

INCOME TAX DISCUSSION FOR

BRUIN PROFESSIONALS

REAL ESTATE AFFINITY GROUP

Presented by:
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ABOUT THE PRESENTER



Guy A. Nicio, CPA, MST

Partner, Windes Tax & Accounting Services

Guy has more than 20 years of public accounting experience. He is Chairman of the firm's Tax department and also serves on the firm's Board of Directors.

He focuses on tax planning, compliance, and consulting with start-up to middle-market businesses and their owners, working closely with his clients to analyze and maintain the most tax efficient structure to suit each client's unique situation.

Guy's tax experience and expertise includes analysis and selection of business entities, federal and multi-state income tax compliance for businesses and individuals, tax planning optimization and strategy, and audit defense.

Guy also heads the firm's Comprehensive Office Solutions Group, which provides client accounting services such as bookkeeping, payroll solutions, sales and use tax compliance, business property tax returns, accounting software implementation and conversions, and fractional outsourced accounting solutions.

Choosing an Entity

	Schedule C	LLC or partnership	S-corporation	C-corporation
Additional Tax Return		✓	✓	✓
Double Taxation				✓
Basis advantages	✓	✓		
Higher Audit Risk	✓			
Self-Employment Tax	✓	✓		
IRC 199A Benefits	✓	✓	✓	
Flexibility		✓		✓

1031 EXCHANGES

IRC Section 1031 (a)(1) states: “No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment, if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.”

1031 EXCHANGES

Who Qualifies for a 1031 Exchange?

The following owners of investment and business property may qualify for a Section 1031 deferral:

Individuals

C Corporations

S Corporations

Partnerships (both general and limited)

