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ACCOUNTANTS & ADVISORS

2023 Year-End Tax Planning Guide

Real Estate Group

While the COVID-19 pandemic is behind us, the impact that the pandemic has had on the real estate industry is not. With the Federal Reserve raising interest rates to combat inflation, the persistent inflation appears to have peaked and is moderating. However, rate cuts are not expected until 2024. The resulting increased debt costs continue to put pressure on capitalization rates in the real estate industry across all asset classes.

The office market appears to have taken the hardest hit and remains under pressure, with tenants looking to reduce their footprint and improve efficiency. High quality assets are outperforming with high rents and low vacancy rates. There appears to be significant progress in return-to-office, with Jones Lang LaSalle's (JLL) survey indicating that employees are spending 3.1 days at the office, which is broadly in line with employer expectations. For lower quality office assets, the leasing terms are under continuing pressure, with lower rates per square foot, large tenant allowances and increased lease incentives. The current and 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, with cash-in refinance and workouts becoming more common.

The multifamily market appears to be the opposite of the struggling office market and continues to be bolstered by the pandemic's legacy of work-from-home and hybrid environments, as well as the increasing spread between owning and renting, as cost of ownership has increased significantly by the increases in home prices and interest rates. Nevertheless, the multifamily market seems to be showing signs of slowing down, and according to Newmark, rent prices contracted at 0.4% year-over-year. The contracting rent growth, coupled by an 8% year-over-year increase in expenses, driven by a 25% surge in insurance is putting pressure on net operating income. Decreasing net operating income and an increase in cap rates of approximately 50 basis points, the decrease in values of multifamily assets is expected.

The industrial asset class remains robust, amid seeing some softening. According to JLL, warehouse and distribution demand is down 12% year-over-year in 2023, with many companies adopting a wait-and-see strategy, prolonging decision-making timelines and some opting for renewals instead of expansions. Manufacturing demand, however, is growing.

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 Internal Revenue Code Sections 179D and 45L, and taking advantage of bonus depreciation, among various other tax strategies are important to understand, as are implications of debt modifications and foreclosures. We hope you find the tax strategies and considerations outlined in this publication to be helpful.

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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 2023 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 2023 even if they aren't paid until 2024 (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 2023/postpone payments until 2024
- 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 2023 and deferring deductions into 2024. This strategy will increase your 2023 tax bill, but it can reduce your overall tax liability for the two-year period.

In November, the IRS released the inflation-adjusted tax brackets for 2024, which reflected a 5.4% inflation adjustment. For taxpayers who don't anticipate an increase in earnings and defer income to 2024, more of that income will fall into a lower tax bracket.

IRS Intensifies Enforcement Measures Targeting Wealthy Taxpayers and Large Partnerships

The Internal Revenue Service (IRS) has unveiled a comprehensive plan to bolster its enforcement efforts aimed at high-net-worth individuals and large partnerships.

Under this initiative, there will be rigorous enforcement actions and scrutiny of tax returns filed by specific categories of high-net-worth individuals.

The Inflation Reduction Act of 2022's fund allocation is fueling these enforcement actions, enabling the IRS to address areas that have long been underfunded. The categories to be targeted include:

- 75 of the largest partnerships with over $10 billion in assets;
- 500 multimillion-dollar partnerships with over $10 million in assets; and
- 1,600 individual millionaires with total incomes above $1 million and recognized tax debt exceeding $250,000.

To enhance their efficiency, the IRS is employing advanced technology, including artificial intelligence (AI), to identify tax returns for examination. This technology, developed through collaboration with data science and tax enforcement experts, allows the IRS to discern patterns and trends that were previously elusive.

Further, the IRS will establish a new, specialized unit dedicated to examining large and complex pass-through entities.

This new unit will operate within the IRS' Large Business & International (LB&I) division and will be staffed with newly-hired employees focused on assessing the compliance of complex partnerships, large corporations and high-income individuals.

The primary objective of this team is to counter non-compliance among wealthy filers who may have utilized pass-through entities to shield income and avoid tax payments.

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 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.

