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ACCOUNTANTS & ADVISORS

2022 Year-End Tax Planning Guide

Real Estate Group

While the COVID-19 pandemic appears to be in the rear-view mirror, it continues to have a profound impact on the economy, the labor market, and the real estate industry. With many predicting that a recession is around the corner, in an effort to curb significant inflation, the Federal Reserve's monetary policy continues to be hawkish through the end of 2022. The resulting rising debt costs have placed pressure on capitalization rates across the entire real estate industry.

Yet it feels like the worst is yet to come for the office market. Many office tenants have honored their leases; however, as such leases expire, it appears as if companies are taking smaller, more efficient and collaborative spaces. The visibility into the return-to-office dynamics remain opaque as the employee-employer tug of war in employees resisting returning to the office continues. Further, the leasing terms are also negatively impacting the office market, with lower rates per square foot, larger tenant allowances and increased lease incentives. The future negative impact on net operating income appears to be inevitable. Coupled with increases to borrowing costs and upward adjustments to capitalization rates, the current and near-term environment does not bode well for the office market. Reduced valuations and reduced loan-to-value ratios can be alarming to owners whose existing loans are coming due. However, with not all office space being the same and with flight to quality spaces continuing, Class A real estate may fare far better than others.

The multifamily market appears to be the opposite of the struggling office market, bolstered by the pandemic and work-from-home and hybrid environments. However, the multifamily market seems to be showing signs of slowing down. According to Newmark, nationally, there was negative absorption of 82,000 units in the third quarter of 2022, while vacancies remained at a historic low of 3.1%. Multifamily remains the most sought-out property type, accounting for 42% of all US commercial real estate year-to-date; however, sales volume in the third quarter of 2022 declined 17.2% year-over-year to $74.1 billion. Compared with the first three quarters of 2021, sales volume has increased 25.0% and deal size continues to escalate. The industrial market also continues to fare well, despite consumer purchasing power, confidence, and general economic headwinds. According to Newmark, vacancies remain at an all-time low of 3.7%, partly bolstered by swelling inventories. New construction pipeline has risen to nearly 700 million square feet, with deliveries expected over the next year. Rental forecasts are slowing down, yet still strong, while investment volumes have decreased 18% in the third quarter of 2022 compared to the same quarter last year.

With challenging times, it's important to find ways to maintain returns to owners and investors, including by being prepared from a tax perspective at the federal and state levels. The benefits of cost segregation studies, energy efficient deductions and credits offered by 179D and 45L, and taking advantage of bonus depreciation, among various other tax strategies are important to understand. We hope you find the tax strategies and considerations outlined in this publication to be helpful.

Table of Contents:

Considerations for Traditional Year-end Tax Planning

As the year-end approaches, it is important for you and your business to consider the opportunities and suggested planning ideas below as they may provide you with alternative outcomes ultimately resulting in cost savings. Before taking action with any of these, taxpayers should thoroughly analyze the proposed transaction(s) and alternative outcomes.

Although tax planning is a 12-month activity, year-end is traditionally the time to review tax strategies from the past and revise them for the future. As the end of 2022 approaches, most of the recent tax proposals have been abandoned and major tax changes from recent years remain in place. This makes year-end planning more predictable. In addition, the impact of inflation makes deferral of income more attractive for most taxpayers.

If your business uses the cash method of accounting, you may be able to defer income by delaying invoices until late in the year or accelerate deductions by paying certain expenses in advance. If your business uses the accrual method of accounting, you may be able to defer the tax on certain advance payments you receive this year. Additionally, you may also be able to deduct year-end bonuses accrued in 2022 even if they aren't paid until 2023 (provided they're paid within 2 ½ months after the end of the tax year and meet the other three conditions outlined in Internal Revenue Code Section 461).

Deferring debt cancellation events – if you are planning a debt reduction transaction that may result in the recognition of income, postponing this event until January can defer recognition of cancellation of indebtedness (COD) income.

Installment sale – if you expect to sell property at year-end, consider selling the property using the installment method to defer payments (and tax) until next year or later. Income recognition will normally be deferred under the installment method until payments are received.

The following traditional income and deduction acceleration techniques and their reciprocal deferral strategies should be considered:

Income Deferral/Acceleration:

- Defer/Receive bonuses before January
- Hold/Sell appreciated assets
- Accelerate income to use available carryforward losses
- Postpone/Complete Roth conversions
- Minimize/Maximize retirement distributions
- Delay/Accelerate billable services

Deductions and Credits Acceleration/Deferral:

- Pay bills in 2022/postpone payments until 2023
- Watch adjusted gross income (AGI) limitations on deductions/credits
- Watch net investment interest restrictions
- Match passive activity income and losses

Deferring income and accelerating deductions isn't the best strategy in all circumstances. If you expect your marginal tax rate to be higher next year, you may be better off accelerating income into 2022 and deferring deductions into 2023. This strategy will increase your 2022 tax bill, but it can reduce your overall tax liability for the two-year period.

In October, the IRS released the inflation-adjusted tax brackets for 2023, which reflected 8% inflation adjustment. For taxpayers who don't anticipate an increase in earnings and defer income to 2023, more of that income will fall into a lower tax bracket.

Is Your Business Eligible for Enhanced Depreciation Opportunities?

Historically, depreciation has created tax-advantaged returns for real estate owners and investors. Depreciation has shielded taxpayers from income taxes on otherwise positive cash flowing properties.

Below is a discussion on some of the methods available for taxpayers to accelerate depreciation. There are several options and scenarios real estate businesses need to consider when assessing what is the most beneficial for them.

