Tax Planning for Real Estate Investors for 1999 & Beyond

by J. Russell Hardin & Jack R. Fay

Introduction

The Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (the Act) was signed into law by President Clinton on July 22, 1998. The law is far-reaching and multi-functional and is surprisingly complex; it affects a broad cross-section of taxpayers in a variety of significant ways. The 1998 Act is actually six acts rolled into one piece of legislation. The law represents a major attempt to rein in the IRS through a ground-up reorganization. The Act also lowers the holding period for the most favorable capital gains rate; makes several technical corrections to the Taxpayer Relief Act of 1997 (TRA 1997); enacts the "Taxpayer Bill of Rights 3;" carves out a separate Electronic Filing section; and adds a list of "revenue raisers" that affect both individuals and corporations.

The purpose of this manuscript is to summarize some of the provisions to the Internal Revenue Code that are now effective as law or that will soon become effective as law. Individuals and business owners are urged to look closely at this sweeping legislation to seek ways in which they can significantly diminish their future income taxes and to examine the new protections and rights that taxpayers enjoy under the new law. The following discussions focus on some of the major provisions of the new tax bill which, directly or indirectly, affect real estate investors. Some suggestions for tax planning are also included. To determine the particular effect, if any, each of these provisions will have on a particular taxpayer, each taxpayer should consult with his or her CPA, tax attorney, or other tax professional.

Electronic Filing

One important component of the IRS Restructuring and Reform Act of 1998 is the electronic filing rules and incentives. The Act has provisions

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to encourage electronic filing of tax returns and information returns (i.e., 1099s and W-2s). The Act sets a goal that 80 percent of all tax and information returns will be filed electronically by the year 2007. The Act also aims for a return-free tax system for individuals whose tax return information is limited to items already reported to the IRS on information returns. The Act has a goal for this return-free system to begin in the year 2008. In addition, the Act directs the Treasury Department to develop a plan that would require all computer-generated tax returns to be filed electronically by the calendar year 2002.

There are several incentives for filing electronic tax returns. First, electronically filed returns are generally prepared using computer tax preparation software. Returns prepared on the computer have an error rate of less than one percent. This means the taxpayer is less likely to encounter such problems as delayed refunds or certain IRS audits. Another advantage of filing an electronic tax return is the speed with which the taxpayer can potentially receive a tax refund. Whereas a paper tax return generates a refund check in approximately six to eight weeks, an electronically prepared and filed tax return can result in the refund amount being deposited in the taxpayer's bank account in nine to 15 days (when coupled with the electronic funds transfer system). Still another advantage of electronic filing is the almost immediate acknowledgment (usually within a day) from the IRS that the return has been received and accepted. A final advantage of electronic filing is the ability to file the tax return separately from the payment when taxes are due. Under the new rules, a taxpayer can file his or her electronic tax return at any point during the tax season (January through April 15), and the taxpayer can wait and pay the taxes that are due on or before April 15.

To encourage the filing of electronic information returns by employers, the Act has delayed the due date for filing information returns. Whereas employers who file information returns on paper must do so by February 28 of each year, employers who file electronic information returns may wait until March 31 to file. This includes, among other things, reporting wages, interest, dividends, and non-employee compensation. The due date for providing copies of information returns to payees, however, currently remains as January 31 of each year (the Treasury is studying the possibility of changing this date to February 15). The effective date of this change is January 1, 2000.

TAXPAYER PROTECTION AND RIGHTS

Burden of Proof

A somewhat controversial provision of the Act is that the burden of proof shifts to the IRS in certain situations. Historically, an IRS determined tax deficiency has been presumed to be correct. This former rule required the taxpayer to persuade the courts that the IRS determination was incorrect and/or that the IRS position was without merit. The IRS has always had the burden of proof in certain cases such as those involving illegal transactions and fraud. The new law, however, places the burden of proof on the IRS in tax litigation with respect to a factual issue.

Specifically, four conditions must be met for the burden of proof to shift to the IRS. First, the taxpayer must comply with the requirements of the Internal Revenue Code (hereafter the Code) and the regulations issued thereunder to substantiate any item that relates to the litigation. Second, the taxpayer must maintain records required by the Code and its regulations. Third, the taxpayer must cooperate with reasonable IRS requests for meetings, interviews, witnesses, information, and documents. Finally, the taxpayer must either be an individual or must be a corporation, trust, or partnership with a net worth of no more than $7 million and no more than 500 employees. In other words, the burden of proof shifts to the IRS for individuals and small businesses with respect to a factual issue.

