Chapter 1

MAXIMIZING TAX BENEFITS FOR SALES OF CAPITAL GAIN ASSETS AND REAL PROPERTY

LEARNING OBJECTIVE

After completing this chapter, you should be able to do the following:

- Identify differences in the current federal income tax rate structure to help clients maximize tax benefits.
- Determine when selling capital assets, business assets, and real estate are to a client's advantage.
- Apply like-kind exchange rules under IRC Section 1031.

INTRODUCTION

This chapter covers what tax advisers need to know, from both the planning and compliance perspectives, to help clients maximize tax savings under the current federal income tax rate structure for capital gains and losses, and IRC Section 1231 gains and losses. We also cover some tax breaks that apply specifically to real estate transactions and the potential application of the 3.8 percent net investment income tax (NIIT).

Preface Regarding Continuing Future Tax Rate Uncertainty

The American Taxpayer Relief Act (ATRA) of 2012 increased federal income taxes on high-income individuals. With ongoing federal deficits and an election year, more increases could be in the cards in the not-too-distant future. Here, in a nutshell, is the current tax-rate story for 2016 and beyond, unless things change:

- The top rate on ordinary income and net short-term capital gains is 39.6 percent (up from 35 percent in 2012).
- High-income individuals can be hit with the additional 0.9 percent Medicare tax on part of their wages and/or net self-employment income.
- The top rate on most net long-term capital gains is 20 percent for upper-income individuals (up from 15 percent in 2012). Although the maximum rate is 20 percent, most individuals will not pay more than 15 percent, and individuals with modest incomes can pay 0 percent. The same preferential rates apply to qualified dividends.
- High-income individuals can be hit with the 3.8 percent Medicare surtax (the net investment income tax or NIIT) on all or part of their net investment income, which is defined to include capital gains and dividends.

Current Capital Gain and Dividend Tax Rates

RATES ON SHORT-TERM CAPITAL GAINS

The Taxpayer Relief Act of 2012 increased the maximum rate for higher-income taxpayers to 39.6 percent.

For 2017, this rate increase only affects

- singles with taxable income greater than $418,400;
- married joint-filing couples with income greater than $470,700;
- heads of households with income greater than $444,550; and
- married individuals who file separate returns with income greater than $235,350.

For 2015, the 39.6 percent rate thresholds were $415,050, $466,950, $441,000, and $233,475, respectively.

Key point: Higher-income taxpayers may be subject to the 3.8 percent Medicare surtax on net investment income (IRC Section 1411), which can result in a higher-than-advertised federal tax rate on short-term capital gains. The IRS calls the 3.8 percent surtax the *net investment income tax* or NIIT. We will adopt that terminology.

RATES ON LONG-TERM CAPITAL GAINS AND DIVIDENDS

The tax rates on net long-term capital gains and qualified dividends are also the same as before for most individuals. However, the Taxpayer Relief Act of 2012 raised the maximum rate for higher-income taxpayers to 20 percent (increased from 15 percent).

For 2017, this change only affected

- singles with taxable income greater than $418,400;
- married joint-filing couples with income greater than $470,700;
- heads of households with income greater than $444,550; and
- married individuals who file separate returns with income greater than $235.350.

For 2016, the 20 percent rate thresholds were $415,050, $466,950, $441,000, and $233,475, respectively.

Key point: Higher-income taxpayers can also be affected by the 3.8 percent NIIT, which can result in a maximum 23.8 percent federal tax rate on long-term gains and dividends (IRC Section 1411).

Key point: The Taxpayer Relief Act of 2012 also made permanent the rule that qualified dividends do not count as investment income for purposes of the investment interest expense limitation—unless the taxpayer elects to have those dividends taxed at ordinary income rates [IRC Section 163(d)(4)(B)]. (The same rule has applied to long-term capital gains for many years and is explained later in this chapter.)

HIGHER RATES ON SOME GAINS AND DIVIDENDS

Unfortunately, the preferential 0 percent/ 15 percent/ 20 percent rates do not apply to all types of long-term capital gains and dividends. Specifically as follows:

- The reduced rates have no impact on investments held inside a tax-deferred retirement account (traditional IRA, Keogh, SEP, solo 401(k), and the like). So, the client will pay taxes at the regular rate (which can be as high as 39.6 percent) when gains accumulated in these accounts are withdrawn as cash distributions. (Gains accumulated in a Roth IRA are still federal-income-tax-free as long as the requirements for tax-free withdrawals are met.)
- Clients will still pay taxes at their higher regular rates on net short-term capital gains from investments held for one year or less. Therefore, if the client holds appreciated stock in a taxable account for exactly one year, he or she could lose up to 39.6 percent of the profit to the IRS. If he or she instead holds on for just one more day, the tax rate drops to no more than 20 percent. The moral: selling just one day too soon could mean paying a larger amount of one's profit to the taxing authorities.

  Key point: For tax purposes, the client's holding period begins the day after he or she acquires securities and includes the day of sale. For example, if your client buys shares on November 1 of this year. The holding period begins on November 2. Therefore, November 2 of next year is the earliest possible date he or she can sell and still be eligible for the reduced rates on long-term capital gains. (See Rev. Ruls. 66-7 and 66-97.)

- IRC Section 1231 gains attributable to depreciation deductions claimed against real estate properties are called un-recaptured IRC Section 1250 gains. These gains, which would otherwise generally be eligible for the 20 percent maximum rate, are taxed at a maximum rate of 25 percent [IRC Section 1(h)(6)]. The good news: any IRC Section 1231 gain more than the amount of un-recaptured IRC Section 1250 gain from a real property sale is generally eligible for the 20 percent maximum rate on long-term capital gains. The same treatment applies to the deferred IRC Section 1231 gain component of installment note payments from an installment sale transaction.

  Key point: Distributions from Real Estate Investment Trusts (REITs) and REIT mutual funds may include some un-recaptured IRC Section 1250 gains from real property sales. These gains, which are taxed at a maximum rate of 25 percent, should be separately reported to the investor and entered on the appropriate line of the investor's Schedule D.

- The 28 percent maximum rate on long-term capital gains from sales of collectibles and QSBC stock remains in force [IRC Section 1(h)(5) and (7)].

The reduced 0 percent/ 15 percent/ 20 percent rates on dividends apply only to qualified dividends paid on shares of corporate stock [IRC Section 1(h)(11)]. However, lots of payments that are commonly called *dividends* are not qualified dividends under the tax law. For instance,

- dividends paid on credit union accounts are really interest payments. As such, they are considered ordinary income and are therefore taxed at regular rates, which can be as high as 39.6 percent;
- dividends paid on some preferred stock issues that are actually publicly traded "wrappers" around underlying bundles of corporate bonds. So clients should not buy preferred shares for their taxable accounts without knowing exactly what they are buying;
- mutual fund dividend distributions that are paid out of the fund's short-term capital gains, interest income, and other types of ordinary income are taxed at regular rates. So, equity mutual funds that engage in rapid-fire trading of low-dividend growth stocks will generate payouts that are taxed at up

to 39.6 percent rather than at the optimal 0 percent/ 15 percent/ 20 percent rates your clients might be hoping for;

- bond fund dividends are taxed at regular rates, except to the extent the fund is able to reap long-term capital gains from selling appreciated assets;
- mutual fund dividends paid out of (1) qualified dividends from the fund's corporate stock holdings and (2) long-term capital gains from selling appreciated securities are eligible for the reduced 0 percent/ 15 percent/ 20 percent rates;
- most REIT dividends are not eligible for the reduced rates. Why? Because the main sources of cash for REIT payouts are usually not qualified dividends from corporate stock held by the REIT or long-term capital gains from asset sales. Instead, most payouts are derived from positive cash flow generated by the REIT's real estate properties. So most REIT dividends will be ordinary income taxed at regular rates. As a result, clients should not buy REIT shares for their taxable accounts with the expectation of benefiting from the 0 percent/ 15 percent/ 20 percent rates; and
- dividends paid on stock in qualified foreign corporations are theoretically eligible for the reduced rates. Here is the rub: these dividends are often subject to foreign tax withholding. Under the U.S. foreign tax credit rules, individual investors may not necessarily receive credit for the full amount of withheld foreign taxes. So, investors can wind up paying the advertised 0 percent/ 15 percent/ 20 percent rates to the U.S. Treasury, plus some incremental percentage to some foreign country. The combined U.S. and foreign tax rates may exceed the advertised 0 percent/ 15 percent/ 20 percent rates. [See IRC Sections 1(h)(11)(c)(iv) and 904.]

The reduced rates do not apply to dividends earned inside tax-deferred retirement accounts (traditional IRA, Keogh, SEP, solo 401(k), and so on). Clients are taxed at their regular rates when dividends accumulated in these accounts are withdrawn as cash distributions. (Dividends accumulated in a Roth IRA are federal-income-tax-free as long as the client meets the requirements for tax-free withdrawals.).

Warning: To be eligible for the reduced 0 percent/ 15 percent/ 20 percent rates on qualified dividends earned in a taxable account, the stock on which the dividends are paid must be held for more than 60 days during the 120-day period that begins 60 days before the ex-dividend date (the day following the last day on which shares trade with the right to receive the upcoming dividend payment). Bottom line: When shares are owned only for a short time around the ex-dividend date, the dividend payout will count as ordinary income taxed at regular rates [IRC Section 1(h)(11)(B)(iii)].

The preferential 15 percent and 20 percent rates are increased by 3.8 percent when the NIIT applies, in which case the actual rates are 18.8 percent and 23.8 percent. In addition, the 25 percent and 28 percent rates can are increased by 3.8 percent when the NIIT applies.

KNOWLEDGE CHECKS

1. The current maximum federal income tax rates (not counting the potential impact of the NIIT) on an individual's IRC Section 1231 gains from selling depreciable real estate are

   a. 28 percent.
   b. 20 percent and 25 percent.
   c. 15 percent.
   d. 28.8 percent.

2. The current maximum federal income tax rate (not counting the potential impact of the NIIT) on qualified dividends earned in an individual's taxable account is

   a. 20 percent.
   b. 35 percent.
   c. 39.6 percent.
   d. 43.4 percent.

3. The maximum federal income tax rate (not counting the potential impact of the NIIT) on recaptured IRC Section 1250 gains is

   a. 15 percent.
   b. 25 percent.
   c. 39.6 percent.
   d. 43.4 percent

MANY INDIVIDUALS OCCUPY 10 PERCENT AND 15 PERCENT BRACKETS AND PAY 0 PERCENT ON INVESTMENT PROFITS

Many more people than you might initially think are eligible for the lowest investment tax rates of 0, 10, and 15 percent. Remember: a person's rate bracket is determined by the amount of taxable income which equals adjusted gross income (AGI) reduced by allowable personal and dependency exemptions and by the standard deduction amount (if the taxpayer does not itemize) or total itemized deductions (if he or she does itemize).

- If your married client files jointly, has two dependent kids, and claims the standard deduction for 2016, he or she could have as much as to $104,800 of adjusted gross income (including long-term capital gains and dividends) and still be within the 15 percent rate bracket. Taxable income would be $75,900, which is the top of the 15 percent bracket for joint filers in 2017.
- If your divorced client uses head of household filing status, has two dependent kids, and claims the standard deduction for 2017. He or she could have as much as to $72,300 of adjusted gross income (including long-term capital gains and dividends) and still be within the 15 percent rate bracket. Taxable income would be $50,800, which is the top of the 15 percent bracket for heads of households in 2017.
- If your single client has no kids and claims the standard deduction for 2017. He or she could have up to $48,350 of adjusted gross income (including long-term capital gains and dividends) and still be within the 15 percent rate bracket. Taxable income would be $37,950, which is the top of the 15 percent bracket for singles in 2017.
- If your client itemizes deductions, 2017 adjusted gross income (including long-term capital gains and dividends from securities received as gifts from you) could be even higher, and taxable income would still be within the 15 percent rate bracket.

Key point: The adjusted gross income figures previously cited are after subtracting any above-the-line write-offs allowed on page 1 of the gift recipient's Form 1040. Among others, these write-offs include deductible retirement account contributions, health savings account (HSA) contributions, self-employed health insurance premiums, alimony payments, moving expenses, and so forth. So, if the gift recipient will have some above-the-line deductions, the adjusted gross income can be that much higher, and he or she will still be within the 15 percent rate bracket.

Tax-Smart Strategies for Capital-Gain Assets

Clients should try to satisfy the more-than-one-year holding period rule before selling appreciated investments held in taxable accounts. That way, they will qualify for the 0 percent/ 15 percent/ 20 percent long-term capital gains rates (plus the 3.8 percent NIIT when applicable). The higher the client's tax rate on ordinary income, the more this advice rings true. Of course, the client should never expose an accrued profit to great downside risk solely to be eligible for a lower tax rate. The client is always better off making a short-term profit and paying the resulting higher tax liability than hanging on too long and losing his or her profit altogether.

Clients should hold equity index mutual funds and tax-managed funds in taxable investment accounts. These types of funds are much less likely to generate ordinary income dividends that will be taxed at higher regular rates. Instead, these funds can be expected to generate qualified dividends and long-term capital gains that will be taxed at the reduced rates.

Clients should hold mutual funds that engage in rapid-fire asset churning in tax-advantaged retirement accounts. That way, the ordinary income generated by these funds will not cause any tax harm.

If the client insists on engaging in rapid-fire equity trading, he or she should confine that activity to the tax-advantaged retirement accounts where there is no tax disadvantage to lots of short-term trading.

Key point: Clients with an equity investing style that involves nothing but rapid-fire trading in stocks and ownership of quick-churning mutual funds should try to do this inside their tax-advantaged retirement accounts. Why? Because using this style in a taxable account generates ordinary income taxed at higher regular rates. Inside a tax-advantaged retirement account, however, there is no harm done. If the clients therefore devote most or all of their tax-advantaged retirement account balances to such rapid-fire equity trading, they might be forced to hold some or all of their fixed-income investments in taxable accounts. That is okay. Even though they will pay their higher regular rate on the ordinary income produced by those fixed-income assets, they should still come out ahead on an overall after-tax basis.

BROAD-BASED STOCK INDEX OPTIONS

The current federal income tax rates on long-term capital gains are still pretty low, ranging from a minimum of 0 percent to a maximum of 20 percent depending on income (plus the 3.8 percent Medicare surtax which can affect higher-income taxpayers). But the rates on short-term gains are not so low. They range from 25 percent to 39.6 percent for most investors (plus the 3.8 percent NIIT for higher-income investors). That is why, as a general rule, you should try to satisfy the more-than-one-year holding period requirement for long-term gain treatment before selling winner shares (worth more than you paid for them) held in taxable brokerage firm accounts. That way, the IRS won't be able to take more than a relatively modest bite out of your profits. However the investment climate is not always conducive to making long-term commitments. But making short-term commitments results in short-term gains that may be taxed at high rates.

One popular way to place short-term bets on broad stock market movements is by trading in ETFs (exchange traded funds) like QQQ (which tracks the NASDAQ 100 index) and SPY (which tracks the S&P 500 index). Of course when you sell ETFs for short-term gains, you must pay your regular federal tax rate, which can be as high as 39.6 percent. The same is true for short-term gains from precious metal EFTs like GLD or SLV. Even long-term gains from precious metal ETFs can be taxed at up to 28 percent, because the gains are considered collectibles gains.

There is a way to play the market in a short-term fashion while paying a lower tax rate on gains. Consider trading in broad-based stock index options.