LLC's

Trusts

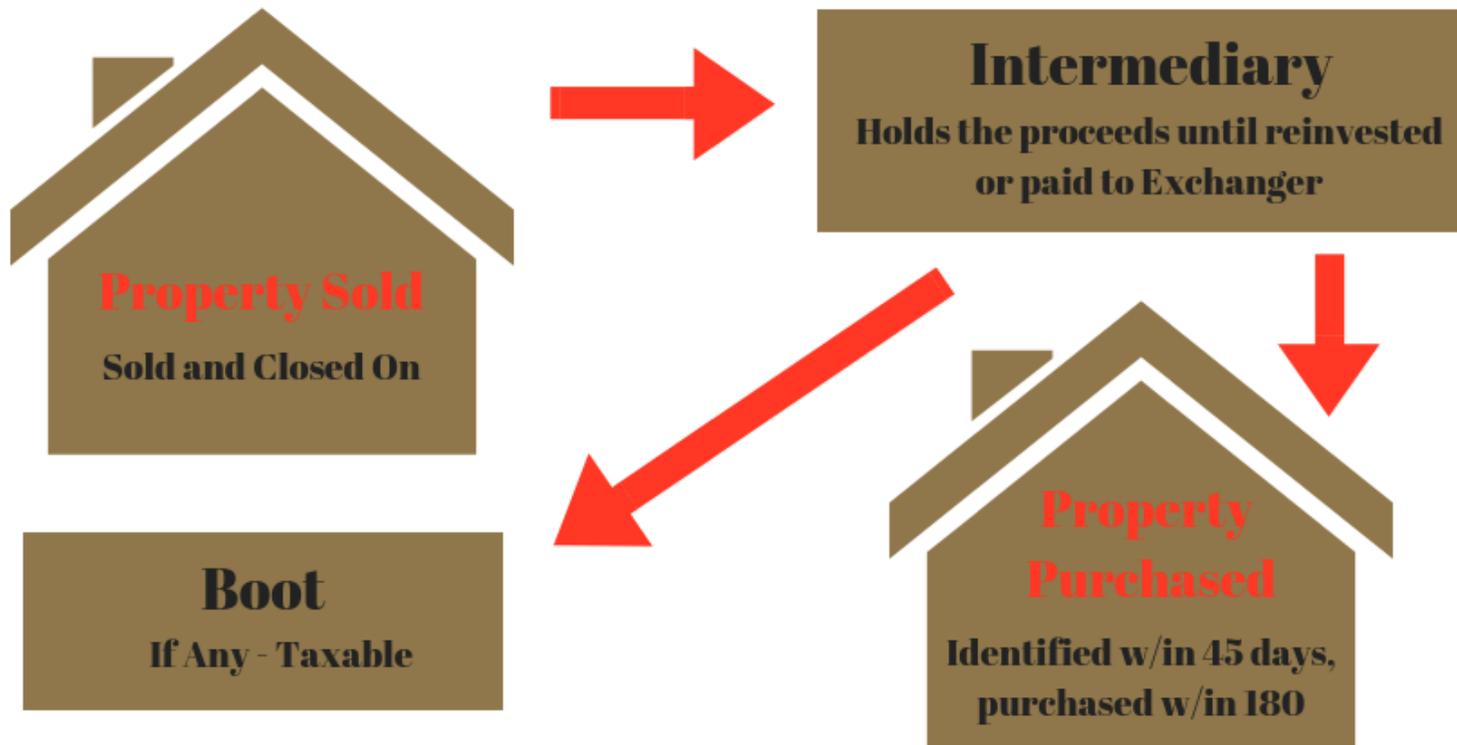
1031 EXCHANGES

What Property Qualifies for a Like-Kind Exchange?

- Held for use in a trade or business or for investment.
 - Quality or grade is not important
 - Must be real property
 - Delaware Statutory Trusts (holding qualifying real estate) count
- Question: Can you structure Bitcoin for Ethereum (cryptocurrencies) as a 1031 exchange? How about machinery and equipment? A business vehicle?
 - Answer: No, under the Tax Cuts and Jobs Act (TCJA), beginning after 12/31/17 Sec. 1031 only applies to real property.