This change does not apply to present court proceedings; only those arising in connection with audits that started after the President signed the Act (July 22, 1998). The burden of proof also shifts to the IRS in two other situations. First, the burden of proof is on the IRS if they use statistics to reconstruct an individual's income. Second, the IRS bears the burden when the court case involves proceedings against an individual taxpayer regarding a penalty or addition to tax. This change became effective with the enactment of the Act (July 22, 1998).

Proceedings by Taxpayers

Several changes to proceedings by taxpayers (*i.e.*, court cases) were built into the IRS Restructuring and Reform Act of 1998. First, the Act permits up to $100,000 in civil damages when an officer or employee of the IRS negligently disregards provisions of the Internal Revenue Code or Treasury regulations in connection with the collection of Federal tax with respect to the taxpayer. Further, if the negligence relates to willfully violating

provisions of the Bankruptcy Code relating to automatic stays or discharges, the civil damages can be as high as $1 million. Second, the U.S. Court of Federal Claims and the U.S. District Courts are granted jurisdiction to determine the proper amount of estate tax liability (or refund) in actions brought by taxpayers deferring estate tax payments under Section 6166. The Act also provides that once a final judgment has been entered by one of the above courts, the IRS is not permitted to collect any amount disallowed by the court. In addition, any amounts paid by the taxpayer in excess of the amount found by the court to be currently due and payable must be refunded to the taxpayer, with interest.

Third, the Act allows a record owner of property against which a Federal tax lien has been filed to obtain a certificate of discharge of property from the lien if the owner of record is not the person whose unsatisfied liability gave rise to the lien. The owner of record is required to apply to the Secretary of the Treasury and either to deposit cash or furnish a bond to protect the lien interest of the United States. Fourth, the Act directs the IRS to modify its administrative procedures to allow tax-exempt bond issuers to appeal adverse examination determinations (loss of tax-exempt status) to the Appeals Division as a matter of right. The appeal is then handled by senior appeals personnel with experience in tax-exempt bond issues. Other changes to proceedings include: jurisdiction for small cases is increased from $10,000 to $50,000; actions for estate refunds which have elected the installment method of payment for estate taxes attributable to a closely held business, may now be heard by the Court of Federal Claims or the Federal District Courts; and deficiency notices must indicate the last date a taxpayer may file a timely Tax Court petition. The effective date of these changes was July 22, 1998.

Innocent Spouse Relief

This Act generally makes innocent spouse relief easier to obtain. An innocent spouse is excused from liability for the couple's joint tax, penalties, and interest if five conditions are met. First, the innocent spouse must have filed a joint income tax return. Second, the understatement of tax on the joint return is attributable to an erroneous item(s) of the other spouse. Third, the innocent spouse must be able to prove that, when he/she signed the return, he/she had no reason to know, and in fact did not know, of the understatement of tax. Fourth, when considering all the facts and circumstances surrounding the case, it would be inequitable to hold the innocent spouse liable for the joint deficiency. Fifth, the innocent spouse elects the innocent spouse relief not later than two years after the IRS begins collection activities. Failure to comply with any one of these conditions will result in denial of innocent spouse relief.

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One of the keys to the successful invocation of innocent spouse relief is the knowledge of the innocent spouse. The courts have held that relevant facts to consider in determining if the spouse had a reason to know about phony deductions include: the spouse's involvement in the family's business and financial affairs; the spouse's education level; the presence of expenditures that appear lavish or unusual; and the spouse's evasiveness and deceit when asked about the couple's finances. A "lack of knowledge" defense can be difficult to prove because the IRS can take the position that even if the innocent spouse claims he/she did not know about a transaction, he/she had reason to know or should have known if the spouse knew of the transaction that gave rise to an omitted item of gross income. The level of knowledge of a phony deduction to prevent the innocent spouse defense is not clear. For example, just because a spouse knows that investment transactions occurred, he/she may not know anything about what deductions might have been taken in conjunction with the investment activities. The innocent spouse protection expanded on July 22, 1998.

Interest and Penalty Relief

This 1998 Act included several changes to the interest and penalty provisions related to various taxpayers. First, the Act establishes a net interest rate of zero on equivalent amounts of underpayment and overpayment of any taxes imposed by the Internal Revenue Code that exist for any period. This provision applies to both self-employment taxes and income taxes. The provision applies after the date of enactment (July 22, 1998); and it applies to interest for periods before the date of enactment

if: the statute of limitations has not expired with respect to the underpayment or overpayment; the taxpayer properly identifies the periods of underpayment and overpayment; and the taxpayer asks the Secretary of the Treasury to apply the zero rate on or before December 31, 1999.