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 flow 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)

Bonus depreciation enables taxpayers to accelerate the depreciation of property purchased that has a recovery period of 20 years or less and is depreciated using the modified accelerated cost recovery system (MACRS). For real estate businesses, this typically includes, but is not limited to, furniture, fixtures, land improvements, flooring, cabinets and appliances.

Currently, any qualifying assets placed into service on or after January 1, 2023 are eligible for bonus depreciation equal to 80% of the purchase price. This benefit will continue to drop by 20% per annum until bonus depreciation phases out completely for assets placed in service on or after January 1, 2027.

The following chart illustrates the phase out.

Date Property is Placed in Service is on or after	Percentage of Eligible Bonus Depreciation
September 27, 2017	100%
January 1, 2023	80%
January 1, 2024	60%
January 1, 2025	40%
January 1, 2026	20%
January 1, 2027	0%

Owners of nonresidential real estate may utilize bonus depreciation 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. One consideration for owners of nonresidential real estate regarding the eligibility of utilizing bonus depreciation on QIP is if the business makes the irrevocable election out of business interest expense limitation. Should they make this election, QIP will be ineligible for bonus depreciation. This is discussed in-depth in the article “Managing the Deductibility of Interest Expense.”

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 and modify their income to disallow the accelerated depreciation.

This adjustment may increase state taxable income, thereby affecting cash flows if distributions are required to cover state income tax expense for the owners. If the partnership does not provide for tax distributions, this can cause unexpected higher state taxable income to investors and can be an especially sensitive issue with passive investors.

Section 179 Deduction

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. Unlike bonus depreciation, it cannot create a net loss for the business. Tangible personal property (e.g., furniture, fixtures, carpets, etc.) is eligible for this deduction. For real estate businesses, the cost of "qualified real property" is also eligible, which includes QIP (discussed above) as well as the following expenditures made for nonresidential real property after the property was originally placed in service: roofs, HVAC, fire protection and alarm/security systems. Land improvements are not eligible.

For tax year 2023, the maximum deduction under Section 179 is $1,160,000 with a dollar for dollar phase out once the amount of qualified Section 179 property placed in service exceeds $2,890,000. Disallowed deductions due to trade or business 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.

There could be significant state impact on owners and investors depending on the location of the property and the residence of the taxpayer.

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 2023. They have a cost segregation performed in tax year 2024. The business can still utilize 80% bonus on any eligible property when the adjustment is made on the 2024 tax return since it relates to a 2023 purchase.

Tangible Property Regulations

The tangible property regulations (sometimes referred to as the “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 the asset’s 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 analyze 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.

Managing the Deductibility of Interest Expense

The Tax Cuts and Jobs Act of 2017 limited the deductibility of business interest expense for taxpayers. This has had a significant impact on the real estate industry and can be especially concerning given the current interest rate market. The following is a discussion of the potential limitations as well as some considerations for real estate owners and businesses.

For tax years beginning after December 31, 2021, the deduction for interest expense is limited to 30% of a taxpayer’s adjusted taxable income (ATI). Generally, ATI is an entity’s net income with interest expense added back (there are several other potential adjustments outside the scope of this article). Prior to the 2022 tax year, entities were able to add back depreciation and amortization as part of the ATI calculation, in addition to interest expense. The sunsetting of the depreciation and amortization addbacks have further limited the deductibility of interest expense in a given tax year. One important item to note is that any limited interest expense is suspended until there is either future income or disposition of the activity; it is not lost forever.

Fortunately, not all real estate businesses are subject to the expense limitation. Taxpayers 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 must be less than $29 million starting in 2023 (receipts may be aggregated amongst entities with similar ownership).

While the small business taxpayer rule can exempt a lot of entities from the limitation, taxpayers still need to consider what's known as "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. If deemed a tax shelter, an entity will be subjected to the interest limitation regardless of receipts.

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 increases to 30 years and for commercial property, the 39-year life increases to 40 years. Electing entities with commercial property will no longer be able to take advantage of bonus depreciation on certain 15-year property called Qualified Improvement Property (QIP). The ineligibility of bonus depreciation for electing entities on QIP 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. The taxpayer 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 compared to long term planning in order to successfully utilize interest expense deductions while factoring in any offsetting depreciation impact.

