Quarterly Newsletter
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INSIGHTS

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Siegfried & Luke, Inc.

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UPCOMING DEADLINES

September 15

- Due date third quarter estimated tax payments
- Due Date for extended 2013 Corporate, Partnership and Trust Income Tax Returns

October 15

- Deadline for extended 2013 Individual Income Tax Returns

October 30

- Due date for third quarter payroll tax filings (US 941, GA DOL-4 and GA G-7)

Like-Kind Exchanges: A Tax Planning Arrangement for Property Owners

With the rising real estate values, selling property may cause an individual to recognize a gain on the sale, which, in general, requires a payment of taxes on the gain. An individual desiring to avoid this payment may choose to opt for a "like-kind exchange." A like-kind exchange allows the seller to avoid gain recognition through the exchange of qualifying like-kind properties. The gain on the exchange of like-kind property is effectively deferred until the replacement property is sold or otherwise disposed.

The IRS allows this tax-deferred transaction because it recognizes that the individual's economic position remains the same (one property has merely been exchanged for another), and therefore the individual should not have to incur any taxable gains. However, the individual will have to recognize gain on money or unlike property that was received in the exchange.

To qualify to receive like-kind treatment, both the property surrendered and received must be held by the individual for investment or for productive use in a trade or business. Buildings, rental houses, land, trucks, and machinery are examples of property that may qualify.

Like-kind exchanges provide a valuable tax planning opportunity if:

- The individual wishes to avoid recognizing taxable gain on the sale of property that will be replaced with like-kind property;
- The individual wishes to diversify his or her real estate portfolio without tax consequence by acquiring different types of properties with the exchange proceeds;
- The individual wishes to participate in a very useful estate planning technique (continued like-kind exchanges allow for permanently avoided recognition of gain); or
- The individual would generate an alternative minimum tax liability upon recognition of a large capital gain in a situation where the gain would not otherwise be taxed. (The like-kind exchange shelters other income from the alternative minimum tax.)

TIME LIMITS

In general, to successfully qualify for this treatment, the exchange must abide by two time limitations beginning with the date of the first transaction. One limitation requires the replacement property to be identified within 45 days, referred to as the "Identification Period." The other time limitation requires the replacement property to be received by the exchanger within 180 days, referred to as the "Exchange Period." Replacement property can be one or several properties if structured or chosen properly.

In the Identification Period, an identification notice must be submitted which states any properties the individual would like to exchange as a replacement to his or her relinquished property. It is wise practice for a solid contract to be in place before the end of the 45 day period.

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If the deal(s) falls apart for any reason and the 45 days have passed, and if the taxpayer has no other identified property to buy instead, the exchange fails and the gain becomes taxable.

The 180-day rule is shortened to the due date of a tax return if the tax return is not put on extension. For example, if an exchange commences late in the tax year, the 180 days can be later than the April 15 filing date of the return. If the exchange is not complete by the time for filing the return, the return must be put on extension. Failure to do so causes the exchange to terminate on the due date of the return.

In addition, if the exchanger combines funds from two exchanges to buy any one replacement property, those two exchanges then become linked to one another and share the same lifespan. Timing for BOTH exchanges begins when the first relinquished property sale closes. The replacement property must be identified as such for BOTH relinquished properties within 45 days from the first relinquished property closing, whether or not the second relinquished property is even sold by that time.

Restrictions are also imposed on the number of replacement properties which can be identified in an exchange. More than one potential replacement property can be identified as long as you satisfy one of these rules:

- Three-Property Rule: Any three properties regardless of their market values.
- 200% Rule: Any number of properties as long as the aggregate fair market value of the replacement properties does not exceed 200% of the aggregate FMV of all of the Relinquished Properties as of the initial transfer date.
- 95% Rule: Any number of replacement properties if the fair market value of the properties actually received by the end of the exchange period is at least 95% of the aggregate FMV of all the potential replacement properties identified.

QUALIFIED INTERMEDIARY

There is more than one way to structure a tax-deferred exchange under §1031 of the IRC. However, the 1991 Regulations established "safe-harbor" procedures which include the use of a Qualified Intermediary, direct deeding, the use of qualified escrow accounts for temporary holding of "Exchange funds" and other procedures which have the official blessing of the IRS.

The Intermediary can act with respect to the property as the agent of any party to the transaction. There must be a written agreement between the taxpayer and the Intermediary stating the seller's intent to exchange and expressly limiting the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the money or property held by the Intermediary.

In conclusion, there is no compelling reason for taxpayers to pay capital gains taxes on their sale of investment property when they intend to reinvest their position into more investment property. Please contact our office if you would like more details regarding the rules applicable to exchanges. ■

Maximizing Social Security Benefits

Claiming social security benefits can be complex, but with a little guidance and understanding, it is possible for any taxpayer to claim the maximum amount which he or she is entitled to receive.

Anyone can begin to collect social security at the age of 62. However, this can lead to a permanent reduction in the amount received by as much as 25%. Knowing the best age at which an individual is able to collect social security is critical because if an individual waits until he or she has reached *full retirement age*, there are considerably more benefits.

For those born between 1943-1954, full retirement age is 66. The age limit gradually increases to 67 for those born between 1955-1959 and everyone born in 1960 or later reaches full retirement age at 67.