This interest netting provision will be significant for corporations with a tax overpayment exceeding $10,000 in one year (on which the government pays 5.5 percent interest) and a tax deficiency exceeding $100,000 in one year (on which the corporation is charged 10 percent interest). Since years and sometimes decades pass before a final determination is made by the IRS in a multiple-year, large corporation audit, the new interest netting provision could result in millions of dollars in savings for large corporations. Under prior law, a corporate taxpayer could have ended up paying 4.5 percent interest (10 percent - 5.5 percent) even though the tax overpayment and tax underpayment may have eventually been offset with no additional taxes due.

Other changes in interest and penalties include: 1). the penalty for failure to pay taxes is .25 percent instead of the usual .50 percent per month (after 1999) for an individual who is paying his or her taxes under an installment payment agreement with the IRS; 2). the Act permits the taxpayer to designate the period to which each payroll tax deposit is to be applied to help mitigate the failure to deposit penalty; 3). the Act suspends the accrual of certain penalties and interest after one year if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability for additional taxes (along with an explanation for how the additional taxes were derived) within one year following the date on which the taxpayer filed a timely return; 4). the Act requires that each notice imposing a penalty include the name of the penalty, a computation of the penalty, and the Code section invoking the penalty; and finally, 5). the Act requires every IRS notice that includes interest to be paid by an individual taxpayer to contain a detailed computation of the interest charged and a citation to the Code section imposing the interest. These provisions became effective on July 22, 1998.

Due Process in IRS Collection Activities

The Act establishes procedures to insure due process where the IRS seeks to collect taxes by levy (including by seizure). Under these new rules, the IRS is required to notify the taxpayer that a Notice of Lien has been filed. During the 30-day period beginning with the delivery or mailing of the notice, the taxpayer may demand a hearing with an appeals officer who has had no prior involvement in the taxpayer's case. Before the IRS can levy against a taxpayer's property, it is required to provide the taxpayer with a Notice of Intent to Levy. Generally, no levy can occur within the 30-day period beginning with the mailing of the Notice of Intent to Levy. During that 30 days, the taxpayer may demand a pre-levy hearing with an appeals officer who has no prior knowledge or involvement with the taxpayer's case. No seizure of a dwelling that is the principal residence of the taxpayer, the taxpayer's spouse, the taxpayer's former spouse, or a minor child is allowed without a court order. This provision is effective for collection actions that started more than 180 days after July 22, 1998.

Confidentiality Privilege

The IRS Restructuring and Reform Act of 1998 extends the present attorney-client privilege of confidentiality to tax advice furnished by any practitioner authorized to practice before the IRS. In other words, the confidentiality privilege is extended to Certified Public Accountants and Enrolled Agents. Privilege may be asserted in any noncriminal proceeding before the IRS, as well as in noncriminal proceedings in the federal courts where the United States is party to the proceeding. This privilege is only available when the tax practitioner is providing tax advice. Privilege may not be asserted for communications made and documents generated for the purpose of preparing tax returns. The Act also excludes from privilege a written communication between a federally authorized tax practitioner and any director, shareholder, officer, employee, agent, or representative of a corporation in connection with the promotion of the corporation's participation in a tax shelter. These rules are effective for communications on or after July 22, 1998.

CHANGES TO CAPITAL GAINS RULES

The Taxpayer Relief Act of 1997 lowered the long-term capital gains tax rate for individual taxpayers from 28 percent to 20 percent (or 10 percent if the property would otherwise be taxed in the 15 percent tax bracket) for property held more than 18 months. The Taxpayer Relief Act also established a 25 percent tax rate on certain depreciable real estate (such as residential rental property) held more than 18 months. The 25 percent maximum rate applies to the gain to the extent of allowable depreciation. The Relief Act additionally established a 28 percent top capital gains rate for collectibles held more than 18 months and sold at an increase. The

IRS Restructuring and Reform Act of 1998 reduced the holding period to qualify for the lower rates from more than 18 months to more than one year. The new one-year holding period applies to capital gains occurring on or after January 1, 1998.