1031 EXCHANGES

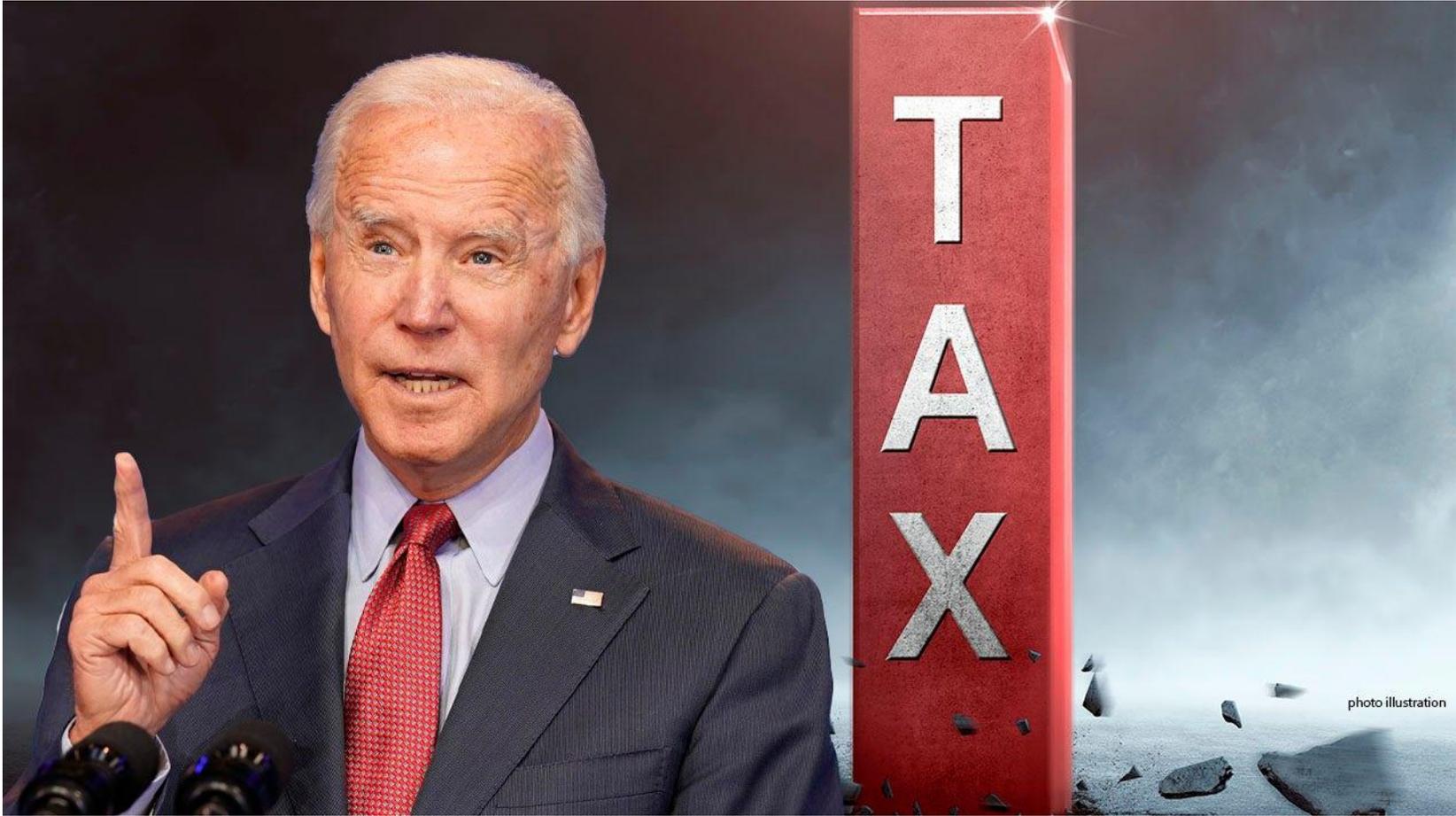
Like-Kind Exchange



1031 EXCHANGES

- Like-kind exchanges have been the most powerful wealth accumulation vehicles for savvy real estate investors for decades.
- Should we continue to utilize 1031 exchanges as a primary tax strategy?
 - Maybe, but only if you can...
 - Limited time only?

BIDEN'S TAX PLAN MAY ELIMINATE 1031 EXCHANGES



BIDEN'S PROPOSED TAX PLAN

- Potential changes relevant to the real estate industry
 - Top tax rate for individuals with income > \$400K increase to 39.6% (plus 3.8% NIIT)
 - Capital Gains rates maximum increase from 20% (plus 3.8%) to 39.6% (plus 3.8%) on gross income greater than **\$1 million** OR greater than \$400K
 - **Repeal of 1031 Tax Deferred Exchanges**
 - Repeal of Sec. 199A Deduction for taxpayers with income over \$400K? **[American Families Plan did not address]**
 - Repeal of Bonus Depreciation Rules (allows 100% depreciation initial year)
 - Estate and Gift Tax rate increases and substantial reduction in lifetime exemptions **[American Families Plan did not address]**
 - Limit on use of valuation discounts
 - Elimination of basis step-up upon death **(certain inherited assets)**

SEC. 199A DEDUCTION

- Sec. 199A
 - allows taxpayers other than C corporations a deduction of 20% of qualified business income earned in a qualified trade or business, subject to certain limitations
 - available to
 - Individual owners of sole proprietorships, rental properties, S corporations, or partnerships; and
 - An S corporation, partnership, or trust that owns an interest in a passthrough entity.
 - Limited to greater of (1) 50% of W-2 wages of trade or business, or (2) 25% of W-2 wages, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property
 - Limited to taxable income for the year over net capital gain plus aggregate qualified corporate dividends
 - All trades or business except specialized service trades or business

SEC. 199A DEDUCTION AND BIDEN'S TAX PROPOSAL

- Sec. 199A has been around since the Tax Cuts and Jobs Act (TCJA) was enacted on Dec. 22, 2017. Thus, many of you have likely already benefitted.
- Now what?
 - If you have not been taking this 20% deduction for any reason, review your tax plan to insure:
 - Proper entity structure (e.g., C corporations do not qualify)
 - Qualifying trades or businesses have taxable income (profit) to benefit from this deduction. Many real estate entities have income completely sheltered by depreciation. It is possible that front loaded depreciation (e.g., Sec. 179 and bonus depreciation) is NOT GOOD for your specific circumstances.
 - Consider review of FMV rent agreement between related parties (landlord and tenant)
 - Tax projections using different methods of depreciation (including cost segregation studies)
 - Multiple entity/business owners may have flexibility in shifting where profits result
 - Monitor legislative developments and maintain 2021 and 2022 forecasts and prepare to pivot for optimal 199A utilization (e.g., taxable income over \$400K may not qualify for 199A).
 - Increasing deductions to get below threshold can result in qualification (e.g., depreciation, retirement plans, capital purchases, deductible payments for cash basis taxpayers).