Additional First Year Depreciation (Bonus Depreciation)

Currently, bonus depreciation enables taxpayers to depreciate 100% of the purchase price of qualifying property in the year it's placed in service. To qualify, the property must have a recovery period of 20 years or less, be depreciated using the modified accelerated cost recovery system (MACRS), and placed in service after September 27, 2017, and before January 1, 2023. For real estate businesses, this typically includes, but is not limited to, furniture, fixtures, land improvements, flooring, cabinets, and appliances.

Owners of nonresidential real estate can take a bonus on qualified improvement property (QIP). QIP is defined as property that is an interior improvement, placed in service after the date the building was first placed in service, made by the taxpayer, and placed in service after December 31, 2017. It does not include elevators and escalators, internal structural framework and improvements that relate to the enlargement of the building. Taxpayers that are considering offering tenant allowances should be aware that these costs could be deemed lease acquisitions costs and amortized over the life of the lease. If bonus depreciation is deemed more beneficial, care must be taken when drafting lease agreements.

This benefit will be gradually eliminated over the coming tax years. Any qualifying assets placed into service on or after January 1, 2023, will only be eligible for bonus depreciation equal to 80% of the purchase price. This will continue to drop by 20% per annum until bonus depreciation is completely phased out for assets placed in service on or after January 1, 2027.

When considering bonus depreciation, real estate businesses need to assess the state implications for their owners. Many states do not conform to federal bonus depreciation. At the state level, there is typically an addition and subsequent subtraction adjustment passed through to the owners that reverse the bonus depreciation enjoyed at the federal level. For taxpayers who can fully utilize federal depreciation, this usually does not present an issue. However, owners or investors who are deemed passive or subject to loss adjustments can be exposed to income tax from the depreciation adjustments at the state level. This often unintended consequence can impact cash flows if distributions are required to cover the state income tax expense for the owners.

Section 179 Expensing

Under Internal Revenue Code Section 179, eligible taxpayers may elect to expense qualifying property up to certain dollar limitations. To be eligible, property must be purchased for use in a trade or business. Tangible personal property (ex. furniture, fixtures, carpets, etc.) is eligible for this deduction. For real estate businesses, the cost of "qualified real property" is also eligible. This includes qualified improvement property (discussed above) as well as the following expenditures made to nonresidential real property after the property was originally placed in service: roofs, HVAC fire protection and alarm systems, and security systems. Land improvements are not eligible.

For tax year 2022, the maximum deduction under Section 179 is $1,080,000. This is set to increase to $1,160,000 for tax year 2023. There is a dollar for dollar phase out once the amount of qualified Section 179 property placed in service exceeds $2,700,000. For example, if a taxpayer has $3,000,000 of qualifying property, the maximum deduction, they can claim for tax year 2022 is $780,000 ($3,000,000 less $2,700,000 ceiling). The deduction is completely phased out if $3,780,000 of qualifying property is placed in service during 2022. This limitation is potentially calculated twice: once at the business level and then again at the owner level if the business is a passthrough entity (i.e., partnership or S-Corporation).

In addition to the limitations discussed above, Section 179 expensing is limited to the trade or business income of an activity. Unlike bonus depreciation, it cannot create a net loss for the business. For purposes of this deduction, trade or business income is calculated before factoring in any deduction under Section 179.

Businesses need to consider their owners or investor base before electing to utilize Section 179. Trusts and estates are ineligible to utilize the deduction (grantor trusts are eligible for the deduction). In addition, owners or investors that are considered passive are not entitled to the deduction, even if the business is eligible, since the income from the activity is not deemed trade or business. Disallowed deductions due to trade or business income limitations are carried forward indefinitely and can potentially be utilized in a future tax year.

As with bonus depreciation, businesses also need to understand the state tax implications. For example, New York follows the federal treatment of Section 179; however, New Jersey limits the deduction to $25,000. There could be a significant state impact on owners and investors depending on the location of the property.

Cost Segregation Studies

Cost segregation studies provide real estate businesses with a powerful depreciation accelerator. A cost segregation study identifies and quantifies the various components of both purchased and constructed assets. This quantification enables businesses to depreciate components of their building using shorter lives. If the assets are eligible, businesses can take bonus depreciation on the segregated building components.

Cost segregation studies do not need to be performed in the year the building was purchased or constructed. Businesses can implement studies in subsequent tax years. If a business chooses to implement a study in a future year, they must recalculate the depreciation that was in effect the year the building was placed in service. For example, a real estate business purchases and places a property in service during 2022. They have a cost segregation performed in tax year 2024. The business can still utilize 100% bonus on any eligible property when the adjustment is made on the 2024 tax return since it relates to a 2022 purchase.

Tangible Property Regulations

The tangible property regulations (repair regulations) are often overlooked and underutilized by real estate businesses. Prior to the implementation of the repair regulations, taxpayers had to capitalize the cost of any asset that had a useful life in excess of one year and depreciate the cost of the asset over said life. There was no clear definition of what a repair was leading taxpayers to capitalize improvements that can now been expensed. The repair regulations, issued in 2014, provided guidance to taxpayers as to what improvements could be considered a repair and expensed in the year incurred. These regulations have enabled taxpayers to deduct significant improvements which under old law may have been capitalized.

One of the most beneficial aspects of the repair regulations is that the expenditure is considered an expense, not a capitalized fixed asset with additional rules and limitations on its depreciation. There are no state adjustments that need to be made. In addition, there is no potential for a recapture of gain attributable to prior depreciation taken on the asset upon disposition. Lastly, there is no phase out or dollar limitation on the amount of qualifying improvements that can be expensed. Unless there is an Act of Congress, this provision is in the tax law indefinitely.