Favorable Tax Rates on Short-Term Gains From Trading in Broad-Based Stock Index Options

The IRC treats broad-based stock index options, which look and feel a lot like options to buy and sell comparable ETFs, as *IRC Section 1256 contracts*. Specifically, broad-based stock index options fall into the non-equity option category of IRC Section 1256 contracts. [See IRC Section 1256(b)(1) and (g)(3) and IRS Publication 550 (Investment Income and Expenses) under the heading "Section 1256 Contracts Marked to Market."]

IRC Section 1256 contract treatment is a good deal for investors because gains and losses from trading in IRC Section 1256 contracts are automatically considered to be 60 percent long-term and 40 percent short-term [IRC Section 1256(a)(3)]. So your actual holding period for a broad-based stock index option doesn't matter. The tax-saving result is that short-term profits from trading in broad-based stock index options are taxed at a maximum effective federal rate of only 27.84 percent [(60% × 20%) + (40% × 39.6%) = 27.84%]. If you're in the top 39.6 percent bracket, that's a 29.7 percent reduction in your tax bill. The effective rate is lower if you're not in the top bracket. For example, if you're in the 25 percent bracket, the effective rate on short-term gains from trading in broad-based stock index options is only 19 percent [(60% × 15%) + (40% × 25%) = 19%]. That's a 24 percent reduction in your tax bill. (Of course, the 3.8 percent NIIT can potentially apply too, for higher-income individuals).

Key point: With broad-based stock index options, you pay a significantly lower tax rate on gains without having to make any long-term commitment. That's a nice advantage.

Favorable Treatment for Losses Too

If an individual taxpayer suffers a net loss from IRC Section 1256 contracts, including losses from broad-based stock index options, an election can be made to carry back the net loss for three years to offset net gains from IRC Section 1256 contracts recognized in those earlier years, including gains from broad-based stock index options [IRC Section 1212I]. In contrast, garden-variety net capital losses can only be carried forward.

Yearend Mark-to-Market Rule

As the price to be paid for the aforementioned favorable tax treatment, you must follow a special mark-to-market rule at yearend for any open positions in broad-based stock index options [IRC Section 1256(a)]. That means you pretend to sell your positions at their yearend market prices and include the resulting gains and losses on your tax return for that year. Of course if you don't have any open positions at yearend, this rule won't affect you.

Reporting Broad-Based Stock Index Option Gains and Losses

According to IRS Publication 550, both gains and losses from closed positions in broad-based stock index options and yearend mark-to-market gains and losses from open positions are reported on Part I of Form 6781 (Gains and Losses from IRC Section 1256 Contracts and Straddles). The net short-term and long-term amounts are then transferred to Schedule D.

Finding Broad-Based Stock Index Options

A fair number of options meet the tax-law definition of broad-based stock index options, which means they qualify for the favorable 60/40 tax treatment. You can find options that track major stock indexes like the S&P 500 and the Russell 1000 and major industry and commodity sectors like biotech, oil, and gold. One place to identify options that qualify as broad-based stock index options is http://tradelogsoftware.com/resources/options/broad-based-index-options.

Although trading in these options is not for the faint-hearted, it's something to think about if you consider market volatility to be your friend.

KNOWLEDGE CHECK

4. How are short-term profits from trading in broad-based stock index options taxed?

   a. As 40 percent long-term capital gain and 60 percent short-term gain.
   b. As short-term capital gains (that is, ordinary income).
   c. As 60 percent long-term capital gain and 40 percent short-term gain.
   d. As ordinary income.

GIFTS OF APPRECIATED SECURITIES

High-bracket clients should consider gifting away appreciated securities to their low-bracket children and grandchildren (assuming the "kiddie tax" does not apply). For instance, if your client has an adult child. The client can give the child up to $14,000 worth of appreciated securities without any adverse gift or estate tax consequences for the client. So can the client's spouse. The child can then sell the appreciated securities and pay 0 percent of the resulting long-term capital gains to the U.S. Treasury (assuming the child is in the 10 percent or 15 percent tax bracket). The same 0 percent rate applies to qualified dividends collected from dividend-paying shares the child receives as gifts from the parents (again assuming the child is in the 10 percent or 15 percent bracket). For this idea to work, however, client and child must together hold the appreciated securities for more than one year. Beware: this strategy can backfire if the child is younger than age 24. Under the kiddie tax rules, some or all of the youngster's capital gains and dividends may be taxed at the parents' higher rate. That would defeat the purpose of this strategy.

SELLING THE RIGHT LOSERS

For yearend tax planning purposes, it is generally more advisable to sell short-term losers as opposed to long-term losers because short-term losses offset short-term gains that would otherwise taxed at ordinary income rates of up to 39.6 percent.

KNOWLEDGE CHECK

5. For year-end tax planning purposes, why is it generally more advisable to sell short-term losers as opposed to long-term losers?

   a. Because short-term losses offset long-term gains that would otherwise be taxed at a maximum rate of 15 percent or 20 percent.
   b. Because short-term losses offset short-term gains that would otherwise taxed at ordinary income rates of up to 39.6 percent.
   c. Because short-term losses can offset ordinary income without any limitation.
   d. Because the Investor Tax Credit can be claimed for short-term losses.

Tax-Smart Strategies for Fixed-Income Investments

The federal income tax rate structure penalizes holding ordinary-income-producing investments in taxable account compared to stocks that the client expects to generate qualified dividends and long-term capital gains. Strategy: clients should generally put fixed-income assets that generate ordinary income (like Treasuries, corporate bonds, and CDs) into their tax-deferred retirement accounts. That way they will avoid the tax disadvantage.

The federal income tax rate structure also penalizes holding REIT shares in a taxable account compared to garden-variety corporate shares that the client expects to generate qualified dividends and long-term capital gains. As you know, REIT shares deliver current income in the form of high-yielding dividend payouts, plus the potential for capital gains, plus the advantage of diversification. These are all desirable attributes to have inside a tax-deferred retirement account. Inside a taxable account, however, REIT shares receive less-favorable treatment than garden-variety corporate shares because their dividend payments are not treated as qualified dividends. Strategy: the tax-deferred retirement account is now generally the best place to keep one's REIT stock investments.

Borrowing to Buy Dividend-Paying Stocks Is Usually Inadvisable

Your individual client can borrow money to acquire dividend-paying stocks for taxable investment account. Then he or she can deduct the interest expense against an equal amount of ordinary income that would otherwise be taxed at up to 39.6 percent. Meanwhile, the client pays a reduced rate (0 percent/ 15 percent/ 20 percent) on all the qualified dividends and long-term capital gains thrown off by his or her savvy stock investments. Although this may seem like a good idea, let us take a closer look.

First, many individuals will find themselves unable to claim current deductions for some or all of the interest expense from borrowing to buy investments. Why? Because a loan used to acquire investment assets generates investment interest expense. Unfortunately, investment interest can only be deducted to the extent of the individual's net investment income for the year [IRC Section 163(d)]. Any excess investment interest is carried over to the next tax year and subjected to the very same net investment income limitation all over again.

Net investment income means interest, net short-term capital gains (excess of net short-term capital gains over net long-term capital losses), certain royalty income, and the like reduced by allocable investment expenses (other than investment interest expense). Investment income does not include net capital gains (excess of net long-term capital gains over net short-term capital losses). Under the current rules, investment income does not include qualified dividends either [IRC Section 163(d)(4)(B)].

Despite the preceding general rules, an individual can elect to treat specified amounts of net capital gain and qualified dividends as investment income in order to "free up" a bigger current deduction for investment interest expense. If the election is made, the elected amounts are treated as ordinary income and are taxed at regular rates [IRC Sections 1(h)(2) and 1(h)(11)(D)(i)]. So when the election is made, the increased investment interest deduction and the elected amounts of net capital gains and qualified dividends wind up offsetting each other at ordinary income rates. As a result, there is generally no tax advantage to borrowing in order to buy stocks. (The exact tax results of making or not making the election are explained in detail later in this chapter.) The big exception is when the individual can avoid making the election because he or she has sufficient investment income (generally from interest and short-term capital gains) to currently deduct all of the investment interest expense.

Even when the investment interest expense limitation can be successfully avoided, there is another tax-law quirk to worry about. It arises when the client borrows to acquire stocks via the brokerage firm margin account. The brokerage firm can lend to short sellers shares held in the client's margin account worth up to 140 percent of the margin loan balance. As compensation, the client then receives payments in lieu of dividends. These payments compensate the client for dividends that would have otherwise been received from the shares that were lent out to short sellers. Unfortunately, these payments in lieu of dividends do not qualify for the reduced tax rates on dividends. Instead, the payments are considered to be ordinary income.

Key point: The tax planning solution is to keep dividend-paying stocks in a separate brokerage firm account that has no margin loans against it.

Purely from a tax perspective, one scenario where it could make sense to borrow to buy dividend-paying stocks is when the client uses home equity loan proceeds to do the deal. Assuming the client can deduct all the interest on the home equity loan, this is a tax-favored arrangement. However, borrowing against one's home to invest in the stock market is obviously a risky business.

VARIABLE ANNUITIES ARE DAMAGED GOODS

Variable annuities are basically mutual fund investments wrapped up inside a life insurance policy. Earnings are tax-deferred, but they are treated as ordinary income when withdrawn. So the investor pays his or her regular tax rate at that time even if most or all of the variable annuity's earnings were from dividends and capital gains that would otherwise qualify for the reduced 0 percent/ 15 percent/ 20 percent rates. This factor, plus the high fees charged by insurance companies on variable annuities, makes these products very problematic. It can take many (too many) years for the tax-deferral advantage to overcome the inherent disadvantages. If the investor ever catches up at all, that is.

Planning for Mutual Fund Transactions

When clients are considering selling appreciated mutual fund shares near year-end, they should pull the trigger before that year's dividend distribution. That way, the entire gain—including the amount attributable to the upcoming dividend—will be taxed at the reduced 0 percent/ 15 percent/ 20 percent rates (assuming the shares have been held more than 12 months). In contrast, if the client puts off selling until after the "ex-dividend" date, he or she is locked into receiving the payout. Some of that will probably be taxed at ordinary rates. In other words, inaction can convert a low-taxed capital gain into an ordinary income dividend taxed at up to 39.6 percent.

For the same reason, it can pay to put off buying into a fund until after the ex-dividend date. If the investor acquires shares just before the magic date, he or she will get the dividend and the tax bill that comes along with it. In effect, the investor will be paying taxes on gains earned before buying in. Not a good idea.

To get the best tax results, the client should be advised to contact the fund and ask for the expected year-end payout amount and the ex-dividend date. Then transactions can be timed accordingly.

The good thing about equity mutual funds is they are managed by professionals. These taxpayers should be (better be) well-qualified to judge which stocks are most attractive, given the client's investment objectives. The bad thing about funds (besides the fees) is that the client has virtually no control over taxes.

The fund—not the client—decides which of its investments will be sold and when. If its transactions during the year result in an overall gain, the client will receive a taxable distribution (in other words, a dividend) whether he or she likes it or not. This is because funds are required to pass out almost all of their gains every year or pay corporate income tax. (The special federal income tax rules for mutual funds are found in IRC Section 852.) When the client gets a distribution, he or she will owe the resulting tax bill even though the fund shares may have actually declined because he or she bought in.

This *unwanted distribution* issue is less of a problem with index funds and tax-efficient (a.k.a., tax-managed) funds. Index funds essentially follow a buy and hold strategy, which tends to minimize taxable distributions. Tax-efficient funds also lean towards a buy-and-hold philosophy, and when they do sell securities for gains, they attempt to offset them by selling some losers in the same year. This approach also minimizes taxable distributions.

In contrast, funds that actively "churn" their stock portfolios in attempting (sometimes futilely) to maximize returns will usually generate hefty annual distributions in a rising market. The size of these payouts can be annoying enough, but it is even worse when a large percentage comes from short-term gains. They are taxed at the investor's ordinary rate (as high as 39.6 percent). Not good.

On the other hand, funds that buy and hold stocks will pass out distributions mainly taxed at the reduced rates for long-term gains.

The bottom line: If the client will be investing via taxable accounts, he or she should really look at what kind of *after-tax* returns various funds have been earning and use these figures in picking between competing funds.

Now, if the client is using a tax-deferred retirement account (IRA, 401(k), and so on) or a tax-free Roth IRA to hold the mutual fund investments, the client can focus strictly on total return and ignore all this stuff about tax woes from distributions.

With the basics behind us, let us cover some specifics about how mutual fund investments are taxed.

IDENTIFYING SALE TRANSACTIONS

Like regular stock shares, mutual fund shares can be sold outright. The client can sell and get cash on the barrelhead. When this happens, the client is (hopefully) well aware that he or she must figure the capital gain or loss for tax purposes. Mutual fund companies allow investors to make other transactions that are also treated as taxable sales—or not, depending on the circumstances. The added convenience is fine and dandy, as long as the client understands the tax ramifications. Here are the three biggest problem areas:

- Client can write checks against his or her account with the cash coming from liquidating part of the investment in fund shares. When the client takes advantage of this arrangement, he or she has made a sale and must now calculate the taxable gain or loss on the deal.
- Client switches the investment from one fund in a mutual fund family to another. This is a taxable sale.
- Client decides to sell 200 shares in a fund for a tax loss. Because the client participates in the fund's dividend reinvestment program, he or she automatically buys 50 more shares in that same fund within 30 days before or after the loss sale. For tax purposes, the client made a wash sale of 50 shares. As a result, the tax loss on those shares is disallowed. However, the client does get to add the disallowed loss to his or her tax basis in the 50 shares acquired via dividend reinvestment.

Once it is determined that there has indeed been a taxable sale, the next step is to compute the capital gain or loss. For this, we need to know the tax basis of the shares that were sold.

CALCULATING MUTUAL FUND SHARE BASIS

When blocks of fund shares are purchased at different times and prices, think of it as creating several layers—each with a different per-share price. When some of the shares are sold, we need some method to determine which layer those shares came from so we can figure their tax basis and calculate the capital gain or loss. Three methods are available:

1. First in, first out (FIFO)
2. Average basis
3. Specific identification

FIFO Method

FIFO assumes the shares that are sold come from the layers purchased first. In rising markets, FIFO gives the worst tax answer because it maximizes gains. However, FIFO must be used unless the client takes action to use the average basis or specific ID methods explained later.

Example 1-1

- Fred bought his first 200 shares in the SoSo Fund for $10 each (the first layer).
- Later, he bought another 200 shares at $15 (the second layer).
- He then sold 160 shares at $17.50.
  - Under FIFO, the client is considered to have sold his shares out of the first layer, which cost only $10 each. His capital gain is $1,200 ($2,800 proceeds, less $1,600 basis).

Average Basis Method

Using this method, the investor figures the average basis in fund shares any time a sale is made.

Example 1-2

- Assume the same situation as in the previous example, except Fred uses the average basis method to calculate his gain or loss.
- The average basis per share is $12.50 ($5,000 total cost divided by 400 shares).
  - Now the capital gain is only $800—$2,800 proceeds less basis of $2,000 (160 shares times $12.50 per share).

Most mutual funds report average basis information on transaction statements sent to investors. So there may be no need to make any calculations. However the taxpayer must make the notation *average basis method* on the line of Schedule D where the gain or loss is reported. The taxpayer must then use the average basis method for all future sales of shares in that particular fund.