Excess Loss Limitations – Federal and State Considerations

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. For the 2023 tax year, trade or business losses are limited to $578,000 for married couples ($289,000 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.

This excess business loss provision was initially scheduled to sunset December 31, 2025. However, 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 80% bonus depreciation in 2023 (60% in 2024) in the year it is first placed in service by the taxpayer. However, many states do not conform to bonus depreciation. In determining tax liabilities, many states start with Federal taxable income and adjust for state provisions that “decouple” from Federal tax treatment. As a result, many states have modifications adding back accelerated deprecation to Federal taxable income. This could lead to adverse tax consequences since the losses from depreciation may have already been limited on their Federal returns. Taxpayers should consult with their advisors to plan accordingly and avoid any surprises when filing their returns.

Debt Modifications in a Distressed Market

The real estate sector is presently encountering exceptional difficulties in this era of high interest rates and high, though seemingly abating, inflation. In a distressed real estate market, owners and lenders may consider loan term renegotiations to maximize their cash flow.

However, this may bring unexpected tax consequences.

Real estate owners may modify their debt to better manage their cash flow by using strategies including:

- Extending the loan’s maturity date;
- Changing the interest rate;
- Exercising conversion features; or
- Changing fixed payment of principal to contingent amounts.

While potentially valuable, these modifications may come at a cost. When the original debt’s issue price is higher than the new debt’s issue price, the taxpayer usually recognizes Cancellation of Indebtedness (COD) income. In other words, they may realize a substantial taxable gain even though they have not received any cash proceeds.

That said, there are provisions that allow taxpayers to exclude or defer COD income.

Bankruptcy and Insolvency

In bankruptcy, taxpayers do not have to include forgiven debt as income. However, taxpayers that are insolvent, but are not bankrupt, can only exclude COD income up to the amount by which their debts are greater than the value of their assets.

Both the bankruptcy exception and the insolvency exception apply at the partner level.

Reduction of tax attributes

Being able to exclude COD income in the event of bankruptcy or insolvency comes at the cost of lowering certain tax benefits, generally in the following order:

1. Net operating losses;
2. General business credits;
3. Minimum tax credits;
4. Capital loss carryovers;
5. Basis of the taxpayer's property;
6. Passive activity loss and credit and carryovers; and
7. Foreign tax credit carryovers.

A taxpayer who wishes to retain net operating losses and other carryovers can elect to reduce basis in depreciable property (or in realty held as inventory).

Qualified Real Property Business Indebtedness (QRPBI)

Subject to limitations, taxpayers who are neither bankrupt nor insolvent may have the option to exclude COD income from the discharge of QRPBI. Note, this election is not available to C corporations.

QRPBI is defined as debt that is:
(a) incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property; and
(b) was incurred or assumed before January 1, 1993, or was incurred or assumed after such date to acquire, construct, reconstruct, or substantially improve such property.

As with the bankruptcy and insolvency exceptions, the QRPBI exclusion applies at the partner, rather than the partnership, level.

To exclude income from the discharge of QRPBI, the taxpayer must make a valid election. The amount of excluded income reduces the basis of the taxpayer's depreciable real property, which is not limited to the property that was secured by the debt.

The fact that the debt must be secured by real property can create challenges when dealing with LLCs. In large acquisitions, it is typical to see multiple tranches of debt, with varying maturities, interest rates, and degrees of risk. Under an IRS safe harbor rule, debt backed by full ownership in a disregarded entity satisfies the "secured by" requirement under certain conditions, but it appears that the safe harbor allows for only one level of debt to be secured by a disregarded entity interest.

Limitations on Excludable Income

Taxpayers have two limits on how much forgiven debt income they can exclude for tax purposes. In general, the amount of income excluded cannot exceed the lesser of:

1. The excess of the outstanding debt principal (immediately before the discharge) over the fair market value of the real property securing the debt (reduced by the principal amount of any other qualified real property business debt secured by the property); or
2. The aggregate adjusted bases of all depreciable real property held by the taxpayer determined as of the first day of the tax year following the discharge (or, if earlier, the property's disposal date)—the overall limitation.

When refinancing, relief is available as long as the new loan amount doesn't exceed the amount of the original business property debt. If a partnership borrows against real property and distributes all of the additional proceeds to its partners, the additional borrowing can't be treated as QRPBI.