Conclusion

The above discussion highlights some of the high-level items that real estate businesses need to be analyzing when strategizing how to maximize their depreciation. Careful planning and analysis of future projects is critical to make sure depreciation is utilized in the most efficient manner.

What does it mean to be a Real Estate Professional?

Rental real estate is generally considered a passive activity. The passive activity rules limit the deductibility of passive losses to the extent of passive income. Passive losses in excess of a taxpayer's passive income are carried forward to future years until there is sufficient passive income to absorb all of the losses or until there is a complete disposition of the activity.

There is an exception to this general rule if a taxpayer qualifies as a real estate professional. The rental income and losses of a real estate professional will not be passive, and the losses will be eligible to offset other income. To qualify as a real estate professional, you must meet the following tests annually:

- More than one-half of the personal services performed during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and

- Such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

Taxpayers who meet the requirements of these two tests must materially participate in their rental activities for their losses to be considered nonpassive. Since this may be difficult to achieve on each separate rental real estate activity, a taxpayer can make an aggregation election to treat all their real property trade or business activities as a single activity to meet the material participation test. Note that this aggregation election is irrevocable unless there is a material change in the taxpayer's facts and circumstances.

Real property trades or businesses include real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage. Taxpayers can combine any of these activities and treat them as one real property trade or business. To materially participate in real property trade or business, a taxpayer must be involved in the activity on a regular, continuous, and substantial basis. The regulations provide taxpayers with a quantitative test that can be used to satisfy this requirement.

The passive activity rules also apply to trusts. Prior to 2014, there was doubt as to whether a trust was capable of performing personal service for purposes of passing the material participation tests. In 2014 the Tax Court ruled in *Frank Aragona Trust v. Commissioner* that a trust is capable of performing "personal services." The Court found that services performed by the individual trustees on behalf of the trust were considered personal services performed by the trust.

Based on this ruling, a trustee who is substantially involved in the trusts real estate business activities could allow the trust to qualify as a real estate professional and the rental income and loss would be nonpassive.

Taxpayers seeking to qualify as a real estate professional should carefully review these rules annually to make sure they meet the necessary requirements. A change in the real property holdings or involvement from year to year could prevent one from qualifying.

Like-Kind Exchanges and Key Items to Be Aware Of

Like-kind exchanges (also referred to as 1031 exchanges) have been an integral part of real estate investments for many years, dating back to the Revenue Act of 1921.

A Section 1031 exchange gives businesses the flexibility and incentive to adjust their business strategy and assets. Owners of real estate often use Section 1031 to make tax-deferred exchanges of underperforming properties for newer replacement properties and/or move to a different location. Previously, this tax break was available for various types of property, such as trade-ins of business vehicles. But as of 2018, the Tax Cuts and Jobs Act strictly limits the Section 1031 rules to real estate transactions.

Although a like-kind exchange may sound quick and easy, it is not as simple as selling one property and buying another. In this section, we will focus on a few aspects of like kind exchanges that are frequently overlooked.

There are general rules that apply to like kind exchanges such as using a Qualified Intermediary, the 45-day identification period, the 180-day replacement period and that the property must be held for productive use in a trade or business or for investment purposes. The use of a Qualified Intermediary acting as an independent third party to facilitate an exchange is a safe harbor in the Treasury Regulations. The Qualified Intermediary will hold the sales proceeds of the relinquished property until such time you are ready to close on the replacement property. This ensures that you do not have constructive receipt of the sales proceeds which would trigger a taxable event. The Qualified Intermediary will help to ensure you meet the identification requirements.

You must identify the potential replacement property within 45 days of the sale of the relinquished property. The 45 days is comprised of calendar days, not only working days, so you must count Saturdays, Sundays, and holidays.

You must follow one of the following three identification rules:

- Identify up to three properties regardless of the total value of the property identified.
- Identify any number of properties as long as the fair market value does not exceed 200% of the relinquished property.
- Identify any number of properties regardless of fair market value as long as at least 95% of the property is ultimately acquired.

The replacement property must be closed within 180 days of the sale of the relinquished property.

When an exchange straddles two tax years

When the sale of the relinquished property occurs near the end of the taxpayer's tax year, the exchange will straddle two tax years. While the statute generally provides for the 180-day replacement period, the period is actually the period that ends on the earlier of:

1) The day that is 180 days after the date on which the taxpayer transferred the relinquished property, or
2) The due date (including extensions) for the taxpayer's tax return for the tax year in which the relinquished property was sold.

For sales of relinquished property that occur in the fourth quarter of the year, this can result in a trap for the unwary that could result in the transaction becoming fully taxable.

Taxpayers with open like-kind exchanges should make sure to file extensions for their tax returns even if they are otherwise ready to file their returns timely. Failure to do so will end the like-kind exchange and can trigger gain recognition.

What if the 1031 exchange fails?

In the case of a failed or partial like kind exchange, taxpayers may be able to defer income into the following tax year rather than the year in which the relinquished property was sold.

If a sale and receipt of cash from a Qualified Intermediary straddles two taxable years, taxpayers can report taxable gain under the installment method. Installment sale treatment generally requires a bona fide intent to complete an exchange. This means that the taxpayer had a reason to believe, based on the facts and circumstances at the beginning of the exchange, that a replacement property would be acquired during the exchange period.

The regulations don't address whether the installment sale method applies to cash received as a result of liability relief. However, the IRS formally addressed the tax consequences in a separate revenue ruling. If there is a relief of liabilities, there may be a gain recognized in the first year if the exchange straddles two years.