Tax Planning Tip: Capital gains on investments held one year or less are taxed at the taxpayer's regular tax rate. The availability of the lower rates for relatively short-term investments clearly accelerates the need for tax planning strategies that favor capital gains over ordinary income. For example, postponing the sale of a capital asset for just a few more days or weeks may put a taxpayer over the one-year limit and invoke the lower tax rate. Also, taxpayers should be vigilant and keep an eye on the United States Congress since it is contemplating still further reductions in the capital gains tax rates.

PASSIVE LOSSES

Although not part of the 1998 Tax Act, passive loss rules continue to be an important tax planning issue for real estate professionals. A real estate professional who "materially participates" in rental real estate activities may not be subject to passive loss limitations if certain requirements are met. The tax laws allow net losses from rental real estate to offset any other income provided the taxpayer materially participates in the rental activity. In essence, a taxpayer who qualifies as a real estate professional is permitted to treat the loss from the rental activity as if it were a loss from a trade or business. This tax relief is available to individuals and closely held C corporations. A C corporation is closely held if five or fewer shareholders own 50 percent or more of the stock during the last half of the year. The conditions that generally must be met include the following: 1). more than half of the taxpayer's personal services (work) must be performed in real property trades or businesses; 2). the taxpayer must perform more than 750 hours of services in real property trades or businesses; and 3). the taxpayer must materially participate in the rental of real estate.

Tax Planning Tip: A real property trade or business is any real property development, acquisition, conversion, construction, redevelopment, rental operation, management, leasing, or brokerage trade or business. In addition, a taxpayer who is an employee of a business engaged in a real property trade or business qualifies if the taxpayer has an ownership interest in the business that is greater than five percent.

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CHANGES TO ROTH IRA RULES

The 1998 Act made several changes to the rules for Roth IRAs. The Taxpayer Relief Act of 1997 originally intended that funds converted from an existing IRA to Roth IRA be held in the Roth IRA for at least five years before withdrawal. However, the law did not stop taxpayers from receiving early withdrawals from their converted Roth IRA and receiving the benefits of the four-year averaging rule on the converted amount, thereby paying no early withdrawal penalty. The 1998 Act imposes a new toll charge on premature withdrawals from the converted Roth IRA. If converted amounts are withdrawn during the four-year spread period, the amount withdrawn will generally be subject to an unfavorable income-acceleration rule.

In addition to the new penalty, the 1998 Act contains three new Roth tax breaks. First, those who convert to a Roth IRA may elect to recognize all income in the year of conversion rather than ratably over four years. Second, taxpayers have until the due date of their tax returns to change their minds about any Roth IRA conversion that took place any time during the tax year (this helps taxpayers who incorrectly project the size of adjusted gross income). Third, a surviving spouse who inherits a 1998 Roth conversion IRA can elect to continue to defer income over the remainder of the four-year spread period.

Tax Planning Tip: Taxpayers should avoid converting an amount so large that they use up their available money to pay the conversion tax. In addition, paying the conversion tax out of IRA funds will be considered a premature distribution with a resulting penalty. Finally, although the 10 percent early withdrawal penalty normally does not apply to withdrawals for education or for first-time home buyers, the 1998 Act prevents these exceptions from being applied to distributions from employer-sponsored retirement plans.

ESTIMATED TAX SAFE HARBOR

Under present law, an individual taxpayer generally must pay a penalty for an underpayment of estimated tax. The individual taxpayer generally does not have an underpayment penalty if he or she makes timely deposits of estimated tax equal to certain safe harbor percentages of the prior year tax liability. For taxpayers with an adjusted gross income of over $150,000, the 1998 Act increases the 105 percent of last year's tax liability safe harbor to 106 percent of last year's liability safe harbor for tax years beginning in 2000 and 2001. The safe harbor percentage for these taxpayers increases from 106 percent to 112 percent for taxable years beginning in 2002.

Tax Planning Tip: There is generally no underpayment of estimated tax penalty for taxpayers who owe less than $1,000 ($500 under prior law) with their tax return or for taxpayers who had no tax liability for the prior tax year.

CAPITAL RECOVERY: DEPRECIATION

Before 1999, taxpayers who elected to use the Alternative Depreciation System (ADS) and the 150 percent declining balance method to depreciate tangible personal property were required to use the ADS life for its computations. Starting in 1999, taxpayers must use the MACRS life rather than the ADS life for property placed in service after December 31, 1998, if the 150 percent declining balance method is selected. Thus there no longer is an election to use the 150 percent declining balance method and the longer ADS life.