After reaching the full retirement age, the taxpayer may still opt to defer collecting until the age of 70. For every year between reaching the full retirement age and turning 70 that social security benefits are deferred results in an 8% increase to the annual payout that will be received. Waiting until full retirement age can result in 76% more benefits than starting benefits at the age of 62. Furthermore, waiting until the age of 70 can result in an additional 32% in benefits.

For married couples, there is also the added bonus of being able to claim a "spousal benefit". With this, if the spouse who earned less income waits until he or she reaches full retirement age to withdraw the benefits, he or she can receive up to 50% of the higher earning spouse's benefit. However, the higher earning spouse will have to also be collecting his or her benefits. The longer the higher earning spouse waits, the more both parties can receive. ■

Features of a 529 College Savings Plan

One effective way to save for college tuition is through a Section 529 plan. A 529 plan is an investment account sponsored by 48 states (excluding Washington and Wisconsin), or through a broker, in which savings and earnings are tax-free provided that the withdrawals are used for qualified college expenses. Contributions can be made regardless of income levels, and two-thirds of states give a tax deduction or credit to residents contributing to state sponsored accounts.

When choosing a 529 plan, the investor has many options. There are varying investment options in each state. Determining the best plan depends on the investor's preference for tax deductions, fee costs, variety of investment options, and aggressive or conservative tracks. Residency is not required to open a state sponsored plan. After opening a 529 plan, the investor can switch investment plans one time per year. The savings can also roll into another state's plan without penalty.

Withdrawals from the 529 plan are required to be used on qualified higher education expenses; otherwise, the taxpayer will owe income tax and have to pay a 10% penalty on earnings. Some states will also require a refund of any state deductions taken over the years.

The withdrawal from a 529 plan can be applied to cover the cost of tuition, fees, and, under certain circumstances, room and board. A withdrawal can be made to cover books, equipment, and supplies, given that they are required for enrollment or attendance. If the student lives off-campus, or is a part-time student, it is important to contact the college's financial aid office to determine the amount that can be withdrawn from an account for room and board.

Transportation costs and repayment of student loans are a few examples of costs a college student may have that are not considered qualified uses of a 529 plan. It is important to only withdraw money that will be applied to the qualified expenses because any extra will be considered a non-qualified distribution and will be taxable income to the account owner and potentially subject to the 10% penalty. ■

Rental Activity & Passive Activity Loss

Taxpayers who invest in passive activities are generally limited in the amount of losses they may deduct related to the passive activity. According to the IRS, an activity is considered to be passive if the activity is a trade or business in which the taxpayer does not materially participate during the year, or if it is a rental activity.

A taxpayer is only allowed to deduct losses related to a passive activity to the extent that they have income from other passive activities. Any passive activity losses in excess of passive activity income are disallowed for the current year and are carried over to future years to be used to offset future passive activity income.

As mentioned earlier, the IRS considers a rental activity to be classified as a passive activity by default. However, there is one way in which a taxpayer can bypass the passive activity loss rule when it comes to rental activities, and that is for the taxpayer to be considered a real estate professional.

In order for an individual to be considered a real estate professional, they must meet two criteria. First, they must materially participate in a trade or business and more than one half of the total services performed for that trade or business must be performed in real property trade or business. Second, total hours of service performed related to the real estate trade or business must be in excess of 750 hours during the year.

If a taxpayer meets these requirements, the rental activity will no longer be treated as a passive activity and any losses related to the rental activity will not be limited. But what if a taxpayer is involved in multiple rental real estate activities and cannot meet the criteria made on the taxpayer's income tax return to group all rental activities into a single activity for purposes of meeting the real estate professional qualification.

A real estate professional will realize another benefit when the rental activity or activities generate income for the year and not losses. As a result of the Affordable Health Care act a new tax was enacted called the Net Investment Income Tax. This is an additional tax of 3.8% levied on investment income such as interest, dividends and passive activity income for taxpayers with Adjusted Gross Income (AGI) in excess of $250,000.

If a taxpayer is considered to be a real estate professional and is invested in a rental activity, any income from that activity will be considered to be non-passive and therefore not subject to the 3.8% Net Investment Income Tax.

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In order to qualify as a real estate professional, it is the responsibility of the taxpayer to substantiate his or her participation in real estate activities. Any taxpayer hoping to bypass the passive activity loss regulations will need to be meticulous in documenting location, time spent, and services rendered within each activity. It is also suggested that he or she retain ample supporting evidence to verify those claims.

With the stringent criteria that an individual must meet to be considered a real estate professional, most taxpayers may not qualify. However, if you feel you may qualify, we will be happy to speak with you to determine if you actually do and could benefit from being treated as a real estate professional. ■

DID YOU KNOW?

In March, the National Labor Relations Board (NLRB) ruled that Northwestern University's football players who received athletic scholarships are considered employees of the school and therefore have the right to unionize. Although this ruling is being fought to be overturned, as far as taxes go, the issue does not matter.

In a private ruling, the IRS said the standard tax rules for scholarships still apply and the players will not be considered employees for tax purposes. Their grants will remain tax-free as long as the scholarships remain intact and the athletes continue to play and are not required to do other work for the school. ■

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Every taxpayer's situation is different and requires careful review and analysis.

If you have any questions about any item covered in this newsletter or items that you have heard about but were not covered, please contact our office to schedule a time to discuss your questions in greater detail.

Information contained in this publication is for educational and informational purposes only. It should not be construed as specific tax or legal advice for your specific situation.

Please contact Siegfried & Luke, Inc. with any questions.

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