Like-kind exchange and cost segregation

Generally, taxpayers must depreciate the carryover basis of property acquired in a like-kind exchange during the current tax year over the remaining recovery period of the property exchanged.

They must use the same depreciation method and convention that was used for the relinquished property. Any excess basis is treated as newly placed in service property. Depreciation must be calculated separately for the carryover basis and the excess basis. This option is typically better when the relinquished property is closer to the end of its tax life.

Tax rules only allow a cost segregation study (for the new property) to apply to the excess basis, not to the carryover basis.

Alternatively, taxpayers can elect to treat the adjusted basis of the exchanged property as if it was disposed of at the time of the exchange. Under this election, a taxpayer treats the carryover basis and excess basis for the acquired property as if placed in service on the date acquired. The depreciable basis of the new property is the adjusted basis of the exchanged property plus any additional amount paid for it. By making this election, the taxpayer may be able to use a more favorable method of depreciation and simplify recordkeeping, but it might result in a longer depreciation period.

Under this option, tax rules allow a cost segregation study to apply to the combined carryover basis and excess basis. The benefits of cost segregation can be significantly higher under this alternative method.

Final Regulations

In November 2020, the IRS issued final regulations defining real property for Section 1031 purposes. The distinction between real and personal property has always been important, but after the Tax Cuts and Jobs Act amended Section 1031 and excluded personal property, defining real property became necessary. The rules are now clear that real property under Section 1031 is still real property even if a taxpayer did a cost segregation study and took bonus depreciation. The definition of real property for purposes of a like-kind exchange differs from the definition of real property for depreciation purposes. Taxpayers may be able to exchange real property even if they depreciated a portion of the relinquished property as personal property. While it is good news that real estate owners can take advantage of both cost segregation and Section 1031 exchanges, the interaction of the two must be carefully examined. Depreciation recapture resulting from the cost segregation study is one of the potential issues.

Drop and Swap

Typically, real estate is held in a multi-member LLC, and that can make the exchange complicated if some of the partners want property and others want to cash out. To have a valid like-kind exchange, a taxpayer must exchange an interest in real estate for another interest in real estate. Exchanges of partnership interests are not valid exchanges.

The easiest solution is for those partners who wish to exchange to buy out the non-exchanging partners. The problem is that the exchanging partners must provide additional capital and the exchange is being made with all the proceeds from sale, not just the proceeds allocable to exchanging partners. This might result in acquisition of a larger property than needed.

One structure that is commonly used when some of the partners want to cash out is “drop and swap.”

Prior to the sale of the partnership’s property, the partnership distributes to each partner (generally tax-free) an undivided interest in the underlying property and liquidates. After distribution, the members hold the property as co-owners under an arrangement intended to qualify as tenancy-in-common (TIC) for purposes of the like kind-kind exchange rules.

Each former partner is thus an owner of an undivided interest in real estate and can exchange or not exchange into new property as they please. “Drop and swap” structures appear to be relatively simple in concept, but there are many complications, and they require careful planning.

Excess Loss Limitations – Federal and New York Considerations

Background

Prior to the Tax Cuts and Jobs Act of 2017 (TCJA), individual and trust taxpayers that qualified as real estate professionals were able to deduct all their real estate business losses against their other sources of income. If the business losses exceeded the other sources of income, a net operating loss would be created. This loss could either be carried back to offset income from prior years or carried forward to future tax years at the election of the taxpayer.

The TCJA limited the deductibility of business losses for individual and trust taxpayers. Beginning with the 2018 tax year, trade or business losses are limited to $500,000 for married couples ($250,000 for single taxpayers). Any “excess business loss” that is not deductible in the current year is carried forward as a net operating loss which can be used to offset income from a future tax period.

The CARES Act suspended the excess business loss limitations for tax years 2018, 2019, and 2020 at the Federal level. It will apply for the 2022 tax year and was set to sunset December 31, 2025, but the Inflation Protection Act of 2022 extended the excess business loss limitation through 2028.

For taxpayers involved in the trade or business of real estate, accelerated depreciation can create substantial taxable losses. Certain qualifying property is eligible for 100% bonus depreciation in the year it is first placed in service by the taxpayer. Taxpayers may want to consider making an election out of bonus depreciation due to the limitations on losses and depreciate their assets according to its useful life.

Impact on New York

The New York provisions decoupling from Federal depreciation (discussed separately) is not factored into the determination of the New York excess loss limitation or the allowable net operating loss. This could result in taxable income and a tax liability even if New York adjusted gross income was recalculated to be zero.

Careful consideration and planning surrounding New York (or other states with similar regimes) is needed when assessing the benefits of accelerated depreciation.

Managing the Deductibility of Interest Expense

Real estate owners have long considered interest expense and depreciation valuable income tax deductions. Since the enactment of the Tax Cuts and Jobs Act (TJCA), owners have had to plan to maximize the benefit of both their interest expense and depreciation deductions. Prior to the TJCA, these deductions operated independently of one another.

For tax years beginning after December 31, 2017, the TCJA limited the interest deduction to 30% of adjusted taxable income. Adjusted taxable income for years beginning prior to January 1, 2022 is generally defined as taxable income with interest expense, depreciation, and amortization added back. For tax years beginning after December 31, 2021, adjusted taxable income does not include the addback adjustment for depreciation and amortization. The sunsetting of these adjustment provisions will further limit the deductibility of interest expense for real estate entities. Any limited interest expense is suspended until there is either future income or disposition of the activity.