Specific ID Method

Using this method, the client specifies exactly which shares to sell by reference to the acquisition date and per-share price. Most mutual funds require written instructions by letter or fax. According to the IRS guidelines, the fund or broker must then follow up by confirming the client's instructions in writing. The specific ID method allows the client to sell the most expensive shares to minimize gain. Remember, the client must take action at the time of the sale. If the client waits until tax return time to get interested in this idea, he or she will have missed the boat.

Written confirmations from funds or brokers are a nicety that may be unavailable in today's world of discount brokerage firms and online trading. So what are clients supposed to do when they want to use the specific ID method? According to the Tax Court, it is sufficient for the client to give oral instructions regarding the shares to be sold. [See *Concord Instruments Corp.*, TC Memo 1994-248 (1994).]

If this is done, the client need not receive a written confirmation from the fund or broker. However, the client must still maintain some sort of proof regarding the oral instructions given to the fund or broker. Scribbling a note on the hard copy transaction statement or keeping a log with one's tax records should do the trick. That said, written confirmations are always the best proof, when available.

Example 1-3

- Same situation as in the preceding examples, except Fred specifies he is selling 100 shares from the second block (costing $15 each) and 60 from the first (costing $10 each).
  - Using the specific ID method to calculate his gain or loss, the basis of the shares sold is $2,100 [(100 × $15) + (60 × $10)]. Now the capital gain is now only $700 – $2,800 proceeds, less basis of $2,100.

Mutual Fund Aggregate Basis Worksheet

The original cost (including brokerage fees, transfer charges, and load charges) of the shares is the starting point for keeping track of the aggregate tax basis of an investment in a particular mutual fund.

1.	Enter the original cost amount.		
	Now make the following adjustments:		
2.	Increase basis by the amount of reinvested distributions.	+	
3.	Increase basis by the amount of long-term capital gains retained by the fund, as reported on Form 2439 (this is fairly rare).	+	
4.	Decrease basis by the amount of fund-level taxes paid on long-term gains retained by the fund, as reported on Form 2439 (again, fairly rare).	–	
5.	Decrease basis by the amount of basis allocable to shares already sold. (See the following worksheet for the basis of shares sold using the average cost method.)	–	
6.	The result is the aggregate tax basis of the remaining fund shares. If one sells one's entire holding in the fund, subtract this aggregate basis figure from the net sales proceeds to calculate the gain or loss. (If one sells some but not all of one's shares, see the following worksheet to figure the capital gain or loss.)	=	

Mutual Fund Capital Gain or Loss Worksheet Using Average Basis Method

Use this worksheet to calculate gain or loss each time an investor sells some but not all of his or her shares in a particular fund for which the average basis method is used. (If the investor sells all of the shares in the same transaction, skip lines 2–4, and simply enter the amount from line 1 directly on line 5.)

1.	Aggregate basis of shares in this fund at the time of sale (from previous worksheet).	
2.	Number of shares owned just before selling.	
3.	Divide line 1 by line 2. This is the average basis.	
4.	Number of shares sold in this transaction.	
5.	Multiply line 3 by line 4. This is the basis of the shares that were sold, using the average basis method.	
6.	Total sales proceeds (net of commissions).	
7.	Subtract line 5 from line 6. This is the taxable capital gain or loss.	

Foreign Taxes on International Funds

If the client invests in international mutual funds, the year-end statements may reveal that some foreign taxes were paid. The client can either deduct the share of those taxes (on Schedule A) or claim a credit against his or her U.S. taxes. Generally, taking the credit is the best option. To take a credit more than $300 ($600 for a joint return), Form 1116 (Foreign Tax Credit) must be filed. If the client has smaller amounts of foreign taxes (no more than $300 or $600 if filing jointly) solely from interest and dividends (such as via international mutual funds), the credit can be entered directly on the appropriate line on page 2 of Form 1040 without filing Form 1116. (See IRS Publication 514, "Foreign Tax Credit for Individuals," for help in preparing Form 1116.)

Converting Capital Gains and Dividends Into Ordinary Income to Maximize Investment Interest Write-Offs

Individuals incurring investment interest expense must include Form 4952 (Investment Interest Expense Deduction) with their returns. The form limits the itemized deduction for investment interest to the amount of "investment income" from interest, short-term capital gains, and so on. [IRC Section 163(d)]. If there is insufficient investment income, the taxpayer can elect to make up some or all of the difference by treating a designated amount of long-term capital gain or qualified dividends as investment income taxed at ordinary rates [IRC Section 163(d)(4)(B)].

The election is made by reporting the amount of long-term capital gain or qualified dividends to be treated as investment income on Form 4952 (the same number is then entered on Schedule D). The amount of gain or qualified dividends so treated can be as much or as little as the taxpayer wishes, but any gain must come from investment assets rather than business assets or rental real estate [IRC Section 163(d)(5)]. In other words, the gain cannot be IRC Section 1231 gain treated as long-term capital gain. The taxpayer then has that much more investment income, which allows the deduction of that much more investment interest expense.

If the election is made, capital gains qualifying for the 15 percent and 20 percent rates are converted before gains taxed at 28 percent. Most taxpayers will not actually have any 28 percent gains and gains qualifying for the 25 percent rate do not come into play here because they are from IRC Section 1231 property.

When 15 percent gains are converted, taxpayers in the 25 percent bracket essentially pay a 10 percent tax for the privilege of deducting more investment interest currently, those in the 28 percent bracket pay 13 percent, those in the 33 percent bracket pay 18 percent, and those in the 35 percent bracket pay 20 percent. Therefore, taxpayers in these brackets will recognize a 15 percent net tax benefit from converting long-term gains into ordinary income.

Taxpayers in the paying 39.6 percent bracket will pay 19.6 percent to convert gains that would otherwise be taxed at 20 percent. Therefore, taxpayers in the 39.6 percent bracket will recognize a net 20 percent tax benefit from converting long-term gains into ordinary income (39.6 percent deduction for the extra investment interest expense minus the 19.6 percent cost for converting gains).

HOW TO MAKE THE ELECTION

The election is made by reporting the elected amount (that is, the amount of qualified dividend income or net capital gain to be treated as investment income taxed at ordinary rates) on line 4g of Form 4952. The elected amount is then "backed out" of the amounts eligible for preferential tax rates via calculations made on those fun-filled Schedule D worksheets.

According to the Form 4952 instructions, the elected amount indicated on line 4g is normally deemed to come first from the taxpayer's net capital gain from property held for investment (shown on line 4e), and then from qualified dividend income (shown on line 4b). However, per the instructions, the taxpayer can choose different treatment by making a notation on the dotted line to the left of the box on line 4e.

Key point: According to Regulation 1.163(d)-1, the election can be revoked only with IRS consent.

ELECTION IS NOT A NO-BRAINER

The following examples illustrate that making the election is not always advisable.

Example 1-4

- Buck (a 35 percent bracket taxpayer) has $6,000 of 2016 investment interest expense, but his investment income from interest and short-term capital gains is only $2,500. He also has several significant 15 percent long-term capital gains from stock and mutual fund transactions.
  - Making the election to convert $3,500 of long-term capital gain into investment income lets Buck deduct all his investment interest. At a marginal rate of 35 percent, $1,225 comes off his 2016 tax bill ($3,500 × 35%).
  - But he would also pay an extra 20 percent on the $3,500 of converted long-term gain because that amount would be taxed at 35 percent instead of 15 percent. The extra tax would amount to $700 ($3,500 × 20%).
  - The net tax savings are $525 ($1,225 minus $700), so Buck realizes a net 15 percent tax benefit from the bigger deduction $525/$3500 = 15%). (He will realize a 15 percent tax benefit if his marginal federal income tax rate is 25 percent, 28 percent, 33 percent, or 35 percent.)

What to do (or not do) in this situation? Clients should consider passing on the election. The 2016 excess investment interest expense ($3,500 in Buck's case) will carry over into 2017 when he may have enough investment income to fully deduct the carryover, plus any investment interest incurred this year.

If his 2017 investment income is high enough, the client will realize a 25 percent, 28 percent, 33 percent, 35 percent, or 39.6 percent tax benefit from the carryover without paying any extra tax on his capital gains. Of course, there is a time value of money advantage to making the election and claiming a bigger 2016 investment interest expense deduction, but a bigger 2017 tax benefit might more than make up the difference.

Example 1-5

- Assume the same facts as example 1-4, except Buck carries over the $3,500 excess investment interest and deducts it in 2017. (Assume Buck already knows he will have plenty of 2017 investment income, because he has decided the stock market is overvalued and has therefore allocated a bigger percentage of his investment assets to fixed income assets and dividend-paying stocks.)
  - Assuming the 35 percent marginal rate still applies to Buck in 2017, the $3,500 deduction for the investment interest expense carried over from 2015 saves him $1,225 on his 2017 federal income tax bill ($3,500 × 35%).

Of course, if the client cannot foresee having enough investment income anytime soon, he or she should make a current-year election to convert enough long-term capital gain to fully deduct the full amount of his or her current-year investment interest expense. This will result in only a 15 percent net tax benefit (if the client is in the 25 percent, 28 percent, 33 percent, or 35 percent marginal bracket) or a 19.6 percent net tax benefit (if the client is in the 39.6 percent marginal bracket), but that is better than waiting indefinitely for the write-off.

KNOWLEDGE CHECK

6. With regard to the election to treat long-term capital gains and qualified dividends as investment income,

   a. The election should almost always be made.
   b. The election should almost never be made.
   c. The election should be strongly considered when it appears unlikely that the client will have sufficient investment income in future years.
   d. The election should be strongly considered when it appears highly likely that the client will have sufficient investment income in future years.

Planning for Capital Gain Treatment for Subdivided Lot Sales via IRC Section 1237 Relief

When a landowner subdivides a parcel to sell off individual lots, he or she is generally considered a real estate dealer, and the lots represent *inventory*. As a result, gains from the lot sales are taxed as ordinary income.

Fortunately, IRC Section 1237 provides an exception to ordinary income treatment. Subject to the limitations explained in the following section, the seller will not be considered a dealer merely because the land has been subdivided into lots or because of advertising, promotion, selling activities, or the use of sales agents.

In other words, if the seller was holding the land for investment, subsequent subdividing and selling activities will not cause the property to be transformed into inventory, and the seller can still take advantage of the reduced 0 percent/ 15 percent/ 20 percent rates on long-term capital gains from sales of lots held more than 12 months. (The 3.8 percent NIIT can also apply to capital gains recognized by higher-income individuals.)

RESTRICTIONS ON IRC SECTION 1237 RELIEF

Needless to say, Congress has imposed some restrictions on the availability of IRC Section 1237 relief:

1. Relief is unavailable to taxpayers whose activities with respect to their other land holdings indicate they are real estate dealers [Regulation Section 1.237-1(a)].
2. Relief is generally unavailable to C corporation sellers [IRC Section 1237(a)]. However it is available to individuals; partnerships; LLCs treated as partnerships for federal income tax purposes; and S corporations.
3. The seller must have held the property for at least five years unless it was inherited. However, under IRC Section 1223, the seller's holding period may include that of a previous owner in certain circumstances. [See examples in Reg. Sec. 1.1237-1(b) and (c).]
4. The land in question must be a *tract of real property* as defined by IRC Section 1237(c) and Reg. Sec. 1.1237-1(g).
5. The seller cannot have ever held any portion of the land for sale in the ordinary course of business (in other words, as inventory); and in the year of sale, the seller cannot hold any other real property primarily for sale in the ordinary course of business.
6. The seller cannot have made any substantial improvements that materially increased the value of the lots that are sold, nor can such improvements be made pursuant to the contract for sale between the seller and buyer. Improvements made by certain related parties (such as a controlled corporation) are considered made by the seller [IRC Section 1237(a)(2)(A) and Reg. Sec. 1.1237-1(c)].
7. After more than five lots from the same tract have been sold, gains from lot sales in the year the sixth lot is sold, and in later years, are ordinary income to the extent of 5 percent of the sales price for those lots [IRC Section 1237(b)].

For purposes of the preceding rules, the seller is treated as holding other real estate owned individually, jointly, indirectly as a member of a partnership or LLC, or indirectly as an S corporation shareholder [Reg. Sec. 1.1237-1(b)(3) and Committee Reports on IRC Section 1314 of Small Business Protection Act of 1996].

However, the seller is generally not treated as indirectly holding other real estate owned by family members, estates, trusts, or C corporations [Reg. Sec. 1.1237-1(b)(3)].

As stated in item 6, substantial improvements made by certain other parties (including the buyer if pursuant to the sales contract) are considered made by the seller and can disqualify the seller from IRC Section 1237 relief.

Example 1-6

- Wayne, who is not a real estate dealer, is a member of an LLC engaged in real estate development. Assume the LLC is a dealer because it holds real estate primarily for sale in its development business. During the year, Wayne subdivides a tract he has owned for many years and sells off four lots for large gains.
  - Unfortunately, Wayne is treated as an owner of the LLC's real estate and is therefore disqualified from IRC Section 1237 relief (see item 5). As a result, Wayne's lot sale gains will be taxed as ordinary income.
  - However, if the real estate development entity was a C corporation (rather than an LLC) and Wayne was a shareholder, his indirect ownership of the C corporation's real estate would not disqualify him from IRC Section 1237 relief. In this circumstance, Wayne could treat his lot sale gains as long-term capital gains subject to reduced tax rates, assuming he also meets all the other IRC Section 1237 requirements.

Example 1-7

- Belinda, who is a real estate dealer, sells four subdivided lots from a single tract she owns.
  - Because Belinda is a dealer during the year she sells the lots, IRC Section 1237 relief is unavailable (see item 1). Accordingly, she will have to pay ordinary income rates on her lot sale gains.

Example 1-8

- Victoria's rich Uncle Dudley gave her a small but valuable real estate tract as a gift. Uncle Dudley made his millions as a real estate developer. He held the tract for four years and intended to subdivide the property and sell off lots in the ordinary course of his business.
- Victoria holds the tract for three years and then subdivides the parcel. She succeeds in selling three lots for large gains.
  - Under IRC Section 1223, Victoria's holding period for the property includes her Uncle Dudley's holding period because she received the tract as a gift. Victoria therefore meets the five-year rule.
  - However, the regulations say she is disqualified from IRC Section 1237 relief because of Uncle Dudley's motive for owning the property, unless Victoria can demonstrate that she did not also hold the tract primarily for sale in the ordinary course of business [Reg. Sec. 1.1237-1(b)(3)]. (Apparently, Victoria could prove this by showing she intended to hold the tract for investment for several years before later deciding to subdivide the property and sell it off as lots.)

Example 1-9

- Rhonda is a CPA who sometimes buys raw land for investment. She has no other activities that would indicate she is a real estate dealer. During the year, Rhonda sells three tracts acquired five years ago for substantial profits.
  - She can treat the gains as long-term capital gains and pay a reduced tax rate. She does not need IRC Section 1237 relief (nor does she qualify for it), because the tracts were investment property and were not subdivided and sold off as lots.
  - The same result would apply if Rhonda is considered a dealer in real estate, as long as she can prove her reason for holding the three tracts in question was for investment rather than primarily for sale in her business as a real estate dealer.

DEFINITION OF TRACT OF REAL PROPERTY

IRC Section 1237 relief is available only if the subdivided land constitutes a "tract of real property." (See item 4.) In general, this means a single piece of real estate. However, two or more pieces can qualify if at any time they were contiguous (that is, having a common boundary at one or more points) in the hands of the seller, or if the pieces would be contiguous but for a road, street, railroad, stream, and so on [IRC Section 1237(c) and Reg. Sec. 1.1237(g)(1)].