ESTATE AND GIFT TAXES & BIDEN PROPOSED TAX PLAN

- Estate Tax and Gift Tax Exemption
- Currently, in 2021 each person has an \$11,700,000 unified estate and gift tax exemption (or \$23,400,000 for two spouses). This exemption amount under current law is scheduled to be reduced after December 31, 2025 to \$5,000,000 plus an inflation adjustment. Some tax change proposals are to reduce in 2022 this exemption amount to \$3,500,000 per person (with no inflation adjustments) while other proposals are to reduce this exemption amount in 2022 to the \$5,000,000 range. There are also proposals to have a split exemption, so that for estate taxes it would be one exemption amount (such as \$3,500,000) and for gift taxes there would be a limitation of a \$1,000,000 exemption (which amount of any used gift tax exemption would then be charged against the estate tax exemption at the taxpayer's death).

ESTATE AND GIFT TAXES & BIDEN PROPOSED TAX PLAN

- Estate and Gift Tax Rates
- Currently, there is an estate and gift tax rate of 40%. President Biden is expected to try to raise this rate to at least 45%. Some Congressional proposed tax legislative changes have proposed even higher estate tax rates, such as 45% tax rate for taxable estates between \$3,500,000 and \$10,000,000; 50% rate for estates between \$10,000,000 and \$50,000,000; 55% rate for estates between \$50,000,000 and \$1,000,000,000; and 65% rate for estates above \$1,000,000,000. The expected effective date for any changes to tax rates or to estate and gift tax exemption amounts is expected to be January 1, 2022. However, consider the possibilities of A) Retroactive enactment and B) Enactment date
- **American Families Plan – Addressed only the step-up in basis for inherited assets on gains in excess of \$1 million for a single filer, or \$2 million for joint filers [before any real estate gain exclusion].**

ESTATE AND GIFT TAXES & BIDEN PROPOSED TAX PLAN

- If these are expected to happen, what can I do about it?
- Answer:



ESTATE AND GIFT TAXES & BIDEN PROPOSED TAX PLAN

- Estate planning attorneys for high net worth individuals are having their busiest year/s ever!
- There is a limited window of opportunity BEFORE Biden's proposed tax plan becomes law.
- Here is what you should be discussing with your estate planning attorney:
 - Gifting strategies to remove assets from your [potentially] taxable estate.
 - Appraisals and discounts in connection with gifts
 - Lack of marketability discount
 - Lack of control discount
 - Specialized trusts available to remove assets from your taxable estate.
 - Target appreciating assets
 - Fractional and minority interests

BONUS DEPRECIATION AND BIDEN'S TAX PLAN

- Up front 100% depreciation has been a HUGE tool for real estate investors and professionals in tax deferral strategies. With this on the chopping block, there is another potential limited window to get a cost segregation study done on real estate.
- **COST SEGREGATION STUDIES**
 - Separate asset values into shorter lived classes eligible for up front depreciation.
 - Use in connection with 1031 exchanges while they last
 - Basis step up at death is still the law, depreciation taken up front through these studies will be stepped all the way back up to FMV upon the death of an owner taxpayer resulting in a double tax benefit.
 - Beware of near-term taxable sales and the resulting income (including depreciation recapture and the shifting of capital gains rates to ordinary income for high income earners under the Biden plan)