Real estate entities that are considered "small business taxpayers" are exempt from this interest limitation. To qualify, a taxpayer's average gross receipts from the prior three years needs to be less than $27 million. Aggregation rules apply when calculating this amount; special attention should be given to this calculation. Taxpayers who qualify as a small business from a receipt standpoint also need to consider the "tax shelter" rules. An entity is considered a tax shelter if there are taxable losses for the year and more than 35% of the losses are allocated to taxpayers that are not active in the business. For this purpose, family members of active owners will be considered active.

Businesses that are generally profitable may experience taxable loss for one year and become profitable again in the subsequent years. Taxpayers in this situation can elect in the loss year to use the allocated taxable income or loss of the immediately preceding taxable year to determine whether the taxpayer is a "tax shelter." This is an annual election and the taxpayers that make this election don't have to apply this rule to subsequent years.

Real estate entities that exceed the gross receipts limitation or are considered a tax shelter can make an election to be a Real Property Trade or Business ("RPTOB"). The interest limitation described above does not apply to electing taxpayers. An electing taxpayer can deduct all its interest expense for the year the election is made and all subsequent years. Once made, the election is irrevocable.

The tradeoff for a real estate entity making the RPTOB election is longer depreciable lives. Taxpayers must switch from the MACRS method of depreciation to ADS.

For residential property, the 27.5-year life goes to 30 years and for commercial property, the 39-year life goes to 40 years. Electing entities with commercial property will no longer be able to take advantage of 100% bonus depreciation on certain 15-year property. The ineligibility of bonus depreciation for electing entities on certain 15-year property can have a significant impact on taxable income or loss. While the increase in depreciable lives from 39 to 40 years may seem inconsequential, taxpayers need to consider any major future renovations or improvements before making the RPTOB election.

If interest expense had previously been subject to this limitation, and the entity subsequently makes the RPTOB election, the previously limited interest expense could be suspended until the entity is liquidated. They will not be able to utilize any of the suspended interest with future operating income. While interest expense will not be lost, it will be added to the basis of the activity. This will result in a conversion of an ordinary interest deduction to a reduction of a capital gain.

The discussion above presents just a few of the high-level items related to interest that every real estate business should consider when planning for taxes. Taxpayers need to weigh immediate benefits against longer range planning to successfully utilize interest expense while factoring in any offsetting depreciation impact.

Sales & Use Tax

More and more building owners and management companies are being audited by the states for Sales and Use tax.

These audits are resulting in firms being assessed thousands of dollars in Use taxes, interest, and, in some instances, penalties.

The reason these assessments are so high is twofold. First, because many real estate and management companies do not file Sales/Use tax returns, there is no statute of limitations. For non-filers, most states will audit the past six years. For routine filers, the statute is usually three years. Tax exams can be quite tedious and time consuming, and invoices for an exam will be needed for the past three or six years. If you do not have all your invoices for the past six years and cannot provide proof that you paid the Sales/Use tax, then the state has the right to assess the tax, even if you did pay it.

The second reason for the large dollar assessments for building owners is that states are cracking down on what qualifies as a capital improvement. Merely issuing a certificate will not make the whole job tax exempt. In every capital improvement project, there are often taxable elements. Examples are carpeting, signage, scaffolding, window treatments, among others. When a state audits contractors, they review the contracts and make lists of building owners who have had major renovations done and refer the landlord for audit.

The popularity of buying goods on the internet from out-of-state vendors is also problematics. While this type of purchasing, as well as catalog purchases are likely to save money, it could also open up a Sales/Use tax liability.

When purchasing goods, it is important to keep in mind the state location of your vendors. If the vendor does not have nexus in your home state, then they might not necessarily be required to collect or remit the Sales tax. However, it is still your responsibility to remit the Use tax to the state where the goods are received.

Estate Planning & Gift Considerations

Under current law, the individual estate tax exemption is increased each year based on an inflation assumption. In 2022, the first $12.06 million of an individual’s estate is exempt from federal estate tax. If you are a married couple splitting gifts, the effective exemption amount is $24.12 million. This amount is reduced by any gifts made in excess of the annual gift tax exclusion in a given year. In 2022, individuals can make gifts of up to $16,000 to any other individual with no gift tax consequences. This amount increases to $17,000 for 2023. Any gifts in excess of that amount will reduce the lifetime gift and estate tax exemption. The exemption is scheduled to be reduced by half in three years or sooner through new legislation. A few estate tax planning techniques you may want to consider are as follows:

- **Make annual exclusion gifts by December 31, 2022.** Each person may make annual, tax free gifts of $16,000 ($32,000 for a married couple splitting gifts) to any number of individuals. Gifting on a tax-free basis is a great option for reducing (or even eliminating) larger gift and estate taxes in the future. Taxpayers living in states with no current state gift tax may wish to accelerate or focus on additional gifting of assets in 2022. Of course, your financial security and long-term objectives should be assessed and discussed before proceeding with such a gifting strategy.

- **Grantor Retained Annuity Trusts (GRATs).** This provides you with a fixed annual amount (an “annuity”) from the trust for a term of years (as short as two years under current law). The annuity retained may be equal to 100% of the amount that you use to fund the GRAT, plus the IRS-sanctioned rate of return (known as the 7520 rate) applicable to GRATs. After the trust term ends, the amount of assets (if any) left in the trust after the annuity payments have been made remain in the trust, free of gift or estate taxes. Because your beneficiaries will retain the full value of the GRAT assets at the end of the trust’s term, if you survive the annuity term, the value of the GRAT assets in excess of your retained annuity amount will then pass to the beneficiaries with no gift or estate tax, either outright or in further trust. If the grantor dies during the term of the GRAT, the entire balance will be included in the grantor’s estate as if the (GRAT) transaction never took place. In addition, if the value of the GRAT assets fall below the amount required for the requisite annuity payments, the GRAT collapses as if the (GRAT) transaction never took place.