A tract of real property can be assembled from acquisitions at various times, and the seller can treat contiguous pieces as a single tract even though some pieces are owned individually; some jointly; and some indirectly as a partner, member of an LLC, or for tax years beginning after 1996 as an S corporation shareholder.

For counting purposes under the *five lot rule* (see item 7), the remaining lots in a tract of real property constitute a new tract after one or more lots have been sold from the original tract and five years have passed since the last sale from the original tract.

DEFINITION OF SUBSTANTIAL IMPROVEMENT

Per item 6, the lot seller cannot make *substantial improvements* that *substantially increase* the value of the lots. Similarly, such improvements cannot be made under the terms of the contract for sale between the seller and buyer. Improvements made by certain related parties (such as the seller's controlled corporation) are considered made by the seller [IRC Section 1237(a)(2)(A) and Reg. Sec. 1.1237-1(c)(2)].

To restate the rule, improvements result in disqualification for IRC Section 1237 relief only if (1) they are substantial in character and (2) they substantially enhance the value of the lot that is sold.

Under the regulations, substantial improvements include commercial or residential buildings; hard surface roads; and sewer, water, gas, and electric lines. Examples of insubstantial improvements include a temporary structure used as a field office; surveying, filling, draining, leveling, and clearing operations; and minimum all-weather access roads, including gravel roads where required by the climate [Reg. Sec. 1.1237-1(c)(4)].

Even substantial improvements will not disqualify the seller from IRC Section 1237 relief for a particular lot sale unless it also directly and substantially enhances the value of that specific lot. What is *substantial*? According to Reg. Sec. 1.1237-1(c)(3), an increase of 10 percent or less is insubstantial, and when improvements increase value by more than 10 percent, all relevant factors should be examined to determine if the increase is substantial.

Under these rules, the values of particular lots could be substantially increased by improvements, but the values of other lots are not. Therefore, some lots may become ineligible for IRC Section 1237 relief, and certain other lots in the same tract still qualify.

Example 1-10

- Vern made major improvements to a tract he had owned for two years. He then made a gift of the property to his son Delgado. Four years later, Delgado subdivided the tract and began selling off lots.
  - Vern's improvements substantially enhanced the value of the lots. Delgado is therefore ineligible for IRC Section 1237 relief because he is treated as having made the improvements that Vern paid for (see item 6).

Election to Disregard Substantial Improvements

Individual taxpayers may be eligible for a special election to treat otherwise disqualifying improvements as not being substantial. The election is available if all the following requirements are met:

1. The seller agrees to not deduct the costs of the improvements or add the costs to the basis of the lot or lots sold.
2. The seller has held the property for 10 years (not counting ownership by the previous owner if the property was inherited).
3. The improvements are limited to roads (including hard surface roads), curbs, and gutters; and water, sewer, and drainage facilities (including both surface and subsurface facilities).
4. The IRS District Director is satisfied that the improvements are necessary to bring the fair market value (FMV) of the lot (or lots) up to the prevailing value for similar sites in the local area. The specifics on how to make this election are covered in Reg. Sec. 1.1237-1(d)(iii). Obviously the election is advisable only when the tax savings from IRC Section 1237 relief outweigh the tax detriment of ignoring the improvement costs.

Situations where the election could make sense include the following:

1. The seller has capital loss carryovers that will shelter all or part of the capital gain from selling the lots (without IRC Section 1237 relief, capital loss carryovers would not shelter the lot sale gains because the gains would be ordinary income).
2. The gains are large in relation to the improvement costs and the tax savings from the reduced long-term capital gain tax rates outweigh the tax benefit from adding the improvement cost to the basis of the lots.

Keep in mind the election is available only when the improvements are necessary to bring the price of the lots up to the prevailing market. If the seller can get market price without the making the improvements, the election is not an option.

Example 1-11

- Tom, who is in the 39.6 percent marginal tax bracket, owns a five-acre tract of unimproved land in a highly desirable residential area. Tom has owned the land for 14 years, and his basis is only $80,000. He wants to subdivide the property into five one-acre lots, in accordance with the local zoning restrictions.
- Unfortunately, Tom's land has some serious (but correctable) drainage problems and is therefore much less valuable than similar nearby unimproved sites. Tom recently received a written offer of $100,000 per acre for his parcel (total of $500,000). Similar nearby improved tracts (with road and drainage improvements) are selling for $200,000 per acre, and the improvements to these similar properties cost an average of about $50,000 per acre.
- According to the IRC Section 1237 regulations, this makes the prevailing market price for comparable unimproved acreage about $150,000 per acre ($200,000 less $50,000). Assume Tom can install a road and correct the drainage problems on all five lots for a total of $325,000. The lots could then be sold for around $200,000 each (total of $1,000,000).

Example 1-11 (continued)

- Tom's proposed improvements would clearly be substantial in character and result in a substantial increase in the value of the lots. However, based on the offer Tom received, the improvements are needed just to raise the value of the lots to the prevailing level. Therefore, Tom is eligible to make the election to treat the improvements as not substantial and ignore their cost in calculating his gain from sale.
  - If Tom makes the improvements for the expected cost, sells the lots for the expected price, and makes the election, he will have a long-term capital gain of $920,000 ($1 million sales proceeds less $80,000 basis), and his federal income tax hit at 20 percent will be $184,000. (The 20 percent rate applies only because the election allows Tom to qualify for IRC Section 1237 relief.) In contrast, if Tom does not make the election, his gain will be only $595,000 ($1 million sales proceeds less basis of $405,000, including the cost of improvements), but the tax on that amount at 39.6 percent is $235,620.
  - In this example, making the election saves the taxpayer $51,620 ($235,620–$184,000) based on current tax rates. (This example ignores the potential impact of the 3.8 percent NIIT.)

THE SIX LOT RULE

Under the IRC Section 1237 rules, when more than five lots from the same tract of real property are sold, gains from lot sales in the year the sixth lot is sold and in later years are treated as ordinary income to the extent of 5 percent of the selling price for each affected lot [IRC Section 1237(b)].

Note that lot sales in tax years before the sale of the sixth lot are unaffected by this gain recharacterization rule, but if more than five lots are sold in the first year of sales, all sales are affected.

The amount of gain that is re-characterized as ordinary income is limited to the excess (if any) of 5 percent of the selling price over the selling expenses for the lot. [See Reg. Sec. 1.1237-1(e)(2) for examples of how this limitation is calculated.] The sale of two or more contiguous lots to the same buyer in the same transaction counts as only one lot sale for purposes of the six-lot rule [Reg. Sec. 1.1237(e)(2)].

In addition, the remaining lots in a particular tract of real property constitute a new tract after one or more lots have been sold from the original tract and five years have passed since the last sale from the original tract. Under this *fresh start* provision, the remaining lots need not still be contiguous to qualify as a single new tract [IRC Section 1237(c) and Reg. Sec. 1.1237(g)(2)].

Example 1-12

- Neville has owned a tract of raw land for six years. In 2015, he subdivides the property into 12 lots and immediately sells single lots to Horace, Evander, Desiree, and Dolly. At the same time, he also sells three contiguous lots to Emory.
  - Under the six-lot rule, Neville is treated as selling only five lots because the three contiguous lots sold to Emory count as only one. Assuming Neville meets all the other IRC Section 1237 requirements discussed earlier, his lot sale gains are all long-term capital gains eligible for preferential tax rates.
- Neville then waits for five years without selling any further lots.
  - His remaining five lots now constitute a new tract of real property for purposes of the six-lot rule (even if some 2015 sales caused the remaining lots to be noncontiguous). Neville can then sell the remaining lots without having to worry about the gain recharacterization rule.

KNOWLEDGE CHECK

7. The fundamental intent of IRC Section 1237 is to allow qualifying taxpayers to

   a. Sell subdivided lots of real property free of any federal income tax.
   b. Pay capital gains tax rates on profits from selling lots.
   c. Pay ordinary income tax rates on profits from selling lots.
   d. Deduct accrued interest on mortgaged lots.

Land Is Not Always a Capital Asset

In two 2014 decisions, the Tax Court and a California District Court ruled that gains from land sales were high-taxed ordinary income rather lower-taxed long-term capital gains (*Cordell Pool,* TC Memo 2014-3 and *Frederic Allen*, 113 AFTR 2d 2014-2262, DC CA 05/28/2014). Here is the scoop on how to determine the federal income tax treatment of land-sale gains.

Capital Gains Tax Basics

Long-term gains recognized by individual taxpayers from the sale of capital assets are taxed at lower federal rates than ordinary income. The current maximum federal income tax rate on net long-term capital gains from most capital assets held for more than one year is "only" 20 percent (plus the 3.8 percent NIIT when applicable).

For real estate, long-term gains recognized by individual taxpayers that are attributable to depreciation are subject to a maximum federal rate of 25 percent (plus the 3.8 percent NIIT when applicable).

In contrast, the maximum federal rate on ordinary income recognized by individual taxpayers is 39.6 percent (plus the 3.8 percent NIIT when applicable or the 0.9 percent additional Medicare tax on salary and self-employment income when applicable).

Key point: Net short-term capital gains recognized by individual taxpayers are taxed at the same high rates as ordinary income and are also potentially subject to the 3.8 percent NIIT.

Land Held as Inventory Is Not a Capital Asset

Preferential tax rates apply only to long-term gains from dispositions of *capital assets*, which do not include property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's business. Such assets are commonly called *inventory*. In determining whether property is inventory (or not), the Tax Court and the Ninth Circuit Court of Appeals have identified the following five factors as relevant.

1. The nature of the acquisition of the property.
2. The frequency and continuity of property sales by the taxpayer.
3. The nature and the extent of the taxpayer's business.
4. Sales activities of the taxpayer with respect to the property.
5. The extent and substantiality of the transaction in question.

Key point: Taxpayers have the burden of proving that they fall on the right side of these factors. If they fail, the IRS wins the argument.

TAX COURT DECISION

In a case decided in early 2014, Concinnity LLC (CL) was classified as a partnership for federal income tax purposes. CL was organized by Cordell Pool, Justin Buchanan, and Thomas Kallenbach (collectively, the taxpayers). These individuals also organized, incorporated, and owned Elk Grove Development Company (EGDC). CL acquired 300 undeveloped acres in Montana for $1.4 million. At the time of the purchase, the land was already divided into four sections (phases 1–4). The land later became the Elk Grove Planned Unit Development (the PUD). CL contracted to give EGDC the exclusive right to purchase from CL phases 1, 2, and 3 which consisted of 300 lots in the PUD. On its 2005 Form 1065, CL reported long-term capital gains totaling $500,761 from two installment sales of the lots in phases 2 and 3. In turn, the three taxpayers (the CL partners) reported their passed-through shares of CL's gains as long-term capital gains on their respective 2005 Forms 1040. After an audit, the IRS claimed that CL's land sales produced ordinary income rather than long-term capital gains and asserted tax deficiencies against the three taxpayers. The unhappy taxpayers took their cases to the Tax Court where they claimed the land sales produced long-term capital gains because the land was held by CL for investment purposes. The Tax Court applied the five factors listed previously and found that none of them weighed in favor of the taxpayers. Therefore, the Tax Court agreed with the IRS that CL's land sale gains should have been reported as high-taxed ordinary income. Here are the details.

Factor No. 1 (Nature of Acquisition)

The IRS claimed that CL acquired the land which came to be included in the PUD to divide and sell lots to customers. Supporting this position was the fact that CL's 2000 Form 1065 identified its principal business activity as "development" and its principal product or service as "real estate." The Tax Court also believed that the record suggested that CL's purpose in acquiring the land was to develop and sell it. Therefore, the Tax Court concluded that evaluation of this factor failed to show that CL held the property for investment rather than as inventory for sale to customers.

Factor No. 2: (Frequency and Continuity of Sales)

The Tax Court noted that frequent and substantial sales of real property indicate sales of inventory in the ordinary course of business; at the same time, infrequent sales indicate property held for investment. In this case, the record was not clear as to the frequency and substantiality of CL's land sales. The Tax Court noted that CL's Forms 1065 reflected two installment sales of lots in phases 2 and 3 to EGDC, and an affidavit stated that CL had directly entered into agreements for the sale of 81 lots in phase 1 without the involvement of EGDC. However, the Tax Court believed that the record was insufficient to establish the overall extent of CL's land sale activities. Therefore, the Tax Court concluded that evaluation of this factor failed to show that CL's land were infrequent or insubstantial.

Factor No. 3 (Nature and Extent of Business)

In evaluating this factor, the IRS claimed that that the only documents in the record indicated that CL brokered land sale deals, found additional investors for necessary development work, secured water and wastewater systems, and guaranteed that necessary improvements were made. The Tax Court agreed that the record showed that CL paid for certain water and wastewater improvements to the PUD and that this level of activity was more akin to a developer's involvement than to an investor's action to simply increase the value of the property. The Tax Court concluded that evaluation of this factor failed to show that CL held Elk Grove PUD land primarily for investment rather than as inventory for sale in the ordinary course of business.

Factor No. 4 (Sales Activities with Respect to the Property)

The record was unclear as to whether CL sought out the 81 individual phase 1 lot buyers or whether those buyers sought out CL. Therefore, the Tax Court concluded that evaluation of this factor failed to show that CL did not spend significant time actively participating in selling lots.

Factor No. 5 (Extent and Substantiality of Transaction)

EGDC agreed to buy the land in Phases 2 and 3 from CL at prices that appeared to be inflated. According to the Tax Court, this indicated that CL did not make bona fide arm's-length sales to EGDC, which was also owned by the three taxpayers. Instead, indications were that EGDC was formed by the taxpayers for tax avoidance reasons: to buy the lots from CL and then sell them to customers in order to avoid the appearance that CL was itself in the business of selling lots to customers. Therefore, the Tax Court concluded that the taxpayers were on the wrong side of this factor.

Bottom Line

Because the taxpayers were not found to be on the right side of any of the five factors, the Tax Court agreed with the IRS that CL held the PUD lots as inventory for sale to customers in the ordinary course of business. Therefore, CL's land sales generated high-taxed ordinary income rather than lower-tax long-term capital gains.

District Court Decision

In *Allen*, a California District Court held that a joint-filing married couple was required to recognize ordinary income rather than long-term capital gain when they received a payment pursuant to a land sale agreement. Factually, Frederic Allen and his wife Phyllis (collectively, the taxpayers) went to District Court seeking a refund of federal income tax assessed by the IRS on $63,662 of income from the sale of 2.63 acres of undeveloped land. The taxpayers claimed that the income was long-term capital gain from selling property held for investment. The IRS said it was ordinary income from the sale of inventory. Allen purchased the land in 1987 and initially testified that that he intended to develop it and sell it himself. He later testified that he bought the land as an investment. Ultimately, he admitted that between 1987 and 1995, he attempted to develop the property by himself. In so doing, he paid for engineering plans and took out a second mortgage. From 1995-1997, he attempted to find investors or partners to help develop and sell the property. In 1999, Allen finally sold the property to Clarum Corporation, a real estate development outfit, in an installment sale deal that was later renegotiated. In 2004, the taxpayers received from Clarum a final installment payment of $63,662, and Clarum issued a Form 1099-MISC to the taxpayers to report the payment. In 2007, the taxpayers finally filed their Form 1040 for 2004, but the return did not report the $63,662 from Clarum. In 2008, they filed an amended return that reported the $63,662 as long-term capital gain.

