Lesser Known Real Estate Leasing Tax Tips

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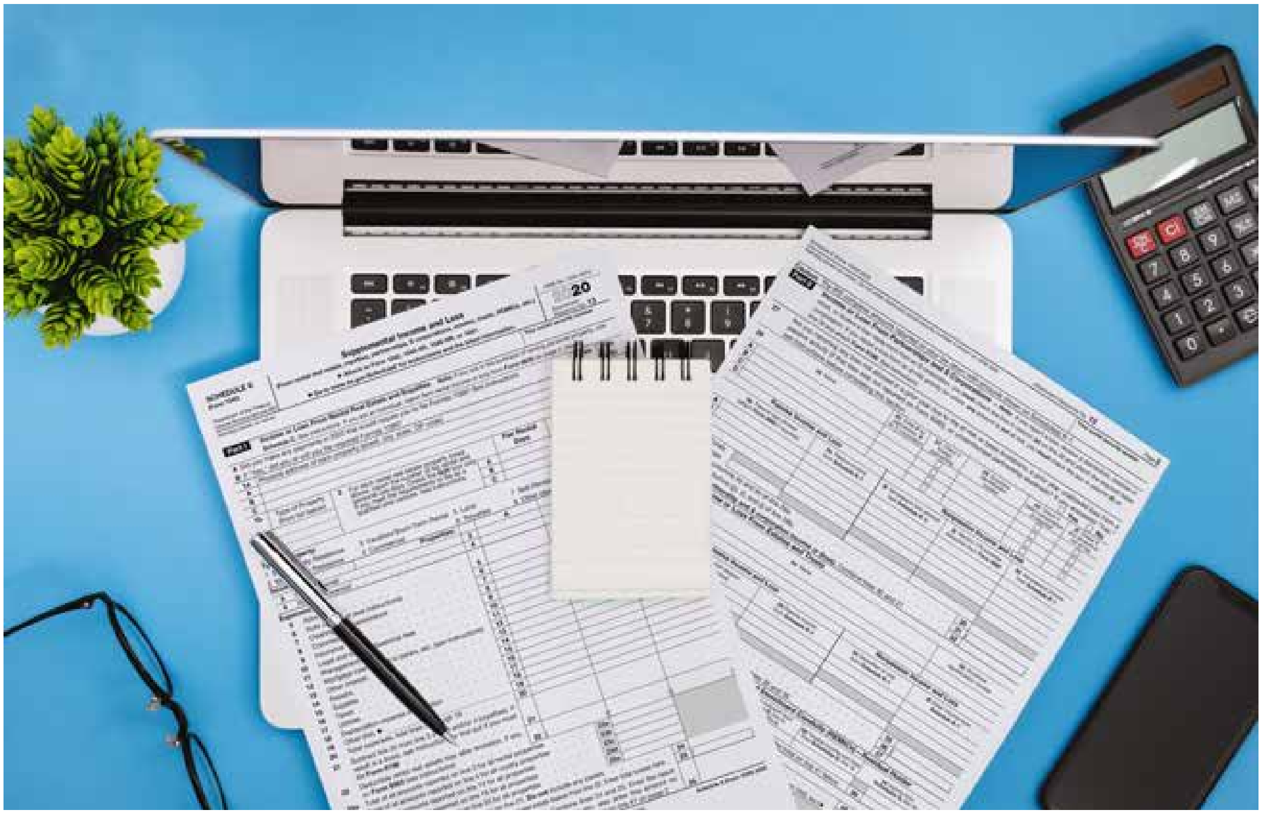

Articles on tax tips for real estate leasing often lull readers into expecting a laundry list of topics such as keeping good records to substantiate travel and entertainment expenses. As any Internet search would reveal, this is the norm in tax literature.

The tips presented here touch on subjects not usually covered in a typical tax article. Consider them when planning real estate leasing activities.