OPPORTUNITY ZONES



ADVANTAGES

Deferred Capital Gains



Tax-Free Appreciation



Reduced Capital Gains



DISADVANTAGES



Untested Investment Model

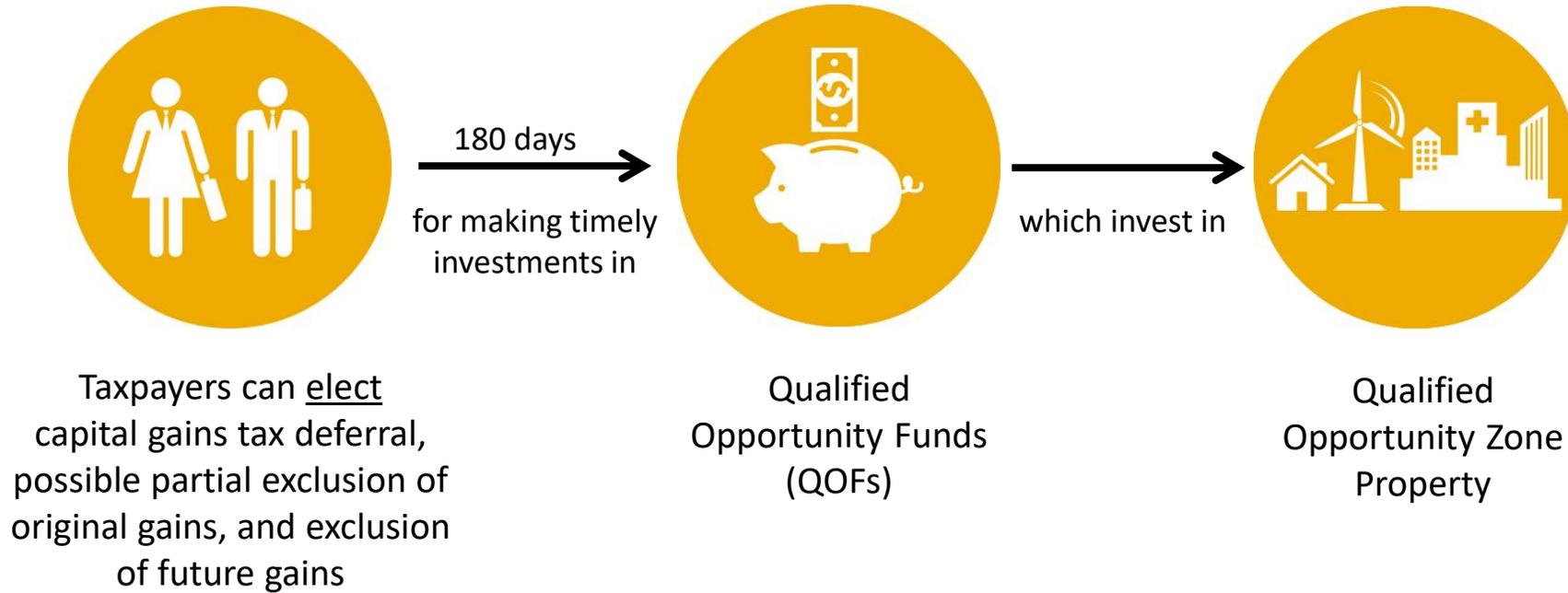


Uncertain Community Benefits



High Buy-In

INTRODUCTION



3 TAX INCENTIVE BENEFITS

Investing capital gains in Opportunity Zones through a Qualified Opportunity Fund results in **three** main tax benefits:



Temporary Deferral of Original Capital Gains Taxes: Elect to defer capital gains taxes until the earlier of (a) an “Inclusion Event” or (b) December 31, 2026, if those gains are properly invested in Opportunity Zones within 180 days beginning on the date of the sale or exchange that generated such capital gain (special rules for time period for partners in a partnership and net 1231 gains).



Reduction of Original Capital Gains Taxes: If investors hold their eligible Opportunity Zone investment for at least five years, they will owe taxes on 90% of the deferred capital gains; if investors hold their eligible Opportunity Zone investment for at least seven years, they will owe taxes on 85% of the deferred capital gains.



Exemption of New Capital Gains Taxes: Elect to permanently exclude incremental capital gains on eligible Opportunity Zone investment held for at least ten years.

TAX INCENTIVES THROUGH OPPORTUNITY ZONES

Step-Up in Basis

At the time of investment in the QO Fund, the deferred gain basis begins at zero.