Using the five-factor analysis explained earlier, the District Court decided that the property was inventory in the taxpayers' hands, because two factors favored that treatment while the other three factors were inconclusive. Therefore, the District Court granted summary judgment in favor of the IRS. So the $63,662 was high-taxed ordinary income rather than lower-taxed long-term capital gain.

TAX PLANNING IMPLICATIONS

In the *Pool* case, better advance planning would have allowed CL's land sale profits to be properly characterized as lower-taxed long-term capital gains. To achieve this result, the taxpayers should have limited CL's activities to acquiring the property and subsequently making just a few land sales to the development entity—EGDC. The taxpayers failed to prove: (1) that CL did not perform significant development work itself and (2) that CL was not involved in selling lots to customers.

In the *Allen* case, the taxpayers' fate may have been sealed on day one because the first factor (nature of the acquisition), which is arguably the single most important factor, weighed decisively against them. But if Allen had taken pains at the beginning to establish that the land was held for investment (which it pretty clearly was not in this case), the outcome could have been different.

Beneficial Capital Gain Treatment Allowed for Sale of Right to Buy Land and Build Condo Project

In a decision rendered in late 2014, the 11th Circuit Court of Appeals concluded that an individual's $5.75 million in proceeds from selling rights to buy land and build a luxury condo project was properly characterized as long-term capital gain rather than ordinary income. The decision reversed an earlier Tax Court opinion. [See *Philip Long*, 114 AFTR 2d 2014-6657 (11th Cir. 2014).]

CASE FACTS

Philip Long was a real estate developer who operated his business as a sole proprietorship. In 2006, he received $5.75 million in exchange for selling contract rights that he had obtained as a successful plaintiff in a lawsuit. The lawsuit involved the rights to buy a parcel of land in Fort Lauderdale, Florida and build a luxury condominium tower on the parcel. After auditing the Long's 2006 Form 1040, the IRS issued a notice of deficiency indicating that Long had taxable income of $4,145,423 in 2006 and owed $1,430,743 of federal income tax for that year. Among other things, the IRS claimed that the $5.75 million received by Long was in lieu of future ordinary income payments and should therefore be counted as ordinary income under the "substitution for ordinary income doctrine."

Long claimed that the $5.75 million should be taxed as long-term capital gain. Thanks to the lawsuit, he owned an option to buy the land underlying the condo project along with the right to build the condo tower itself. He had been working on this project for some 13 years. The IRS rejected his claim. The unhappy taxpayer took his case to the Tax Court.

Unfortunately for Long, the Tax Court agreed with the IRS that the $5.75 million constituted ordinary income because, according to the Tax Court, Long intended to sell the land underlying the condo project land to customers in the ordinary course of his business.

11TH CIRCUIT REVERSES TAX COURT

The 11th Circuit's decision starts off by noting that gain from selling a *capital asset* that the taxpayer has held for more than a year constitutes long-term capital gain that is taxed at preferential rates. In contrast, ordinary income is taxed at higher rates. The term *capital asset* means property held by the taxpayer (whether or not connected with his or her business), but does not include property held by the taxpayer primarily for sale to customers in the ordinary course of his or her business. In certain circumstances, contract rights can qualify as capital assets.

The 11th Circuit then pointed out that the Tax Court had erred by mistakenly concluding that Long sold the land underlying the condo project for the $5.75 million. In fact, he never owned the land. What he actually sold was the right to purchase the land pursuant to the terms of the condo development agreement and the associated right to build the condo tower. As stated earlier, he won these rights in a legal judgment rendered by a Florida court. Therefore, the real issue was whether Long held the contract rights primarily for sale to customers in the ordinary course of his business. The 11th Circuit found no such evidence. Instead the court ruled that the evidence showed that Long had always intended to develop the condo project himself, until he ultimately decided to sell his contract rights.

The 11th Circuit also rejected the government's argument that the $5.75 million received by Long was in lieu of future ordinary income payments and should therefore be counted as ordinary income under the "substitution for ordinary income doctrine." According to the court, the rights that Long sold only represented the potential to earn future income based on the owner's future actions and on future events that could not necessarily be fully anticipated. Rights to earn future undetermined income (as opposed to rights to receive income that has already been earned) constitute a capital asset.

Finally, the 11th Circuit concluded that Long had owned the contract rights for more than one year because they resulted from a lawsuit that was filed in 2004. Because the contract rights constituted a capital asset that Long had owned for more than one year (he sold the rights in 2006), he was entitled to treat the $5.75 million in proceeds from selling the rights as long-term capital gain. The Tax Court's earlier decision to the contrary was reversed.

CONCLUSION

It is almost always better to be able to characterize taxable income as capital gain rather than ordinary income. As the 11th Circuit decision summarized in this analysis illustrates, capital gain treatment may be available in somewhat surprising circumstances.

Escape Taxable Gains Altogether With Like-Kind Exchanges

Clients who are serious real estate investors periodically adjust their portfolios by getting rid of some properties and acquiring new ones. Unfortunately, selling appreciated properties results in a current tax hit—something real estate investors hate, especially when they intend to simply "roll over" their sales proceeds by purchasing new properties.

The good news is IRC Section 1031 allows taxes to be deferred if a like-kind exchange can be arranged. Deferral is mandatory, rather than elective, when IRC Section 1031 applies.

IRC Section 1031 says taxable gains are deferred when buyers and sellers swap properties that are similar in nature, except to the extent cash or dissimilar property (*boot*) is received in the transaction. If a party to the transaction receives boot, gain is currently recognized in an amount equal to the lesser of the total gain or the boot's FMV [IRC Section 1031(b)].

Even deferred like-kind exchanges can qualify for the gain deferral privilege [IRC Section 1031(a)(3)]. This is very important, because it is usually difficult for a seller who wants to make a like-kind exchange to locate another party who has suitable replacement property and who also wants to make an exchange rather than a cash sale. As you will see, under the deferred exchange rules, the seller need not make a direct and immediate exchange of one property for another. The seller can, in effect, sell for cash and then locate the replacement property a little bit later. And the owner of the replacement property can actually sell for cash without spoiling the first party's ability to defer taxable gain.

LIKE-KIND EXCHANGE BASICS

Under IRC Section 1031, mandatory non-recognition of gains (and losses) applies when *like-kind* properties are exchanged in what would otherwise be a taxable sale transaction.

To qualify, both the property given up by the seller and the property received must be investment property or business property in the seller's hands. Note that investment property can be swapped for other like-kind investment property or for like-kind business property, and vice versa. From the perspective of either party to the exchange transaction, it does not matter whether or not the other party qualifies under IRC Section 1031 (Rev. Rul. 75-292).

Like-kind means similar in general nature or character. The regulations give a liberal interpretation to this standard. For example, Reg. Sec. 1.1031(a)-1 says improved real estate can be swapped for unimproved real estate, a strip shopping center can be traded for an apartment building, a marina can be swapped for a golf course, and so on. However, real property cannot be traded for personal property. Finally, property held for personal use (such as a home or a boat), inventory, partnership interests, and investment securities do not qualify for IRC Section 1031 treatment.

The majority of IRC Section 1031 exchanges involve only real estate.

Realized Versus Recognized and Receipt of Boot

When two parties wish to make a IRC Section 1031 exchange of properties with differing FMVs, the party with the less valuable property must add additional consideration to equalize the values. This is called *boot*. Boot can actually be in the form of cash or dissimilar property, or a mixture of both.

In analyzing a IRC Section 1031 transaction, the first step is determining the amount of realized gain (or loss) for each party. Realized gain equals

1. FMV of property (including any non-cash boot) plus any cash boot received, minus
2. the tax basis of the property given up (including any non-cash boot) plus any cash boot given.

In contrast to the realized gain, the *recognized* gain is the amount that must be currently reported under the federal income tax rules (not to exceed the realized gain). As explained earlier, a party to a IRC Section 1031 exchange generally has no recognized gain unless boot is received. If boot is received, the recognized gain is the lesser of

1. the realized gain, or
2. the FMV of the boot.

Example 1-13

- Huck and Buck trade undeveloped agricultural acreage in a IRC Section 1031 like-kind exchange.
- Huck's land has FMV of $50,000 and tax basis of $30,000. Buck's land is worth only $43,000, and his basis is $8,000.
- To equalize the trade, Buck gives Huck $7,000 worth of manure.
  - Huck's realized gain is $20,000 ($43,000 + $7,000 – $30,000); however, he currently recognizes only $7,000 (lesser of the $20,000 realized gain or the $7,000 worth of boot received).
  - Buck's realized gain is $35,000 ($50,000 – $8,000 – $7,000), but he has no recognized gain on the land swap, because he receives no boot.

Any loss realized in a IRC Section 1031 exchange cannot be recognized currently. As shown in example 1-23, the realized loss becomes *built-in* to the basis of the like-kind property received.

If a party to the exchange gives only cash boot plus like-kind property and receives only like-kind property in return, he or she will not have any recognized gain.

However, if the transferor gives *dissimilar property* as boot, he or she recognizes gain or loss equal to the difference between its FMV and tax basis, as if it were sold for FMV [Reg. Sec. 1.1031(d)-1(e)]. For instance, if in example 1-13 Buck's basis in the manure was $4,000, he would recognize no gain on the land swap, but he would recognize a $3,000 gain on the manure part of the deal.

BASIS AND HOLDING PERIOD FOR LIKE-KIND PROPERTY RECEIVED

In effect, the tax basis of the like-kind property received is adjusted down or up for any unrecognized gain or loss attributable to the like-kind property given up [IRC Section 1031(d)]. Therefore, the tax basis of the like-kind property received equals the following:

1. The tax basis of the like-kind property given up

\+ 2. Gain recognized (if any) on like-kind property given up

\+ 3. FMV of boot given up (if any)

– 4. FMV of boot received (if any)

The holding period for the new like-kind property received includes the holding period of the old like-kind property given up [IRC Section 1223(1)].

As for any noncash boot received, its tax basis will always be equal to FMV, because it's received in a fully taxable transaction. Therefore, as of the transaction date, a new holding period begins for the noncash boot.

Example 1-14

- Assume the same facts as in example 1-13.
  - Huck's basis in the like-kind property received is $30,000 ($30,000 + $7,000 + $0 – $7,000). This makes sense because the property Huck now holds has a FMV of $43,000.
  - In effect, the $13,000 unrecognized gain from the old property has become a $13,000 built-in gain in the new property (FMV of $43,000 less tax basis of $30,000).
  - Buck's basis in his new like-kind property is $15,000 ($8,000 + $0 + $7,000 – $0). Again, this makes sense because the property Buck now holds has a FMV of $50,000.
  - Buck's $35,000 unrecognized gain from the old property has become a $35,000 *built-in* gain in the new property (FMV of $50,000 less tax basis of $15,000).

Example 1-15

- Assume the same facts as in example 1-13, except Buck's basis in his original piece of land was $45,000.
  - His basis in the new like-kind property becomes $52,000 ($45,000 + $0 + $7,000 – $0). This makes sense, because the $2,000 unrecognized loss from the original land has become a $2,000 *built-in* loss in the land Buck now holds ($50,000 FMV less $52,000 tax basis).

EFFECT OF LIABILITIES

In real life, most IRC Section 1031 real estate transactions involve properties burdened by mortgages. The impact of liabilities on realized and recognized gains and losses is explained in the following section.

Effect on Realized Gain Computation

Under Reg. Sec. 1.1031(d)-2, the transferor's realized gain equals the following:

1. Gross amount of debt shifted to the transferee

\+ 2. FMV of boot received in form of cash or dissimilar property (if any)

\+ 3. FMV of like-kind property received

– 4. Tax basis of like-kind property given plus any boot given

– 5. Gross amount of liabilities taken on by transferor

Effect on Recognized Gain Computation

The transferor's recognized gain equals the lesser of the realized gain (as explained earlier) or the boot received. When the transferee assumes a liability or takes property subject to a liability, this counts as boot received for purposes of computing the recognized gain. When both parties assume liabilities or take property subject to liabilities, amounts are netted. For example, if the transferor takes on liabilities in excess of the amount shifted to the transferee, the transferor has *given* boot equal to the net amount, and the transferee has *received* boot in the same amount.

However, deemed net boot given from liabilities (excess of the line 5 amount over the line 1 amount) cannoit be used to offset *actual* boot received in the form of cash or dissimilar property (the line 2 amount) [Reg. Sec. 1.1031(d)-2, example 2]. Put another way, the transferor must recognize gain equal to the lesser of the realized gain or the actual boot received (the line 2 amount), even when the transferor has given net boot attributable to liabilities.

When the transferor gives actual boot in the form of cash or dissimilar property (included in the line 4 amount), the actual boot given offsets any net boot received from liabilities (excess of line 1 amount over line 5 amount) [Reg. Sec. 1.1031(d)-(2), example 2]. Thus, if actual boot given exceeds the net boot received from liabilities transferred to the other party, there is no recognized gain.

Example 1-16

- Rhonda owns Happy Acres (FMV of $4,000,000, mortgage of $3,400,000, and tax basis of $3,000,000). She swaps the property for Grumpy Hills (FMV of $3,600,000, mortgage of $3,500,000, and tax basis of $3,200,000), which is owned by Bill. Because Bill's equity in Grumpy Hills is only $100,000 versus Rhonda's $600,000 equity in Happy Acres, Bill tosses in $500,000 of cash to square the deal.
  - Rhonda's realized gain is

1.	$3,400,000	Happy Acres debt shifted to Bill
2.	500,000	FMV of boot received
3.	3,600,000	FMV of like-kind property received
4.	(3,000,000)	Tax basis of property given up
5.	(3,500,000)	Grumpy Hills debt assumed by Rhonda
	$1,000,000	

  - Rhonda's recognized gain is limited to $500,000, which equals the amount of actual boot received. Rhonda gets no "credit" for the $100,000 of net boot given from liabilities (excess of $3.5 million she assumed over $3.4 million she shifted to Bill). However, as seen in the following list item, the net boot given from liabilities increases Rhonda's tax basis in Grumpy Hills.
  - Rhonda's tax basis in Grumpy Hills is

1.	$3,000,000	Tax basis of Happy Acres
2.	100,000	Boot given from liabilities
3.	500,000	Gain recognized on disposition of Happy Acres
4.	(500,000)	Boot received (cash)
	$3,100,000	

  - Thus, Rhonda has a *built-in* gain of $500,000 in Grumpy Hills (FMV of $3,600,000 less her basis of $3,100,000). This equals her realized gain of $1,000,000, less the $500,000 deferred by making the like-kind exchange.
  - Bill's realized gain on the disposition of Grumpy Hills is

1.	$ 3,500,000	Grumpy Hills debt shifted to Rhonda
2.	0	FMV of boot received
3.	4,000,000	FMV of like-kind property received
4.	(3,700,000)	Tax basis of property and boot given
5.	(3,400,000)	Happy Acres debt assumed by Bill
	$ 400,000	

  - Bill's recognized gain is $0, because he offsets the $100,000 of net boot received from liabilities with the $500,000 of actual boot given to Rhonda.

Example 1-16 (continued)

– Bill's basis in Happy Acres is

$3,200,000	Tax basis of Grumpy Hills
500,000	Boot given
0	Gain recognized on disposition of Grumpy Hills
(100,000)	Boot received (from liabilities)
$3,600,000	

– Thus, Bill has a *built-in* gain of $400,000 in Happy Acres (FMV of $4,000,000 less his basis of $3,600,000). This equals his realized gain of $400,000 from Grumpy Hills, all of which was deferred by making the like-kind exchange.