The Takeaway

When planning real estate leasing activities, decide whether the activity is an investment or business, plan for *all* taxes, carefully choose the form of the entity, maintain a corporate record book, and plan for whether the activity is passive or nonpassive.

Tip No. 1: Decide Whether Activity is an Investment or Business

A discussion of tax issues involving real estate in general and real estate leasing in particular must focus on the great divide in taxation: capital gain versus ordinary income. This bifurcation between capital and ordinary income lurks behind just about every tax topic and business decision. President Biden's tax plan hit this issue hard by effectively proposing to eliminate the capital gains tax, at least for many. The proposal has not yet become law, so ordinary income is still taxed at a much higher rate than capital gain income. For the real estate investor or professional—indeed, for just about any taxpayer who is serious about investing or operating a business—the ordinary income versus capital gain divide looms large in planning.

For those in real estate, the ordinary income versus capital gain division often turns on the question of whether one is an investor or in the real estate business. The investor achieves capital gain income while the one in business pays ordinary income tax on earnings and gains. Conversely, one who experiences losses can either deduct the loss against all other income (ordinary loss) or offset the loss against capital gains (capital loss), subject to the passive loss limitations, which will be discussed later.

The differences in tax rates between capital gain and ordinary income are material. Seven tax rates are in effect for both 2020 and 2021: 10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent, and 37 percent. The 2021 tax brackets were adjusted to account for inflation, which means that in 2021 a taxpayer could end up in a different tax bracket than they were in in 2020. Another factor for determining tax brackets is filing status. For example, a 22 percent tax bracket for 2021 begins at $40,526 and ends at $86,375 for single taxpayers, but begins at $54,201 and ends at $86,350 for head-of-household filers. President Biden has proposed increasing the 37 percent tax rate to 39.6 percent, which would apply to single filers with taxable income over $452,700 and joint filers with taxable income exceeding $509,300.

For the year 2020, the tax rate for capital gain is generally 15 percent for those with incomes up to $441,450 (single filers) and 20 percent for those with higher incomes. For 2021, the 15 percent tax rate applies to incomes up to $445,850 (single filers) and 20 percent for higher incomes. Also, capital gains are computed by deducting the tax basis of the asset from the amount realized on sale. Ordinary income is paid on all income.

Another factor in the ordinary income/capital gain divide is whether one makes or loses money. The higher tax rate for ordinary income means losses are more valuable if they are ordinary losses. An ordinary loss reduces ordinary income taxed at the higher tax rates, as opposed to capital losses, which reduce capital gain income.

This capital gain/ordinary income (or investor versus being in the real estate business) division is ever-present. The following tax issues are affected by whether the taxpayer is an investor or in the real estate business:

- Section 199A, 20 percent deduction allowed against income from a pass-through business.
- Limits imposed on deductions for business interest, but not applicable to small business.
- Deduction for investment interest limited to net investment income. Investment interest does not include passive activity and, therefore, does not include real estate rental activity.
- The character of gain or loss from a sale of the property. The capital gain for sale of real estate property held for more than one year applies only to the property used in a trade or business.
- The net investment income tax. The premium, add-on tax for investment income does not apply for real estate rental activity that is nonpassive and rises to the level of a trade or business.
- The excess business loss limitation. Taxpayers not operating in corporate form can use up to $250,000 of net losses ($500,000 if married, filing jointly) to offset nonbusiness income. If real estate rental activity is not a trade or business, net losses from rental activity are not limited by this rule.
- Treatment of joint interests as a separate entity. Joint interests can be treated as a separate entity for tax purposes if the people carry on a trade or business and divide the profits from the activity.
- The excess passive investment income tax. S Corporations pay an entity-level tax if more than 25 percent of the corporation's gross receipts are from passive investment income.
- Net operating losses. Nonbusiness deductions are taken into account when computing net operating losses.
- Form 1099 filing requirements. Businesses are required to issue Forms 1099 to each noncorporate service provider.

