - LLC/partnership can pay manager via a 20% carry in the entity

No deduction for payment to manager, possible taxed as capital gain to manager

Example

LLC buys property for $100,000 for investment. Hires employee to manage the property , compensation is 20% of gain realized on sale. LLC sales property for $200,000, realizes $100,000 of gain. Pays manager a bonus of $20,000 reducing its taxable income to $80,000 which is allocated to LLC member and taxed at capital gain.

Tax $80,000 at 15% = $12,000

$20,000 at 35% = $7,000

TOTAL = $19,000

Alternative - LLC issues manager a profits interest for his management role - treated like member with no capital interest. Same sale. Capital gain is allocated 20% to manager and 80% to other member. All taxed at capital gain.

C. Possible change - Several bills floated but, in general, will force manager to recognize ordinary income on income from efforts.

For more information contact: Greg Wilson at grw@gwilson.com or 415-981-9545