DEFERRED LIKE-KIND EXCHANGES

Although the tax advantages of making a like-kind exchange are considerable for both parties, it is usually difficult or impossible to locate another party who has suitable like-kind property and is willing swap (most sellers want cash or at least an installment sale arrangement). As a result, IRC Section 1031 exchanges are rarely accomplished by making a simultaneous exchange of like-kind properties.

Instead we see *deferred exchanges* (commonly called *Starker exchanges*, after a famous 1979 court case). The qualification rules for deferred exchanges are found in Reg. Sec. 1.1031(k)-1. Deferred exchanges come in two flavors: three-party deals and four-party deals.

DEFERRED THREE-PARTY EXCHANGES

In this type of transaction, the transferor (the *first* party) trades his or her property to the *second* party, who then promises to find and buy replacement property from a *third* party.

The second party places the sales proceeds that would otherwise go to the first party in escrow. The funds are then used by the second party to purchase replacement property from a third party.

Finally, the replacement property is transferred by the second party to the first party. This completes the like-kind exchange.

Because the first party never actually gets his or her hands on any cash and ends up with like-kind property, the transaction is considered a IRC Section 1031 exchange from his or her perspective.

DEFERRED FOUR-PARTY EXCHANGES

When the second party cannot or will not acquire replacement property to swap with the first party—or cannot be trusted to do so—a four-party exchange is required. Actually, these are more common than the three-party variety described earlier.

Here, the transferor (the *first* party) transfers his or her property to a qualified intermediary (the *fourth* party).

The intermediary's role is simply to facilitate a like-kind exchange for a fee.

The first party's property is transferred to a cash buyer (the *second* party).

The intermediary then uses the resulting sales proceeds to buy suitable replacement property (which has been previously identified by the first party) from a *third* party.

Finally, the intermediary transfers the replacement property to the first party to complete the like-kind exchange.

From the first party's perspective, this whole series of transactions qualifies as a like-kind exchange because he or she ends up with like-kind replacement property (supplied by the third party) rather than cash. The second party ends up paying cash for the original property (supplied by the first party). The third party ends up having sold his or her property for cash (supplied by the second party).

Naturally, qualified intermediaries charge for their services, usually based on a sliding scale according to the value of the deal. In percentage terms, the fees are generally quite nominal.

RULES FOR TAX-FREE DEFERRED EXCHANGES

IRC Section 1031(a)(3) and Reg. Sec. 1.1031(k)-1 supply the two basic rules for deferred exchanges:

- Replacement property must be identified before the end of a 45-day *identification period*.
- Replacement property must be transferred to the seller before the end of the *exchange period*, which can extend up to 180 days.

The identification period commences when the first party transfers the original property (in other words, the closing date for that transaction). During the 45-day period, the replacement property must be unambiguously identified or actually received by the first party. This rule is satisfied if the replacement property is specified in a written document signed by the first party and sent to (1) the party who is to supply the replacement property or (2) another party, such as a qualified intermediary, escrow agent, or title company. In the document, the first party can list up to three properties considered suitable as replacement property. However, the aggregate FMV of the three cannot exceed 200 percent of the FMV of the original property.

The exchange period also commences when the first party transfers the original property. The exchange period ends on the *earlier* of (1) 180 days thereafter or (2) the due date (with extensions) of the first party's federal return for the tax year that includes the date of transfer. When the 180-day period straddles year-ends and would be cut short by the original due date of the return for the year of the transfer, obtaining an extension restores the full 180-day period. However, an extension must actually be obtained in order for this provision to come into play.

Avoiding Constructive Receipt Problems With Escrow Arrangements

When the first party transfers property in exchange for the buyer's promise to purchase and transfer suitable replacement property (or the qualified intermediary's promise), the first party will naturally want assurance that the remaining legs of the transaction will be accomplished. Therefore, the buyer's promise to acquire and transfer replacement property is generally secured by placing the sales price in an escrow account. Alternatively, the funds may be placed in escrow with the qualified intermediary hired to facilitate the exchange.

The potential problem with escrow accounts is that the IRS may claim the first party was in constructive receipt of the sales proceeds. This would unravel the intended like-kind exchange and result in a taxable sale transaction. However, Reg. Sec. 1.1031(k)-1(g) provides safe harbor rules for escrow accounts. If these are met, constructive receipt problems are avoided.

Under the safe harbor rules, the first party will not have constructive receipt of cash or cash equivalents placed in a *qualified escrow account* if

- the escrow holder is not a *disqualified person* (various parties related to the first party and parties considered agents of the first party), and
- the escrow agreement expressly limits the first party's right to receive, borrow, pledge, or otherwise obtain the benefits of the assets held in the escrow account.

Despite the second rule, the first party is not prohibited from being credited with interest on funds held in a qualified escrow account [Reg. Sec. 1.1031(k)-1(g)(5), (g)(6), and (h)].

Example 1-17 Deferred Three-Party Exchange

- Melinda (the first party) owns Halfacre, which is worth $2,000,000 and has a tax basis of $500,000. Second-party Harold (unrelated to Melinda) wants to buy the parcel for development. However Melinda insists on a like-kind exchange in order to avoid any current tax liability.
- Ultimately Melinda agrees to transfer Halfacre in exchange for Harold's promise to acquire and transfer suitable replacement property. In accordance with the agreement, Melinda transfers Halfacre to Harold on December 1, 2016. Harold's promise is secured by $2,000,000 of cash placed in a qualified escrow account.
- Within the 45-day identification period, Melinda sends Harold a signed document designating Pineland—currently owned by Vanessa (the third party) and having a FMV of $1,600,000—as suitable replacement property.
- On March 19, 2017, Harold buys Pineland from Vanessa for $1,600,000 cash. On the same day, he transfers Pineland to Melinda along with the $400,000 balance from the escrow account.
  - In this example, both the 45-day identification period rule and 180-day exchange period rule are met (the starting point for both periods is the December 1, 2016, closing date for the transfer of Halfacre to Harold).
  - Accordingly, this deal qualifies as a deferred three-party exchange for Melinda. On March 19, 2017, she recognizes a $400,000 taxable gain—lesser of $400,000 boot received or realized gain of $1.5 million. [See Reg. Sec. 1.1031(k)-1(g)(8), example 1 and Reg. Sec. 1.1031(k)-1(j)(2)(vi), example 1.]

Note: The escrow arrangement must be a *qualified escrow account*, in order to avoid any risk of Melinda being considered in constructive receipt of the entire $2,000,000 as of December 1, 2016.

Deferred Four-Party Exchanges

In real life, second parties are often unwilling or unable to acquire title to the replacement property or are not considered trustworthy enough to be relied upon. In such cases, the solution is using a qualified intermediary to conduct a four-party exchange.

Under the IRC Section 1031 regulations, the qualified intermediary is not considered the agent of the first party, even though the intermediary actually functions in that capacity. Accordingly, the first party can transfer his or her property to the qualified intermediary and instruct the intermediary to sell the property for cash. The first party will not be considered in constructive receipt of the sales proceeds received by the qualified intermediary [Reg. Sec. 1.1031(b)-2(a)]. (If the intermediary does not meet the qualified-intermediary definition, there will generally be an agency relationship for tax purposes, and the first party will have a constructive receipt problem.)

Reg. Sec. 1.1031(k)-1(g)(4) defines a qualified intermediary as a person who is not the taxpayer or a *disqualified person* and who, pursuant to a written *exchange agreement* with the taxpayer,

- acquires the original property from the taxpayer;
- transfers the taxpayer's property to the buyer;
- acquires replacement property from the seller; and
- transfers the replacement property to the taxpayer.

Disqualified persons are defined in Reg. Sec. 1.1031(k)-1(k) and include certain parties automatically considered to be the taxpayer's agent (taxpayer's employee, attorney, and so on) and certain parties related to the taxpayer under IRC Sections 267(b) or 707(b), as modified.

In real estate transactions, qualified intermediaries may be unwilling to actually hold title to the original and replacement properties – however briefly – because of environmental liability issues. Therefore, Reg. Sec. 1.1031(k)-1(g)(4)(v) says the qualified intermediary is deemed to accomplish the previous title transfers via written assignments of contract rights. Actual title transfers are not necessary. Example 1-18 illustrates the rules that must be satisfied to accomplish a successful deferred four-party exchange.

Example 1-18 Deferred Four-Party Exchange

- Assume the same facts as in example 1-17, except, for the reason previously discussed, Harold refuses to have even momentary ownership of Pineland, because of potential exposure to environmental liabilities for any owner in the chain of title. Therefore, Melinda engages a qualified intermediary—We Do Swaps—to facilitate a deferred four-party exchange.
- On December 1, 2016, Melinda contracts to sell Halfacre to Harold for $2 million cash. The closing date is to be January 15, 2017. On or before that date, Melinda enters into a written exchange agreement with We Do Swaps to function as a qualified intermediary (assume We Do Swaps is also unwilling to hold actual title to the properties involved in the transaction).

Example 1-18 Deferred Four-Party Exchange (continued)

- Before title to Halfacre is actually transferred to Harold, Melinda assigns in writing to We Do Swaps her contract rights to sell the property (this is pursuant to the exchange agreement between Melinda and We Do Swaps). Melinda also notifies Harold of the assignment in writing before transferring Halfacre to him. Melinda then transfers title to Halfacre directly to Harold on January 15, 2017.
  This is called a *direct deed* transaction, because the title to Halfacre actually bypasses We Do Swaps. At closing, Harold transfers $2,000,000 to a qualified escrow account set up at the local bank (or the payment could go into an account controlled by We Do Swaps).
- Melinda now locates Pineland (owned by Vanessa) and contracts to purchase it as replacement property for $1,600,000. The scheduled closing date for this transaction is March 19, 2017. Before that date, Melinda assigns in writing to We Do Swaps her contract rights to buy Pineland and notifies Vanessa of this assignment in writing. On March 19, 2017, the escrow agent releases $1,600,000 to Vanessa to close on Pineland. On the same date, Vanessa direct-deeds Pineland to Melinda. Melinda also receives the remaining $400,000 from the escrow account.
  - All legs of the deferred exchange are now complete. The 45-day and the 180-day rule are both met (the starting point for both periods is the January 15, 2017 closing date for the Halfacre transaction). By entering into the exchange agreement with We Do Swaps and assigning her purchase and sale contract rights, Melinda is deemed to have made a like-kind exchange with We Do Swaps. As a qualified intermediary, We Do Swaps is deemed to have acquired and transferred both Halfacre and Pineland.
  - Accordingly, on March 19, 2017, Melinda recognizes a $400,000 taxable gain. As can be seen, these are exactly the same tax results as in example 1-17, which involved a three-party exchange.
    [See Reg. Sec. 1.1031(k)-1(g)(8), Example 4 and Reg. Sec. 1.1031(k)-1(j)(2)(vi), Example 2.]

Variation

The tax results would also be the same if pursuant to the exchange agreement with Melinda, We Do Swaps takes actual title to Halfacre and Pineland before transferring them to Harold and Melinda, respectively. [See Reg. Sec. 1.1031(k)-1(g)(8), Example 3.]

Watch Out

If Melinda fails to transfer her Halfacre contract rights to We Do Swaps on or before direct deeding Halfacre to Harold, she is not considered to have engaged in a like-kind exchange with We Do Swaps. The unfortunate result is that Melinda is now treated as having made a taxable sale of Halfacre to Harold, followed by a taxable purchase of Pineland through her agent, We Do Swaps. [See Reg. Sec. 1.1031(k)-1(g)(8), Example 5.]

Reverse Starker Exchanges

As explained earlier, deferred exchanges where the replacement property is identified and acquired after the "relinquished property" (the property originally held by the taxpayer seeking IRC Section 1031 exchange treatment) has effectively been sold are often called Starker exchanges. As discussed, regulations permit properly structured Starker exchanges to fall under the IRC Section 1031 rules which can yield tremendous tax deferral advantages for real estate clients.

However, the tax treatment of reverse-Starker exchanges has been left unclear for many years. In a reverse-Starker exchange, the replacement property is acquired before the relinquished property is unloaded. In other words, the taxpayer has identified a property he or she wishes to acquire in a IRC Section 1031 exchange but has not yet identified the property to be given up in exchange. The regulations cited earlier in this chapter did not provide any guidance regarding such reverse Starker exchanges.

In Rev. Proc. 2000-37 (as modified by Rev. Proc. 2004-51), the IRS finally addressed this longstanding question. Rev. Proc. 2000-37 provides safe-harbor treatment (meaning IRC Section 1031 treatment will be deemed to apply) for reverse Starker exchanges that are conducted via "qualified exchange accommodation arrangements" (QEAAs).

A QEAA is considered to exist if

1. to facilitate the exchange, the legal titles to (or attributes of beneficial ownership in) both the replacement and relinquished properties are transferred to an "exchange accommodation titleholder" (as defined by Rev. Proc. 2000-37). Once the exchange accommodation titleholder acquires title to (or attributes of beneficial ownership in) the replacement and relinquished properties, the exchange accommodation titleholder must continue to hold the properties until the replacement property is ultimately transferred to the taxpayer and the relinquished property is ultimately transferred to its new owner.
2. at the times the replacement property and the relinquished property are transferred to the exchange accommodation titleholder, the taxpayer (the party seeking IRC Section 1031 treatment for the deal) must have a bona fide intent to exchange said properties in a transaction that qualifies for nonrecognition treatment (in whole or in part) under IRC Section 1031.
3. within five business days after the date of transfer of title to (or attributes of beneficial ownership in) the replacement or relinquished property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder must agree in writing that said property is being held to facilitate a IRC Section 1031 exchange under Rev. Proc. 2000-37 and that the tax reporting rules established by Rev. Proc. 2000-37 will be respected by both parties.
4. within 45 days after the transfer of title to (or attributes of beneficial ownership in) the replacement property to the exchange accommodation titleholder, the taxpayer must identify the relinquished property in a manner consistent with Reg. Sec. 1.1031(k)-1(c). (Alternative or multiple properties may be identified.)
5. within 180 days after the transfer of title to (or attributes of beneficial ownership in) the replacement property or relinquished property to the exchange accommodation titleholder, the replacement and relinquished properties must be transferred to their respective new owners.
6. the combined time period that the replacement and relinquished properties are held by the exchange accommodation titleholder cannot exceed 180 days.

The exchange accommodation titleholder fulfills the same role as a qualified intermediary in a "regular" four-party deferred exchange, as explained in example 1-18. The taxpayer should take pains to ensure that the exchange accommodation titleholder meets the definition of a qualified intermediary.

In essence, the exchange accommodation titleholder is simply a transient owner (or beneficial owner) of the relinquished property and the replacement property. However, the exchange accommodation titleholder is treated for tax purposes as the legitimate legal owner solely in order for IRC Section 1031 treatment to apply to the exchange.

The taxpayer and the exchange accommodation titleholder can engage in certain commercially necessary transactions in order to accomplish the desired property exchange. For example, the taxpayer can loan the exchange accommodation titleholder the money needed to acquire the replacement property or the taxpayer can guarantee debt incurred by the exchange accommodation titleholder to do so. The taxpayer can also indemnify the exchange accommodation titleholder against costs incurred in the transaction. The taxpayer can even lease the replacement property from the exchange accommodation titleholder. And the taxpayer can manage the replacement property and supervise improvements to it while it is held by the exchange accommodation titleholder. (See IRC Section 4.03 of Rev. Proc. 2000-37.)