Tip No. 2: Plan for All Taxes, Including the Estate Tax

When planning for real estate leasing, plan for *all* taxes, not just income taxes. Remember, especially, estate taxes. The large lifetime estate and gift tax exemptions have relaxed everyone, but the potential for an estate tax is a real economic risk. First, Congress might enact President Biden's tax proposals, which in brief reduce the estate tax exemption to $3.5 million ($7 million for couples) from the current $11.7 million. Second, even if Congress does not enact those tax proposals, the exemption is already scheduled to drop to $5 million (adjusted for inflation) at the end of 2025.

The time for considering the risk of an estate tax is now. Some key strategies in estate planning are:

- transfer assets to your family before those assets' intrinsic value is realized;
- organize assets you are considering transferring to take advantage of valuation discounts, such as in a family partnership;
- make low-interest loans to your family to enable them to purchase new assets instead of you purchasing them;

- avoid outright transfers, but use a generation-skipping trust; and
- before gifting to your family, be certain you have retained sufficient assets to support you and your spouse.

Tip No. 3: Carefully Choose the Form of Entity

One of the most important first decisions for your real estate business or investments is choosing the form of entity. The prime consideration when selecting an entity—apart from taxes—is how to best manage liability risk. The goals are to keep the risk of potential liability that is inherent in real estate leasing from threatening your other assets and to keep other liability risk from impairing your real estate leasing assets or activities. One approach is to select a form of business entity that limits liability, then compartmentalize liability risk so the liability risk exposes only the assets involved in the activity.

Consider these points when selecting an entity.

- A pass-through entity is usually favored, which narrows the choice to a limited liability company (LLC) or Subchapter S corporation. A pass-through entity avoids double taxation of the regular corporation.
- Practically speaking, accountants tend to favor Subchapter S corporations while tax lawyers generally prefer LLCs. The S Corporation offers some relief from the self-employment tax, but S Corporations are tricky to start and maintain, and their rigid operational rules are easily violated. Mistakes with an S Corporation can result in loss of the S election, which can be painful. Further, S Corporations offer little flexibility in estate planning. LLCs, on the other hand, offer flexibility in estate planning but require more subtlety on self-employment taxes.

Tip No. 4: Maintain a Corporate Record Book, and Maintain It Well

Keeping a corporate record book will perhaps strike many as an outdated idea. Those black binders sit on the shelf, but who ever opens them? However, the corporate record book belongs on the list of most important goals of operating any business or investment activity, especially real estate leasing. It's on par with keeping a good set of accounting books. The advantages of a well-maintained corporate record book are subtle but real:

- When selling the real estate leasing business or investment, purchasers (or their lawyers) will ask to see the corporate record book. A well-maintained one will ease the sales transaction. Further, it can enhance a purchase price on sale of assets. When presenting a purchaser of a business with a seller's well-maintained corporate record book, purchasers (or their lawyers) become more willing to bend on other issues.
- A well-thought-out corporate record book documents clear and logical business decisions as well as the reasoning supporting those decisions. Basically, it's a business diary.
- Maintaining a corporate record book will bring business discipline to one's real estate leasing activity. It organizes thoughts.
- The IRS will often ask whether a transaction or activity has a business purpose. Good accounting books help support the tax consequences of one's decisions. The same goes for the corporate record book.

A well maintained corporate record book is a business advantage. It is the secret sauce.

Tip No. 5: Plan for Whether the Activity is Passive or Nonpassive

Passive loss rules are pervasive. In brief, passive activity rules force taxpayers to lump their activities into boxes.

Inside the passive activity box, losses derived from passive activities (passive losses) can be offset only on gains from passive activities (passive gains). Inside the nonpassive box, losses from nonpassive activities can be offset against any income. The IRS has decided that real estate rental activity is generally passive, but with important exceptions. Most try to fall within the exceptions.

For more on passive activity, read *TG* article "Rental Tax Issues Worth Watching."

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