Charitable Contributions: Tax Strategies

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. Developing a charitable giving strategy can help you achieve the meaningful impact you envision and take advantage of tax benefits along the way.

- **Gifts to public charities.** Contributions of cash to qualified public charities can be deducted in an amount up to 60% of the taxpayer's adjusted gross income (AGI) in a given year. For contributions of appreciated publicly-traded securities, 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.

*** Caution:** 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 2023, 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.

- **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 5.8% in December 2023).

*** Planning opportunity:** 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 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 2023.

  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. 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.

***** Caution & Reminder:** 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.

***** Caution & Reminder:** 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.

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

*** Planning opportunity:** Consider a partial non-liquidating distribution from investment partnership interests consisting of long-term appreciated securities in order 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.

Estate Planning & Gift Considerations

Under current law, the individual estate tax exemption is increased each year based on an inflation assumption. In 2023, the first $12.92 million of an individual's estate is exempt from federal estate tax (13.61 million in 2024).

If you are a married couple splitting gifts, the effective exemption amount is $25.84 million. This amount is reduced by any gifts made in excess of the annual gift tax exclusion in a given year. In 2023, individuals can make gifts of up to $17,000 to any other individual with no gift tax consequences. This amount increases to $18,000 for 2024.

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 two 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, 2023.** Each person may make annual, tax free gifts of $17,000 ($34,000 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 2023. 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, currently 5.8%) 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, 2023 to apply 2023 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 2023, you can transfer $85,000 ($170,000 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.)

- Below Market Loans or Intra-Family Loans: Today, family members can extend long term loans to each other at interest rates less than 5.3% 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 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. 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.

Is a Delaware Statutory Trust Right for You?

Sophisticated sponsors, investors and other real estate professionals understand that there are considerable advantages to investing in real estate for building wealth, including regular cash flow, significant tax deductions, diversification, and tax-free exchanges of real estate. While there are different real estate ownership structures, such as a partnership, limited liability company (LLC), or tenant-in-common (TIC), it is the Delaware Statutory Trust (DST) that may prove, depending upon circumstances, to be the most flexible and beneficial way in which to own real estate from an acquisition and disposition investment strategy.

How DSTs Work

The IRS approved the use of DSTs in 2004 by confirming that ownership of a beneficial interest in a properly structured DST is the equivalent of owning an undivided interest in the real estate owned by the DST.

While DSTs can become quite nuanced, the essential concept is straightforward: the trust, created under Delaware state law, allows multiple investors to purchase and hold a real estate asset. The trust is organized and managed by a trustee, which is usually the sponsor. Investors are known as beneficiaries that acquire an undivided interest in the asset held by the DST. Like a TIC, an investor can use a beneficial interest in a DST as replacement property in a 1031 exchange. The managing trustee of the DST is usually the sponsor or affiliate of the sponsor, and the DST owns title to 100% of the interest in the property. Typically, investors are not required to sign guarantees nor nonrecourse carve-outs on the loan.

A DST appears to be similar to a TIC structure, but operates more like an LLC. Like members of an LLC, the beneficial owners of a DST enjoy protection from personal liability for the actions of the DST. Similar to an investor of a TIC and LLC, the DST beneficiaries are entitled to their proportionate share of income, deductions and losses, and related cash-flow from the investment. DSTs are governed by a trust agreement that places management of the DST in the hands of the trustee or an independent manager, with the beneficial owners having little to no say in the management of the DST.

A DST is generally preferable to a TIC, since there are perceived weaknesses and difficulties of financing a TIC. For instance, a TIC is limited to 35 investors and requires a single member LLC for each TIC investor, which requires lender financing for each of the TIC investor entities. With a DST, on the other hand, there is one loan, and the lender does not need to underwrite each beneficial owner. Furthermore, a TIC action requires unanimous vote; whereas in a DST, there is centralized management as the beneficial owners have no right to vote, which eliminates the concern that a single investor can hold up the process and other matters.