Planning opportunity: Note that the amount of principal not received as part of an annuity payment will be subject to a current gift tax. Since the amount is not considered a present interest (meaning beneficiaries do not have immediate use of the money), the amount will not be eligible for the gifting exclusion. Why not use a “zeroed-out GRAT” structure so that the value of the gift transferred to the beneficiary is zero?

Planning Opportunity: Instead of setting up one GRAT to house all transferred assets, why not set up multiple GRATs to house different asset types – some conservatively invested and others with more risk? The winners, or appreciated GRATs, do their job of transferring wealth to the next generation; the losers collapse, as if the GRAT for these assets never took place. In the end, all GRATs should have an economic purpose and have some risk exposure. Also, varying the beneficiaries and trust start dates may be advisable.

- Consider funding education through 529 plans by December 31, 2022 to apply 2022 annual gift tax exclusion treatment to the contributions. You can now still “front load” 529 plans by making five years’ worth of annual exclusion gifts to a 529 plan. In 2022, you can transfer $80,000 ($160,000 for a married couple splitting gifts) to a 529 plan without generating gift tax or using any of your gift tax exemption. The money (and the growth of the 529 account) leaves your estate faster than if you made the contributions each year. (Note: gifts cannot be made to the same beneficiaries over the next four years without incurring a gift tax.)

- Low-Interest Loans or Intra-Family Loans: Today, family members can extend long term loans to each other at interest rates less than 4.4% for long-term loans (over 9 years). It is a simple and effective estate planning mechanism for transferring wealth to children or grandchildren without gift tax. Note that when you make a loan to a family member, you must charge interest to avoid making a gift. Therefore, to the extent that the family member earns a higher rate of return on the borrowed funds than the very low interest rate being paid, the excess or difference is effectively transferred free of gift taxes. The loan should be documented and executed.

Sales to Defective Trusts

Transferring a real estate property into a trust as part of an estate plan, where the value of the property exceeds the available exemption could result in gift tax due. Instead of gifting the property to the trust, sell the property to a grantor trust in exchange for a down payment and a promissory note.

Under current tax rules, the grantor and the grantor trust are considered the same, and transactions between them are ignored: there is no income tax gain recognized when the assets are sold to a grantor trust, and no interest income needs to be recognized as interest is paid back on the note. There is no gift when the value of the promissory note matches the value of the assets.

This arrangement allows an individual to move appreciating assets to the trust in exchange for a note (repaid in cash) and some interest. The low interest rate environment makes this very attractive. Further, the note can be structured as interest-only with a balloon payment at the end of the term.

An individual effectively exchanges the appreciating assets for cash and reduces the future value of his taxable estate. To make this work, the trust must have sufficient assets to justify the borrowing (10% of the purchase price is common) and this amount could be gifted to the trust if necessary (which would require some available gift exemption).

Finally, an appraisal is required to support the value of the assets sold, which could possibly show lower valuations because of the current economy and valuation discounts.

Life Insurance

As part of the estate planning process, thought should be given to liquidity. That is, what will be the source of funds for the payment of estate tax? For those with significant holdings of illiquid assets, such as real estate and art, these assets will be subject to estate tax, but may not be easily sold. More importantly, it may not be opportune or desirable to dispose of these assets, and even if there was a decision to sell, the ability to have proceeds available to pay the tax within nine months of death, when it is due, could be problematic. Life insurance may provide a solution. There are planning opportunities with insurance and creative structures available to fund policies that are efficient without placing high demands on current cash flow.

Spousal Lifetime Access Trust (“SLAT”)

The Spousal Lifetime Access Trust serves to utilize an historically high lifetime gift tax exemption, while still providing the ability, should the need arise, to access the gifted assets. To illustrate the concept, suppose Spouse A creates a trust for the benefit of the other spouse, Spouse B, and possibly their children. The trust allows for distributions to Spouse B during such spouse’s lifetime, after which time the trust continues for the benefit of the children. Spouse B would create a similar trust for the benefit of Spouse A and the children. In good times, the couple would use and enjoy assets outside the SLATs. But should there be a reversal of fortune in the lives of A and B, there is the ability for them to receive distributions from the trusts for their benefit. While any such distributions would bring assets into the estate that were previously removed, this would be done only where there was a real need for these assets.

The income from a SLAT is taxable to the creator of the trust, whether or not there are distributions to beneficiaries. The creator’s payment of the trust’s tax might seem like an additional gift to the trust, but IRS rules do not count it as such, making this feature an added benefit.

This strategy also allows for the trusts to continue after the death of the beneficiary spouse for the benefit of the children and grandchildren, who may receive distributions from the trust during their lifetimes. In this case, it is possible to avoid having the trust taxed in the estate of these beneficiaries upon their deaths, providing the creator of the trust with the opportunity to do multi-generational planning.

State and Local Tax Deduction & Pass-Through Entity Tax ("PTET")

The state and local tax deduction was limited to $10,000 for tax years after 2017 under the Tax Cuts and Jobs Act. Taxpayers in high tax states lost a significant deduction that reduced their federal income tax liability.

Some high tax states proposed various work arounds to try and provide residents with a way around this limitation. The most popular work around was to impose a tax on pass-through entities where the owners of the pass-through entity would receive a credit on their individual returns offsetting the tax liability due on the pass-through income. In turn, the pass-through entity would deduct the state taxes paid thereby reducing the federal income ultimately passing through to the partners/shareholders.