However, the IRS admits that some reverse-Starker exchanges that fall outside the Rev. Proc. 2000-37 guidelines may still qualify for IRC Section 1031 treatment, presumably based on consideration of all facts and circumstances. (See Sections 3.02 and 3.04 of Rev. Proc. 2000-37.) In other words, the rules under Rev. Proc. 2000-37 are intended only as a safe harbor for reverse Starker exchanges, as opposed to absolute standards that must be followed in order for IRC Section 1031 treatment to apply.

For example, the IRS has allowed IRC Section 1031 treatment for a direct reverse Starker exchange. (See Ltr. Rul. 9823045.)

On the other hand, the IRS has disallowed IRC Section 1031 treatment for other reverse Starker exchanges for various reasons. [See TAM 200039005 and *Donald DeCleene, et ux. v. Commissioner*, 115 TC No. 34 (November 17, 2000).]

Observation: As a practical matter, taxpayers seeking IRC Section 1031 treatment for reverse Starker exchanges would be crazy not to comply with the safe harbor guidelines of Rev. Proc. 2000-37 (as modified by Rev. Proc. 2004-51).

Example 1-19

Assume the same essential facts as in example 1-18, except this time Melinda identifies the replacement property before she identifies the property she wishes to relinquish in a reverse Starker exchange. Melinda engages a qualified intermediary—We Do Swaps—to function as the exchange accommodation titleholder in what ultimately turns out to be a four-party reverse Starker exchange with Vanessa and Harold.

On December 1, 2016, Melinda contracts with Vanessa to purchase Pineland as the replacement property for $1,600,000. The scheduled closing date for this transaction is January 15, 2017. Before that date, Melinda assigns in writing to We Do Swaps her contract rights to buy Pineland. This is pursuant to the exchange agreement between Melinda and We Do Swaps. Melinda also notifies Vanessa of this assignment in writing. Melinda then loans We Do Swaps the $1,600,000 needed to buy Pineland. Assume We Do Swaps is unwilling to hold actual legal title to the properties involved in the exchange for liability reasons. Melinda, Vanessa, and We Do Swaps agree in writing that Pineland will be beneficially owned (albeit only momentarily) by We Do Swaps to facilitate a IRC Section 1031 exchange under the Rev. Proc. 2000-37 guidelines. At the closing on January 15, 2017, Vanessa direct deeds Pineland to Melinda (that is, the actual legal title to Pineland bypasses We Do Swaps and goes directly to Melinda), and We Do Swaps releases the $1,600,000 to Vanessa.

Example 1-19 (continued)

On January 20, 2017, Melinda finally identifies Halfacre as the property she wishes to relinquish in exchange for Pineland. On that same date, she contracts to sell Halfacre to Harold for $2 million cash. The closing date is March 19, 2017. On or before that date, Melinda enters into a written exchange agreement with We Do Swaps to function as a qualified intermediary.

Melinda assigns in writing to We Do Swaps her contract rights to sell Halfacre to Harold. Melinda also notifies Harold of the assignment in writing. Melinda, Harold, and We Do Swaps agree in writing that Halfacre will be beneficially owned (albeit only momentarily) by We Do Swaps to facilitate a IRC Section 1031 exchange under the Rev. Proc. 2000-37 guidelines. At the closing on March 19, 2017, Melinda direct deeds Halfacre to Harold; he transfers $2,000,000 to We Do Swaps; and We Do Swaps transfers the $2,000,000 to Melinda. The $2,000,000 represents a return of the $1,600,000 loan from Melinda to We Do Swaps plus the $400,000 difference between the sale price for Halfacre ($2,000,000) and the purchase price for Pineland ($1,600,000).

All legs of the reverse Starker exchange are now complete. The 45-day and the 180-day rule are both met (the starting point for both periods is the January 15, 2017, closing date for the Pineland transaction). By entering into the exchange agreement with We Do Swaps and assigning her purchase and sale contract rights, Melinda is deemed to have made a like-kind exchange with We Do Swaps. (For this purpose, the transactions with Vanessa and Harold are ignored.)

Accordingly, on March 19, 2017, Melinda recognizes a $400,000 taxable gain. This is the amount of taxable cash boot that she received when all was said and done. As can be seen, these are exactly the same tax results as in example 1-18, which involved a "regular" Starker exchange.

Variation

The tax results would be the same if pursuant to the exchange agreement with Melinda; We Do Swaps takes actual legal title to Pineland and Halfacre before transferring them to Melinda and Harold, respectively. [See Reg. Sec. 1.1031(k)-1(g)(8), Example 3.]

Watch Out

If Melinda fails to transfer her Halfacre contract rights to We Do Swaps on or before direct deeding Halfacre to Harold, she is not considered to have engaged in a like-kind exchange with We Do Swaps. The unfortunate result is that Melinda is now treated as having made a taxable purchase of Pineland through her agent, We Do Swaps, followed by a taxable sale of Halfacre to Harold. [See Reg. Sec.
1.1031(k)-1(g)(8), Example 5.]

KNOWLEDGE CHECKS

8. The difference between the amount of gain realized in an IRC Section 1031 like-kind exchange and the amount of gain recognized is?

    a. The amount realized includes both the amount of gain taxed currently and the amount of gain deferred for tax purposes, and the amount recognized is the currently taxed portion of the gain.
    b. The amount realized is the amount the taxpayer knows he or she actually owes tax on, and the amount recognized is the lesser amount he or she is actually willing to pay tax on.
    c. There is no difference. Realized gain and recognized gain are just two ways to say the same thing.
    d. The amount realized equals the total sale price and the amount recognized equals the amount of sale price that has been collected so far.

9. In the context of a IRC Section 1031 like-kind exchange, a qualified intermediary is

    a. A consultant hired by one side to negotiate the best possible deal terms for that side.
    b. A tax expert hired to structure the best possible tax results for whichever party hires him.
    c. A party hired to facilitate a deferred exchange.
    d. A party hired to appraise the value of the properties involved in the exchange.

10. Under the federal income tax rules for deferred IRC Section 1031 exchanges, which is correct?

    a. Only Starker exchanges are allowed.
    b. Both Starker and reverse-Starker exchanges are allowed.
    c. Neither Starker nor reverse-Starker exchanges are allowed.
    d. IRC Section 1031 exchanges are fully taxable.

Primer on the 3.8 Percent Net Investment Income Tax

The IRS calls the 3.8 percent Medicare surtax on investment income the net investment income tax, or NIIT. We will adopt that terminology. The NIIT was established by Section 1411 of the IRC, which was added as part of the 2010 healthcare legislation. The NIIT is effective for tax years beginning after December 31, 2012. Therefore, it is effective for 2013 and beyond for calendar-year taxpayers, which include almost all individual taxpayers.

In late 2012, the IRS issued the first round of NIIT guidance in the form of a batch of proposed reliance regulations (which taxpayers can choose to rely on for tax years beginning 2013).

In late 2013, the IRS released a batch of final NIIT regulations and a new batch of proposed regulations as well. These regulations are generally effective for tax years beginning after December 31, 2013, but taxpayers can also choose to follow them for tax years beginning in 2013 [Regulation 1.1411-1(f)].

NIIT Basics

For individuals, trusts, and estates, the following types of income and gain (net of related deductions) are generally included in the definition of net investment income and thus potentially exposed to the NIIT [IRC Section 1411(c)].

- Gains from selling assets held for investment – including gains from selling investment real estate and the taxable portion of gains from selling personal residences.
- Capital gain distributions from mutual funds.
- Gross income from dividends.
- Gross income from interest (not including tax-free interest such as municipal bond interest).
- Gross income from royalties.
- Gross income from annuities.
- Gross income and gains from passive business activities (meaning business activities in which the taxpayer does not materially participate) and gross income from rents. Gross income from non-passive business activities (other than the business of trading in financial instruments and commodities) is excluded from the definition of net investment income for NIIT purposes, and so is gain from selling property held in such activities [IRC Section 1411(c)].
- Gains from dispositions of passive ownership interests in partnerships and S corporations.
- Gross income and gains from the business of trading in financial instruments or commodities (even if the activity is non-passive).

Impact on Individual Taxpayers

An individual is hit with the NIIT only when modified adjusted gross income (MAGI) exceeds $200,000 for an unmarried taxpayer, $250,000 for a married joint-filing couple or a qualifying widow or widower, or $125,000 for taxpayers who use married filing separate status. These MAGI thresholds are fixed by statute and will not be adjusted for inflation in future years. The amount subject to the NIIT is the *lesser* of (1) net investment income or (2) the amount by which MAGI exceeds the applicable threshold.
For this purpose, MAGI is defined as (1) regular AGI from the bottom of page 1 of Form 1040 plus (2) certain excluded foreign-source income of U.S. citizens and residents living abroad net of certain

deductions and exclusions [IRC Section 1411(d)]. Relatively few taxpayers will be affected by this add-back. Non-resident aliens are not subject to the NIIT [IRC Section 1411(e)].

Impact on Trusts and Estates

Trusts and estates can also be hit with the NIIT [IRC Section 1411(a)(2)]. For them, the NIIT applies to the lesser of (1) the trust or estate's undistributed net investment income or (2) the trust or estate's AGI in excess of the threshold for the top trust federal income tax bracket. For 2016, that threshold is only $12,400, and the threshold is for 2015 is only $12,300. As a result, many trusts and estates may be hit with the NIIT.

TRACKING THE VARIOUS NIIT REGULATIONS AND THEIR EFFECTIVE DATES

As mentioned earlier, we now have two batches of proposed NIIT regulations, one batch of final regulations, and another batch of final regulations to follow sometime in the future. Here is a scorecard of the various sets of regulations and their effective dates.

- For the earlier proposed regulations issued in late 2012, see Proposed Regulations 1.1411-1–10 and 1.469-11 (found in REG-130507-11). These proposed regulations can be followed for tax years beginning in 2013. However if a taxpayer takes a position in a tax year beginning in 2013 that is inconsistent with the final regulations and such position affects the treatment of items in one or more later tax years, the taxpayer must make reasonable adjustments to ensure that the NIIT liabilities for such later tax years are not inappropriately distorted. For example, adjustments may be required to ensure that income or deduction items are not taken into account more than once in calculating net investment income. [See Regulation 1.1411-1(f) and (g).]
- For the final regulations issued in late 2013, see Regulations 1.1411-1, -2, -3, -4, -5, -6, -8, -9, and -10, and 1.469-11 (found in TD 9644). With the exception of Regulation 1.1411-3(d), which deals with charitable remainder trusts (CRTs) and applies to CRT tax years beginning after December 31, 2012, the final regulations apply to tax years beginning after December 31, 2013. However, taxpayers can also choose to follow the final regulations for tax years beginning in 2013. [See Regulation 1.1411-1(f) and (g) and Regulation 1.1411-3(f).]

Key point: With some notable exceptions that we will summarize later, the final regulations are mostly the same as the earlier proposed regulations.

- For the newer proposed regulations issued in late 2013, see Proposed Regulations 1.1411-3, 1.1411-4, and 1.1411-7 (found in REG-130843-13). These newer proposed regulations are generally effective for tax years beginning after December 31, 2013. However, if the final regulations include stricter rules than these proposed regulations, the stricter rules will not be effective until they are issued as final regulations. (See the Preamble to REG-130843-13.) Note that taxpayers can also choose to follow these newer proposed regulations for tax years beginning in 2013. [See Regulation 1.1411-1(f) and (g).]

Key point: With respect to the specific issues that they cover, the newer proposed regulations are significantly different and more comprehensive than the earlier proposed regulations.

QUICK GUIDE TO NIIT REGULATIONS

Here is where to find guidance on specific subjects in the NIIT regulations.

General Rules

For the general NIIT rules and definitions, see Proposed Regulations 1.1411-1 and -2 and Final Regulations 1.1411-1 and -2. See also the FAQ at www.irs.gov.

Trusts and Estates

For the rules applicable to trusts and estates, see Proposed Regulation 1.1411-3 and Final Regulation 1.1411-3. Note that special rules apply to certain types of trusts such as electing small business trusts; tax-exempt trusts (such as charitable trusts and retirement plan trusts); grantor trusts that are ignored for federal income tax purposes; and trusts that are not classified as trusts for federal income tax purposes (such as real estate investment trusts).

Net Gains

For the rules on how to calculate net gains that must be included in net investment income and the impact of capital losses and other property disposition losses, see Proposed Regulation 1.1411-4 and Final Regulation 1.1411-4.

Passive Versus Non-Passive Businesses

For the rules on determining whether business income and gains are passive or non-passive, see Proposed Regulations 1.1411-4 and -5 and Final Regulations 1.1411-4 and -5. This is an important distinction, because income and gains from non-passive business activities are generally exempt from the NIIT.

Trading in Financial Instruments or Commodities

For the rules applicable to the business of trading in financial instruments or commodities, see Proposed Regulation 1.1411-5 and Final Regulation 1.1411-5. Note that such income and gains must be included in net investment income even if the trading activity is non-passive.

Portfolio Income

For the rules applicable to portfolio income, see Proposed Regulation 1.1411-5 and Final Regulation 1.1411-5.

Rental Activities and Passive Business Activities

For the rules applicable to income and gains from rental activities and passive business activities, see Proposed Regulations 1.1411-5 and 1.469-11 and Final Regulations 1.1411-5 and 1.469-11.

Business Working Capital

For the treatment of income and gains from the investment of business working capital, see Proposed Regulation 1.1411-6 and Final Regulation 1.1411-6.

Allocable Deductions

For the rules on determining allowable allocable deductions when calculating net investment income, see Proposed Regulation 1.1411-4(f) and Final Regulation 1.1411-4(f). These rules also cover the impact of personal deduction disallowance rules in determining allowable allocable deductions when calculating net investment income.

Dispositions of Non-Passive Partnership and S Corporation Ownership Interests

For special rules on the NIIT treatment of gains and losses from dispositions of non-passive partnership and S corporation ownership interests, see original Proposed Regulation 1.1411-7 (found in REG-130507-11) and newer Proposed Regulation 1.1411-7 (found in REG-130843-13).

Distributions From Tax-Favored Retirement Plans

For the NIIT exemption for distributions from tax-favored retirement plans and accounts, see Proposed Regulation 1.1411-8 and Final Regulation 1.1411-8.

Self-Employment Income

For the NIIT exemption for income and deductions taken into account in calculating net self-employment income, see Proposed Regulation 1.1411-9 and Final Regulation 1.1411-9.

CFCs and PFICs

For the NIIT treatment of income from controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs), see Proposed Regulation 1.1411-10 and Final Regulation 1.1411-10.

Calculating Net Investment Income

For purposes of determining the NIIT, net investment income is calculated in two steps.

Step 1

Add up the following:

- Gains from dispositions of assets that are considered held for investment – including stocks, bonds, mutual fund shares, investment real estate, and the taxable portion of gains from selling personal residences.
- Capital gain distributions from mutual funds.
- Gross income from dividends.
- Gross income from interest (not including tax-free interest such as municipal bond interest).
- Gross income from rents.
- Gross income from royalties.
- Gross income from annuities.
- Gross income and gains from passive business activities (as opposed to non-passive business activities in which the taxpayer materially participates), including gains from dispositions of passive ownership interests in partnerships and S corporations (Final Regulations 1.1411-4 and -5, and Proposed Regulation 1.1411-7).
- Gross income and gains from the business of trading in financial instruments or commodities – even if the activity is non-passive [Regulation 1.1411-5(c)].