Restrictions on DSTs

DSTs and their trustees are subject to a set of IRS restrictions sometimes referred to as the "7 Deadly Sins."
These are:

- no new capital contributions allowed once the DST is closed;
- no new or renegotiated financing;
- no reinvestment (all proceeds from a sale must be distributed to beneficiaries);
- capital expenditures are limited to normal repair and maintenance;
- reserves or cash held between distribution dates can be invested only in short-term debt obligations;
- all cash other than necessary reserves must be distributed on a current basis; and
- no new leases or renegotiated leases are allowed after the DST is closed.

While investors should be aware of these restrictions, they should also be equally aware that many can be mitigated with experienced legal counsel and professional tax advice. For instance, a Master Lease structure can be used to renegotiate leases and avoid leases with multiple, actual tenants. Also, a springing LLC can be used when a major issue arises. This allows the DST to convert to an LLC to take actions to remedy a situation (e.g., loan refinance).

Additional Advantages of DSTs

With respect to sponsors, DSTs offer an additional source of equity. DSTs provide 1031 investors the ability to trade into a DST. This flexibility opens a whole new pool of potential investors. One resource reports that $32.1 billion of 1031 equity has been raised from 2010 through 2022.

Another appealing aspect of DSTs is that upon sale, each beneficiary, including the sponsor, can do a 1031 exchange of their respective proceeds without the consent of the other beneficiaries. They can even trade into another DST of the same or different sponsor. This is also good news for sponsors, who have a pipeline of deals and, consequently, will have more dollars to invest in their next project if they take advantage of a DST structure. This flexibility, unlike an LLC or partnership, also avoids the need for a drop-and-swap structure which can be risky from a tax perspective.

Is a DST Right for You?

DSTs are becoming more popular and have significant tax benefits for sponsors and investors. Because of their unique structure and requirements, DSTs should be approached with experienced legal counsel and tax professionals to ensure they are properly structured to take full advantage of their benefits.

Opportunity Zones – Start Planning for Gain Recognition

The Opportunity Zone Program provides taxpayers with tax enhanced returns on their qualified investments into designated opportunity zones. The program provides several benefits for taxpayers including temporary deferral of gains, step-up in tax basis on certain investments, and exclusion of taxable gains for investments held for 10 years or more. The tax benefits, coupled with sound economics, can greatly elevate the attractiveness of a deal or investment. The gains that were reinvested into opportunity zones and deferred as part of this program are not deferred until the investment is liquidated. Rather, the gain deferral is a temporary relief of tax liability. All gains deferred into opportunity zones will be deemed to be recognized and

taxable on December 31, 2026. This may be a challenging recognition event if the properties are not generating cash flow by the time the tax is due. Investors in opportunity zones should start thinking about the tax liability coming due so they can adequately plan cash flows. Investors may also want to look at their portfolio and identify capital losses to offset the gain recognition.

To further complicate planning, not all states conformed to the Federal provisions. In addition, some states decoupled from the provisions years after the program was established. This could mean that taxpayers have already paid tax on their gains at the state level while others were able to defer the gain. In addition, qualified investments into the same fund may have been tax deferred to the state in one year and fully taxable in another. Taxpayers should work with their advisors to make sure they appropriately plan and not drastically over or underpay any estimated tax liability.

While the recognition event is still several years away, it's important to start planning now.

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.

About Anchin

Anchin is a leading accounting, tax and advisory firm, specializing in the needs of privately-held companies, investment funds and high-net-worth individuals and families.

Its highly-focused industry specialization helps clients overcome challenges and achieve their financial objectives with exceptional confidence. Consistently recognized in respected "best of" lists for service, firm management and employee satisfaction, Anchin prioritizes partner-level engagement, and commitment to employee happiness. The full-service firm, with a staff of 500, including more than 65 partners, provides a wide range of assurance, financial reporting, tax and advisory services [including tax strategies and compliance; tax credits and incentives; state and local and international tax strategies, family office strategies management and succession advisory; growth, transition and exit strategies; transaction advisory; client accounting advisory services; cybersecurity and digital risk solutions; and litigation support, forensic accounting and valuation services]. Anchin has offices in New York City, Uniondale, New York, and in Boca Raton, Florida, and is an independent member of BKR International, a network of more than 160 firms with over 500 offices in over 80 countries around the world. Discover what's possible by visiting us online at www.anchin.com.

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