In November of 2020, the IRS issued Notice 2020-75, clarifying that a pass-through entity would be entitled to a deduction equal to the state taxes paid to a state for an entity tax where the shareholder or partner would receive a credit that would reduce their state tax liability by the amount of taxes paid. With the release of this Notice, many states have passed their own PTET. California, New York, and Massachusetts have, to name a few. Certain states such as New Jersey and Connecticut introduced a PTET tax prior to the release of the notice. Each of these have different requirements to participate as well as different methods of calculating the PTET.

To participate in New York State's PTET for 2023, the pass-through entity is required to file an election prior to March 15, 2023. New York State (NYS) has different methods of calculating the tax for a partnership and a "resident S corporation" (all New York State resident shareholders) than it does for an S corporation with both NYS and non-NYS resident shareholders. Partners and shareholders who receive an allocation of the New York State PTET credit will be able to offset their New York State tax liability with any excess eligible to be refunded. Please refer to our earlier Anchin Alert for more details on the NYS PTE Tax (https://www.anchin.com/news/anchin-alert-new-york-provides-clarity-on-the-new-pass-through-entity-tax-an-opportunity-for-tax-savings).

In September, New York announced legislation moving up the start date of the New York City (NYC) PTET from January 1, 2023 to January 1, 2022. The NYC PTET is only available for partnerships with NYC resident partners and S corporations of which all shareholders are NYC residents. Nonresidents of NYC will not receive any benefit under the regime because the NYC personal income tax only applies to city residents. The election for 2022 is now available online; however, opting into the New York State PTET is required to be eligible for the City's PTET election. For those electing in, no NYC PTET estimates are required prior to March 15, 2023, but cash basis taxpayers must remit an estimate on or before December 31, 2022 to be deductible on their 2022 federal tax return.

Note that even if opting in NYC residents must continue to pay 2022 estimated taxes as if they are not entitled to a NYC PTET credit. For more information on the NYC PTET please refer to our Anchin Alerts (https://www.anchin.com/articles/commonly-asked-questions-about-the-nyc-pass-through-entity-tax/ and https://www.anchin.com/articles/official-guidance-on-the-nyc-pass-through-entity-tax/).

With regard to California, a PTET election is made on the entity's tax return. However, prior to the 2022 tax return's filing, an estimated PTET payment must be made. For tax years 2022 through 2025, an electing CA PTE must make two payments. The first payment for the greater of 50% of the PTET paid for the prior year or $1,000, must be made by June 15th of the taxable year for both calendar year and fiscal year pass-through entities. The second payment must be made by the pass-through entity's filing deadline without extensions. If the June 15, 2022 payment was underpaid or not paid, the entity is not eligible to make the election for the 2022 tax year. There are currently no exceptions to this rule, even if an entity anticipates its 2022 PTET liability to be less than 50% of its 2021 liability. Please refer to our earlier Anchin alert regarding the CA PTET for more details (https://www.anchin.com/articles/what-you-need-to-do-now-to-be-eligible-for-californias-2022-ptet/).

Tax year 2022 also saw law changes to enhance New Jersey's version of the PTET known as the Business Alternative Income Tax (BAIT). Specifically, the law modifies how the BAIT is calculated so that more income is subject to the tax, thus enabling a larger credit to be obtained. Under the revisions, a partnership's distributive proceeds upon which the tax is computed now includes both in-state and out-of-state income for resident partners. The changes also provide that pass-through entities do not need to make nonresident withholding payments on behalf of a nonresident partner if the nonresident expects a refund of the withholdings as a result of the BAIT credit. Finally, a BAIT credit will be permitted for tiered partnerships and S corporations that are partners in partnerships. Such credits can be passed through to the partners or shareholders or applied against the tax liabilities of the partnership or S corporation and its BAIT liabilities. For additional information on these NJ changes please see our Anchin Alert (https://www.anchin.com/articles/new-jerseys-bait-updates-provide-an-even-greater-tax-benefit/).

While the benefits of the PTET can be significant, before deciding to participate in a PTET, careful consideration should be given to where the owners live. If they are a nonresident of the state where the pass-through entity is domiciled, it is possible that the resident state would not allow an offsetting credit equal to the tax paid in the nonresident state (the PTET state). The impact on other tax attributes (e.g., Section 199A 20% pass-through entity deduction) of the pass-through entity should also be considered. Further, one should factor in potential PTET refunds which are taxable for federal purposes, as well as the economics of opting in specifically due to the rate differential between the PTET and the partners' individual income tax rates.

Please speak to your Anchin Relationship Partner to discuss the impact a PTET could have on your business.

State Income Sourcing for Property Managers

Property managers who handle the day-to-day functions of rental properties need to allocate their management fee income among the various states they do business in. Each state has adopted slightly varied rules of the two methods available for allocation: the cost of performance method and the market-based method.

States that have adopted the cost of performance method source the management fee income to the state where the actual work is performed. If the income-producing activity occurred in more than one state, the sales are generally sourced entirely to the state which had the greatest cost of performance, although a few states do apportion the income pro rata based on the work performed.

States that have adopted the market-based method source the management fee income to the state where the property owner received the benefit of the services. In the case of rental properties, the state where the benefit is received will be the state the property is located in.

The lack of uniformity amongst the states can create situations where income is taxed twice. This happens when the work is being done in a state that follows cost of performance sourcing and the rental property is in a state that follows market-based sourcing. There are also situations where the income is not allocated to any state when the work is performed in a state that follows market-based sourcing and the rental property is located in a state that follows cost of performance sourcing.