- After 5 years, the basis increases by 10% **EXPIRES ON 12/31/21 UNLESS PROPOSED BILL EXTENDS 2 YEARS**
- After 7 years, the basis increases by 5% **EXPIRED ON 12/31/19 UNLESS PROPOSED BILL EXTENDS 2 YEARS**

As a result, the investor could receive a 15% step-up in basis if the investment is held up to 7 years.

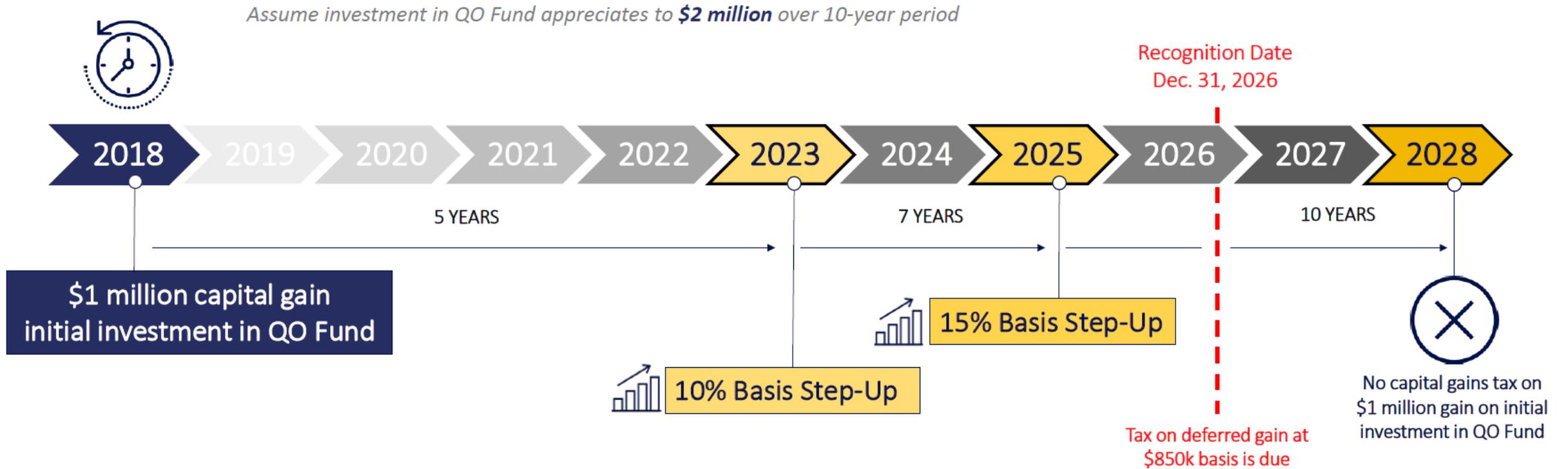
The percent of capital gains tax paid at Recognition Date will depend on the basis step-up stage at which the tax payer is invested in the QO Fund.

Considerations

Investment Length & Benefit Received

- **Less than 5 years:** Capital gains tax is deferred until the date the Qualified Opportunity Fund investment is sold.
- **Between 5 and 7 years:** 10% step-up in basis on investment in the Qualified Opportunity Fund (tax paid on 90% of deferred capital gain).
- **Between 7 and 10 years:** 15% step-up in basis on investment in Opportunity Fund (tax paid on 85% of deferred capital gain). **EXPIRED AS OF 12/31/19**

EXAMPLE OF OPPORTUNITY FUND INVESTING



Investing to “Substantially Improve” Business Property

- Qualified Opportunity Fund investments in “business property” must be “substantially improved” – meaning during any 30-month period after acquisition of a property, additions to the basis of the property must exceed an amount equal to the adjusted basis at the time of acquisition by the QO Fund. In other words, rehab costs must exceed the acquisition cost.
- “Business property” is defined as tangible property in a QO Zone where the original use of the property commences with the QO Fund –i.e. new construction –or the property is substantially improved during any 30-month period after acquisition.