There was also a change or clarification in the 1998 Tax Act relating to depreciation limits for electric vehicles. The annual depreciation deduction was tripled for such vehicles in accordance to 1997 legislation, and the 1998 Act clarifies that the maximums for years after the vehicle's six-year recovery period are also tripled.

Tax Planning Tip: Whenever and wherever it is feasible for a company or an employee to use an electric vehicle, this can be a significant tax benefit to take the larger amounts of depreciation deductions.

NET OPERATING LOSS CHANGES

The Tax Act of 1998 made some significant changes in the computation of a net operating loss (NOL) in nonbusiness transactions. Previously, nonbusiness deductions were normally not taken into account in the computation of a non-corporate taxpayer's NOL; however, personal casualty and theft losses (net amounts after reduction of the $100 and 10 percent floors) were treated as business losses for NOL purposes. This apparent inconsistency allowed NOLs from personal casualty and theft losses but disallowed nonbusiness deductions in the computation of such NOLs. The new law [Section 172(d)(4)(C)] now provides that casualty and theft losses incurred in a nonbusiness transaction by a non-corporate taxpayer are taken into account in the computation of a net operating loss; and in the NOL computation, the casualty and theft losses are not treated as miscellaneous itemized deductions subject to the two percent floor or as itemized deductions subject to the three percent cutback.

Another NOL change is that the portion of an NOL which qualifies as a "specified liability loss" may be carried back 10 years instead of the normal two-year carryback period. Specified liability losses [Section 172(f)(1)(B)(i)] include losses related to the following: product liability, reclamation of land, decommissioning of a nuclear power plant, dismantling of a drilling platform, remediation of environmental contamination, and a worker's compensation claim.

Tax Planning Tip: It will be essential for individuals who suffer from casualty or theft losses, farmers who have NOLs, and others who have specified liability losses to spend some time in the computation of NOLs and in tax planning the best route for carryback and carryforward periods to take advantage of these new tax provisions.

CLARIFICATIONS ON GAINS FROM SALE OF PRINCIPAL RESIDENCE

In a decision which benefits many taxpayers, Congress settled the question of how to apply the new capital gains exclusion to the sale of a residence owned and used for less than two years. The general rule indicates that to be eligible for the capital gains exclusion, a taxpayer must have owned the home and occupied it as a principal residence for at least two of the five years prior to the sale or exchange.

The 1998 law states that a taxpayer who fails to meet the two-year test because of a change of place of employment, health, or other unsuspecting circumstance may be able to use a fraction of the $250,000 exclusion (or $500,000 for married, filing jointly) equal to the fraction of the two years that the ownership and use requirement is met. For example, an unmarried taxpayer who owns and uses a principal

residence for one year and then moves because of a job transfer may exclude up to $125,000 (one-half the regular amount of $250,000 exclusion under the Tax Act of 1997). If he or she has a gain of $75,000 on the sale of the residence, it is all excluded rather than only one-half of the $75,000, in accordance to the clarification provided in the Tax Act of 1998.

MISCELLANEOUS ITEMS

A miscellaneous, but significant item, in the Tax Act of 1998 affects all taxpayers who have a tax liability starting in 1999 (effective on 1998 tax returns) as they are to make checks and money orders payable to the "U.S. Treasury," not to the "Internal Revenue Service." Another miscellaneous item that is not part of the 1998 Act but is a change in IRS procedures involves private letter rulings. On January 20, 1999, the IRS announced that businesses with less than $1 million in gross income now qualify for a special $500 user fee when they request a private letter ruling. The fee for most other private letter ruling requests is $5,000. A private letter ruling is a written statement issued by the IRS to a taxpayer that interprets and applies the tax laws to the taxpayer's specific set of facts. This change makes private letter rulings available to small businesses.

CONCLUSION

The IRS Restructuring and Reform Act of 1998 is a complicated piece of legislation that contains numerous amendments and new provisions. Many of these provisions can help businesses of all sizes in many industries reduce their tax burden if properly applied. A law as complicated as this needs a great deal of study if one is to maximize the tax breaks that are potentially available in such a sweeping piece of legislation. Those managers and owners who are responsible for maximizing shareholder wealth and maintaining appropriate capital structures should look very closely at this law. In addition, many of the new tax provisions have a significant impact on individuals. Individuals, business owners, and business managers should consult with appropriate tax professionals to assure proper application and maximum benefit from the new law. REI

NOTES

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