Step 2

Reduce the total from Step 1 by deductions properly allocable to the types of income listed in Step 1. The result is the net investment income amount. Examples of potentially allocable deductions include investment interest expense, investment advisory fees, brokerage fees, expenses related to rental and royalty income, state and local income taxes, tax preparation fees, and fiduciary expenses of trusts and estates [Regulation 1.1411-4(f)].

Key point: These calculations are made on new IRS Form 8960 (Net Investment Income Tax – Individuals, Estates, and Trusts).

INCOME THAT IS EXEMPT FROM THE NIIT

The following categories of income, among others, are exempt from the NIIT (Regulations 1.1411-4, -5, -8, and -9).

- Wages and self-employment income.
- Operating income from non-passive business activities and businesses.
- Distributions from tax-favored retirement plans and accounts such as 401(k) plans, pension plans, traditional IRAs, and Roth IRAs. (These plans and accounts are described in IRC Sections 401(a), 403(a), 403(b), 408, 408A, and 457(b).]
- Social Security benefits.
- Tax-exempt interest, unemployment compensation, alimony, and Alaska Permanent Fund Dividends.

GAINS FROM SELLING PERSONAL RESIDENCES

Gain from selling a principal residence is federal-income-tax-free to the extent of the allowable IRC Section 121 home sale gain exclusion (up to $250,000 for an unmarried taxpayer and up to $500,000 for a married joint-filing couple). Such tax-free principal residence gains are exempt from the NIIT. However to the extent a principal residence gain exceeds the exclusion, the excess is considered investment income that is potentially subject to the NIIT. Gain from selling a vacation property is also considered investment income that is potentially subject to the NIIT. (See the examples later in this section.)

CHILD'S INVESTMENT INCOME REPORTED ON PARENT'S RETURN

When a child's interest, dividends, and capital gains are reported on the parent's return via Form 8814, those income items are included in calculating the parent's net investment income – after subtracting amounts that are excluded from gross income due to the Form 8814 threshold amounts and excluded Alaska Permanent Fund Dividends.

INDIVIDUAL TAXPAYER EXAMPLES

Here are some general examples that illustrate how the NIIT can affect individual taxpayers.

Example 1-20

Floyd files as an unmarried individual. He has $300,000 of MAGI, which includes $90,000 of net investment income. He owes the 3.8 percent NIIT on all of his net investment income (the lesser of his excess MAGI of $100,000 or his net investment income of $90,000).

Example 1-21

Gerald and Gloria file jointly. They have $300,000 of MAGI which includes $110,000 of net investment income. They owe only the 3.8 percent NIIT on $50,000 (the lesser of their excess MAGI of $50,000 or their net investment income of $110,000).

Example 1-22

Heidi files as an unmarried individual. She has $199,000 of MAGI. She is completely exempt from the 3.8 percent NIIT, because her MAGI is less than the $200,000 threshold for unmarried individuals. Therefore, it doesn't matter how much net investment income she has.

Example 1-23

Ingrid and Irving file jointly. They have $249,000 of MAGI. They are completely exempt from the 3.8 percent NIIT, because their MAGI is less than the $250,000 threshold for joint filers. Therefore, it doesn't matter how much net investment income they have.

Example 1-24

Jack is an unmarried individual. In the current year, he sold his highly appreciated principal residence, which he had owned for 30 years, for a $550,000 gain. Thanks to the Section 121 IRC principal residence gain exclusion break, his taxable gain for federal income tax purposes is "only" $300,000 ($550,000 gain – $250,000 exclusion for unmarried taxpayers). Unfortunately, the entire $300,000 gain counts as investment income for purposes of the 3.8 percent NIIT.

To keep things simple, assume Jack has no other investment income and no capital losses. But he does have $125,000 of MAGI from other sources (salary, self-employment income, taxable Social Security benefits, whatever).

Due to the big home sale gain, Jack's net investment income is $300,000 (all from the home sale), and his MAGI is $425,000 ($300,000 from the home sale plus $125,000 from other sources).

Jack owes the NIIT on $225,000 (the lesser of: (1) his net investment income of $300,000 or (2) his excess MAGI of $225,000 ($425,000 – $200,000 threshold for singles). The NIIT amounts to $8,550 (3.8% x $225,000).

Example 1-25

Ken and Kylee file jointly. In the current year, they sold their greatly appreciated vacation home, which they had owned for 25 years, for a $600,000 gain. That profit is fully taxable, and it is also treated as investment income for purposes of the 3.8 percent NIIT.

To keep things simple, let's stipulate that the couple has no other investment income and no capital losses. But they do have $125,000 of MAGI from other sources (pension income, taxable Social Security benefits, taxable retirement account withdrawals, whatever).

Due to the big vacation home profit, their net investment income is $600,000 (all from the vacation home sale), and their MAGI is $725,000 ($600,000 from the vacation home plus $125,000 from other sources). They owe the NIIT on $475,000 (the lesser of (1) their net investment income of $600,000 or (2) their excess MAGI of $475,000 ($725,000 – $250,000 threshold for joint-filing couples). The NIIT amounts to $18,050 (3.8% × $475,000).

Planning to Minimize or Avoid the NIIT

This analysis covers some planning strategies that individuals can use to minimize or avoid exposure to the 3.8 percent NIIT.

Identifying Affected Individuals

You are exposed to the NIIT only if your MAGI exceeds the applicable threshold of: $200,000 if you are unmarried, $250,000 if you are a married joint-filer or qualifying widow or widower, or $125,000 if you use married filing separate status.

The amount subject to the NIIT is the lesser of: (1) your net investment income or (2) the amount by which MAGI exceeds the applicable threshold. For this purpose, MAGI is defined as regular AGI from the bottom of page 1 of Form 1040 plus certain excluded foreign-source income net of certain deductions and exclusions (relatively few individuals are affected by this add-back).

NIIT Avoidance Strategies Must Aim at the Proper Target

Because the NIIT hits the lesser of: (1) your net investment income or (2) the amount by which your MAGI exceeds the applicable threshold, planning strategies must be aimed at the proper target to have the desired effect of avoiding or minimizing your exposure to the NIIT.

If Exposure Mainly Depends on Net Investment Income Level

If your net investment income amount is significantly less than your excess MAGI amount (the amount by which MAGI exceeds the applicable threshold), your exposure to the tax mainly depends on your net investment income level. Therefore, you should focus first on strategies that will reduce net investment income. Of course, some strategies that reduce net investment income will also reduce MAGI. If so, that cannot possibly harm your situation.

If Exposure Mainly Depends on Excess MAGI Level

On the other hand, if your excess MAGI amount is significantly less than your net investment income amount, your exposure to the tax mainly depends on your MAGI level. Therefore, you should focus first on strategies that will reduce MAGI. Of course, some strategies that reduce MAGI will also reduce net investment income. If so, that cannot possibly harm your situation.

Example 1-26

Randy will file as an unmarried individual. Unless something changes, he will have $375,000 of MAGI which will include $100,000 of net investment income. He will owe the NIIT on all $100,000 of his net investment income (the lesser of Randy's excess MAGI of $175,000 or his net investment income of $100,000). Without some effective tax planning, the NIIT hit will amount to $3,800 (3.8% × $100,000).

As you can see, Randy's exposure to the NIIT mainly depends on his net investment income level. Therefore, he should focus first on strategies that will reduce net investment income. For instance, he could sell loser securities from his taxable brokerage firm accounts to offset earlier gains from those accounts. Additional strategies to reduce net investment income are explained in the following example.

In contrast, strategies that would lower Randy's MAGI would not reduce his exposure to the NIIT unless those strategies reduce his MAGI by a whole lot. For instance, making an additional $15,000 deductible contribution to his tax-favored retirement account would not by itself reduce Randy's exposure to the NIIT.

Example 1-27

Sandy and Ted will file jointly. Unless something changes, they will have $375,000 of MAGI which will include $160,000 of net investment income. They will owe the NIIT on $125,000 (the lesser of their excess MAGI of $125,000 or their net investment income of $160,000). Without some effective tax planning, the NIIT hit will amount to $4,750 (3.8% × $125,000).

As you can see, this couple's exposure to the NIIT mainly depends on their MAGI level. Therefore, Sandy and Ted should focus first on strategies that would reduce MAGI. For instance, making $25,000 of additional deductible contributions to their tax-favored retirement accounts would reduce their MAGI by $25,000 and significantly reduce the NIIT hit. Selling loser securities from their taxable brokerage firm accounts to offset earlier gains from those accounts would also reduce MAGI. Additional strategies to reduce MAGI are explained in the next section.

In contrast using a method that allocates some additional deductions to offset their investment income would not reduce this couple's NIIT bill, unless the method reduces their net investment income amount by a big number (not likely).

Example 1-28

In 2017, Vern and Wanda will file jointly. In that year, they expect to sell their greatly appreciated vacation home, which they have owned for many years, for a whopping $650,000 gain. That profit will be fully taxable for federal income tax purposes and it will also count as investment income for purposes of the NIIT. To keep things simple, assume Vern and Wanda will have no other investment income and no capital losses for 2017. However, they will have $175,000 of MAGI from other sources (salary, bonuses, self-employment income, and so forth).

Due to the big vacation home profit, the couple's 2017 net investment income—unless something changes—will be a whopping $650,000 (all from the vacation home sale) and their MAGI will be an even-more-whopping $825,000 ($650,000 from the vacation home plus $175,000 from other sources). Without some effective tax planning, Vern and Wanda will owe the NIIT on a whopping $575,000 (the lesser of (1) net investment income of $650,000 or (2) excess MAGI of $575,000 ($825,000 - $250,000 threshold for joint-filing couples). The NIIT hit would amount to $21,850 (3.8% x $575,000).

In this example, the sole source of exposure to the NIIT is the big gain from selling the vacation home which pushed their excess MAGI way over the applicable threshold. Vern and Wanda should consider the following strategies:

- Sell the vacation home on the installment plan to spread the big gain over several years and thus minimize or maybe even eliminate exposure to the NIIT.
- If possible, swap the vacation home in an IRC Section 1031 like-kind exchange, which would defer the big gain and completely eliminate exposure to the NIIT until further notice.
- Failing the previous steps, Vern and Wanda should take steps to reduce their 2017 MAGI, which would reduce their exposure to the NIIT. Some MAGI-reduction strategies are explained in the following section.

Seven Strategies to Reduce Current-Year Net Investment Income

1. Sell loser securities held in taxable brokerage firm accounts to offset earlier gains from such accounts. (This will also reduce MAGI.)
2. Gift soon-to-be-sold appreciated securities to children or grandchildren and let them sell them to avoid including the gains on your return. (This will also reduce MAGI.) But beware of the kiddie tax, which can potentially apply until the year a child or grandchild turns age 24.
3. Instead of cash, donate appreciated securities to IRS-approved charities. That way, the gains will not be included on your return. (This will also reduce MAGI.)
4. Select a method for determining deductions allocable to gross investment income that will maximize such deductions and thereby reduce net investment income (see the discussion earlier in this chapter).
5. If possible, become more active in rental and business activities (including those conducted through partnerships and S corporations) to "convert" them from passive to non-passive by meeting one of the material participation standards. That would make income from the activities exempt from the NIIT, because the NIIT does not apply to income from non-passive business activities (including rental activities that rise to the level of non-passive business activities).
6. To facilitate the preceding strategy, consider taking advantage of the one-time opportunity to regroup activities for purpose of applying the passive activity rules.
7. If possible, defer gains subject to the NIIT by making installment sales or IRC Section 1031 like-kind exchanges. (These steps will also reduce MAGI.)

Five Strategies to Reduce Current-Year MAGI

1. Sell loser securities held in taxable brokerage firm accounts to offset earlier gains in such accounts. (This will also reduce net investment income.)
2. Gift soon-to-be-sold appreciated securities to children or grandchildren and let them sell them to avoid including the gains on your return. (This will also reduce MAGI.) But beware of the kiddie tax, which can potentially apply until the year a child or grandchild turns age 24.
3. Instead of cash, donate appreciated securities to IRS-approved charities. That way, the gains will not be included on your return. (This will also reduce net investment income.)
4. Maximize deductible contributions to tax-favored retirement accounts such as 401(k) accounts, self-employed SEP accounts, and self-employed defined benefit pension plans.
5. If you are a cash-basis self-employed individual, take steps to defer business income into the next year and accelerate business deductions into the current year.

Five Longer-Term Strategies to Minimize or Avoid NIIT in Future Years

The following moves might not do much to reduce or eliminate exposure to the NIIT in the current year, but they could help a lot over the long run.

1. Convert traditional retirement account balances to Roth accounts, but watch out for the impact on MAGI in the conversion year. The deemed taxable distributions that result from Roth conversions are not included in net investment income, but they increase MAGI – which may expose more of your investment income to the NIIT in the conversion year. Over the long haul, however, income and gains that build up in a Roth IRA will usually be bullet-proof with respect to the NIIT, because qualified Roth distributions are tax-free for both regular income tax and NIIT purposes. Because qualified Roth distributions are not included in MAGI (unlike the taxable portion of distributions from other types of tax-favored retirement accounts and plans), qualified Roth distributions will not increase your exposure to the NIIT by increasing your MAGI.
2. Invest more taxable brokerage firm money in tax-exempt bonds. This would reduce both net investment income and MAGI. Use tax-favored retirement accounts to invest in securities that are expected to generate otherwise-taxable gains, dividends, and interest.

3. Invest in life insurance products and tax-deferred annuity products. Life insurance death benefits are generally exempt from both the federal income tax and the NIIT. Earnings from life insurance contracts are not taxed until they are withdrawn. Similarly, earnings from tax-deferred annuities are not taxed until they are withdrawn.
4. Invest in rental real estate and oil and gas properties. Rental real estate income is offset by depreciation deductions, and oil and gas income is offset by deductions for intangible drilling costs and depletion. These deductions can reduce both net investment income and MAGI.
5. Invest taxable brokerage firm account money in growth stocks. Gains are not taxed until the stocks are sold. At that time, the negative tax impact of gains can often be offset by selling loser securities held in taxable accounts. In contrast, stock dividends are taxed currently, and it may not be so easy to take steps to offset them.

CONCLUSION

Some of the strategies explained here are double tax-savers because they can reduce both your regular federal income tax (FIT) bill and your NIIT bill. If you are self-employed, some of the strategies are triple tax-savers because they can reduce your FIT bill, your NIIT bill, and your self-employment tax bill. Finally, these strategies might reduce your state income tax bill as well. However, some of these strategies take time to implement. So get started on identifying strategies that can help your clients before it is too late to implement them.

KNOWLEDGE CHECKS

11. In what year did or does the NIIT take effect?

    a. 2013.
    b. 2015.
    c. 2017.
    d. 2010.

12. The NIIT is never imposed on

    a. Income and gains from the investment of business working capital.
    b. Passed-through income and gains from partnerships and S corporations.
    c. Income and gains accumulated in tax-favored retirement accounts such as 401(k) accounts and IRAs.
    d. Income from rental activities.

13. The NIIT is never imposed on

    a. Gains from selling personal residences.
    b. Self-employment income.
    c. Gains from selling investment real estate.
    d. Interest income.