For example, if Partnership X provides services from its office located in New York, a cost of performance state, for a property located in California, a market-based state, both New York and California will source the revenue from such services to their respective states. Thus, there is a "doubling-up" effect regarding the sourcing of such revenue. On the other hand, if the services were provided in California for a property located in New York, neither state would lay claim to the revenue, leading to a potential "no-where income" situation. Because of this complexity it is important for property managers to ensure their record keeping is accurate of where the work is performed and where the benefit is received to manage their state tax risk

Charitable Contributions

The charitable deduction continues to be a flexible and beneficial option for philanthropically minded people to support the causes they hold dear and to also reap tax benefits for doing so. The tax rules governing charitable contributions remained largely intact under the TCJA. Beginning in 2022, two charitable tax breaks under the CARES Act for making cash donations have been removed.

First, the benefit of deducting cash contributions to public charities up to 100% of the taxpayer's adjusted gross income (AGI) no longer applies and second, the $300/$600 tax deduction for non-itemizers is no longer available.

Gifts to public charities. Contributions of cash, including contributions to Donor Advised Funds (DAF), can be deducted up to 60% of the taxpayer's adjusted gross income (AGI), and the full fair market value (FMV) of appreciated property held over one year can generally be deducted up to 30% of AGI.

Gifts to private foundations. Contributions of cash can be deducted up to 30% of AGI, and the full FMV of publicly traded securities (if owned for over a year) can be deducted up to 20% of AGI. The deduction for gifts of other appreciated property may be limited to the taxpayer's cost basis.

Deduction of contributions subject to the 30% and the 20% limitations are first reduced by the amount of cash contributions subject to the 60% limitation. Excess amounts not currently deductible can by carried forward for 5 years.

Understanding the tax strategies related to charitable contributions can help you decide how much to give, what asset to give and when to give, so you can provide the maximum amount to charity—and receive the maximum tax advantages for yourself. Some viable strategies are outlined below.

Bunching Charitable Donations. Prepaying charitable contributions on an alternating or every few years basis allows taxpayers to itemize deductions in the year contributions are made and use the standard deduction in years when there is little or no charitable giving.

A **Donor Advised Fund (DAF)** is a vehicle that could be used and makes it easy for taxpayers to bunch donations. Using a DAF, the taxpayer is able to claim the charitable deduction in the year of funding and can make grants from the DAF to desired charities over a period of years.

If you would like to create a donor advised fund in 2022, you can establish one as late as December 31st; however, additional time may be required if you are planning on funding the account with anything other than cash.

Our Firm has established a donor advised fund as an accommodation to our clients and friends. Contact your Anchin Relationship Partner for more information.

Charitable Lead Annuity Trusts (CLATs). CLATs are charitable trusts designed to pay an annuity to charitable beneficiaries during their term, after which, the remaining assets are returned to the grantor or distributed to family members. CLAT creators can enjoy a current income tax deduction for the present value of the payments expected to go to charity over the term of the trust. The discount rate is the IRS 7520 rate (currently 5.2% in December 2022).

CLATs can be used to offset current income with charitable deductions, with the possibility of the remaining assets returning to the taxpayer or to family members. The CLAT can be designed to reduce current income tax and have little or no gift tax (depending on who gets any remainder and the terms of the trust).

The value of the remainder depends on the performance of the CLAT's assets. Performance returns in excess of the IRS prescribed rate (the 7520 rate) result in remainder assets that can be returned to the taxpayer or be passed to family members.

Qualified Charitable Distribution (QCD) from an IRA. If you are at least age 70½, have an IRA, and plan to donate to charity this year, another consideration is to make a QCD from your IRA. This strategy can satisfy charitable goals and allows funds to be distributed from an IRA without any tax consequences. A QCD can also be appealing because it can be used to satisfy your required minimum distribution (RMD)—up to $100,000 for tax year 2022.

QCDs may be attractive if you have few other deductions or if you are already close to your charitable deduction limitations. Because the tax-free QCD is never reported as a deduction, it is not counted against the charitable limits and does not require you to itemize deductions to be effective.

Alternatively, if you are required to take an RMD and have a desire to contribute to a charity, you could use the RMD proceeds to make a charitable donation. Your IRA distribution would then be reported as income, but the subsequent charitable contribution using the proceeds from the RMD would generally offset the tax consequences—to the extent that the limits allow it.

What about Securities? If you are contemplating making charitable contributions before year end, the most tax-efficient way to do this is to give appreciated publicly traded stock that has been held for more than a year. In doing so, donors receive a charitable contribution deduction equal to the fair market value of the securities contributed and escape paying capital gains tax (and the 3.8% surtax on net investment income) on their built-in appreciation. Also, the donation of appreciated, publicly traded securities does not require you to get a qualified appraisal to establish the value of your deduction. Note that this is a much better result than selling the stock, paying a capital gains tax, and then deciding to use the proceeds to make cash contributions to charity.

Do not donate depreciated securities to charity. If this is the case, sell the securities first and then donate the proceeds to charity so that you can take the capital loss on the sale and get a charitable deduction for the donated cash.

If you are planning on donating a non-publicly traded stock to a public charity, you are ***required*** to get a qualified appraisal to establish its value. Otherwise, you will only be entitled to a charitable deduction equal to your basis in the stock.

The value of a donation of publicly traded securities held for a year or less is limited to the donor's cost basis.

Consider a partial non-liquidating distribution from investment partnership interests consisting of long-term appreciated securities to make charitable contributions. This planning opportunity may also be advantageous for securities received from an investment partnership subject to the carried interest rules discussed earlier.

Before undertaking any of the above giving strategies, you should consult your legal, tax or financial advisor. Nonetheless, each of the strategies, properly employed, represents a tax-advantaged way for you to give more to your favorite charities.

For more information on the topics discussed in this year-end tax planning guide, please contact your Anchin Relationship Partner.

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