TIME IS OF THE ESSENCE

DECEMBER 31, 2028

Qualified Opportunity Zone designations expire after December 31, 2028. Proposed Regulations, however, provide that the election to step-up the basis after the 10-year holding period will be preserved until December 31, 2047, 20 ½ years after the latest date that an eligible taxpayer may properly make an investment that is part of an election to defer gain under section 1400Z-2(a).

DEADLINES:

- **December 31, 2019 [EXPIRED NOW, NO 15% STEP UP, ONLY 10% STILL AVAILABLE]**
Latest date to invest in Qualified Opportunity Fund and be eligible for 15% basis step-up (7-year holding period)**
- **December 31, 2021**
Latest date to invest in Qualified Opportunity Fund and be eligible for 10% basis step-up (5-year holding period)**

* The basis step-ups apply to the deferred gains invested in the Qualified Opportunity Fund and must otherwise be recognized by the Recognition Date, which is December 31, 2026.

180-DAY WINDOW FOR INVESTORS

- **Individuals (excluding entity owners)**

- 180-days (not 6 months) from the date of the sale [Note: See Covid-19 rule next slide]

- **Pass-through entities (Partnerships, multi-member LLC's, S-corps)**

- Entity level investments have 180-days from date of sale

- **Owners (partners, members, shareholders) of pass-through entities**

- May elect to start counting 180-days beginning on the due date of the entity return.
- Calendar year-end pass through entities original due date was March 16, 2020 (180-days = Sep. 11th)

- **Section 1231 gains**

- Final Treasury Regulations eliminated the netting rule. Each transaction treated separately, thus 180-day period is same for 1231 gains as non 1231 capital gains.

COVID – 19 UPDATE FOR OPPORTUNITY ZONES

- Covid-19 Deadline Extensions
 - IRS Notice 2020 – 23
 - 180-Day QOZ Fund Investment Period (For investors)
 - If the 180-day period expires on or after April 1, 2020 and before July 15, 2020, that period does not expire until July 15, 2020. **EXPIRED**
 - Working Capital Safe Harbor (For fund manager)
 - QOZ rules provide a QOZ business with a 31-month window to deploy working capital with documented plan (working capital safe harbor)
 - If QOZ business is located in federally-declared disaster area, additional 24-months
 - As of April 3, 2020 every state and most territories are subject to disaster declaration, thus most QOZ businesses would have an additional 24-months working capital safe harbor
 - Reasonable cause against 90% asset penalty (possible Covid-19 circumstances beyond control)

OPPORTUNITY ZONE FUND VS. 1031 EXCHANGE

Comparison	Opportunity Zones	1031 Exchange
Use of Property	Do not have to be like-kind	Must be like-kind property
Nature of Property	Tangible property used in a trade or business, can be real or personal, and substantially all of it must be located in an Opportunity Zone	Only real property, no personal property
Identification of replacement property	No requirement	Replacement property must be identified in 45 days, with limits on numbers of properties
Location Limitation	Limited to a Qualified Opportunity Zone	Anywhere in the United States
Closing on replacement	180 days	180 days
Proceeds that must be invested	Only the gain from the sale	Entire proceeds from the sale
Partnership interests	Allowed	Not allowed
Stock in corporations	Allowed	Not allowed
Personal property	Allowed	Not allowed
Time of recognition of deferred gain	Earlier of sale of opportunity zone fund or December 31, 2026	Upon sale of replacement property (unless further deferred in another like-kind exchange)
Time of recognition of gain over and above deferred gain	Upon sale of opportunity zone fund unless held for more than 10 years, in which case there would be no gain	Upon sale of replacement property (unless further deferred in another like-kind exchange)
Income tax basis step up for holding property 5 or 7 years	10% if 5 years before December 31, 2026; 15% if 7 years before December 31, 2026	None
Related parties	Sale to related party cannot be deferred	Not prohibited, but 2 year holding period after exchange required

SUMMARY TAKEAWAYS

- Biden's Tax Reform will substantially impact real estate**
- There is a limited window to execute certain strategies**
- Review deal flow and possibly execute tax optimal transactions**
- Work with knowledgeable estate planning attorneys and CPAs**
- Be prepared, stay informed, plan, and be ready to pivot.**

QUESTIONS?

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