Quarterly Newsletter
February 2016

INSIGHTS

A quarterly publication by
Siegfried & Luke, Inc.

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UPCOMING DEADLINES

March 15

- Initial due date for 2015 corporate income tax returns

April 18

- Initial due date for 2015 individual, partnership, and trust & estate income tax returns
- Due date for 2016 first quarter estimated tax payment

Combining the 121 Exclusion with a 1031 Exchange

A complex tax planning strategy is available for taxpayers who are looking for a way to sell appreciated personal property without recognizing huge gains for tax purposes. The strategy involves combining the Internal Revenue Code (IRC) 121 exclusion of gain on the sale of a principal residence with an IRC Section 1031 exchange for like-kind property held in a trade or business or for investment. Tax legislation and IRS rulings provide guidance on how this can be accomplished.

First, it is important to discuss the 121 Exclusion and a 1031 Exchange. Section 121 states the gain on the sale of property, which has been owned and used by the taxpayer as a principal residence for two of the last five years prior to the date of sale, shall not be included in the taxpayer's gross income, as long as the gain is not more than $500,000 for joint returns ($250,000 for single returns).

Section 1031 provides property held for use in a trade or business or for investment can be exchanged for like kind property (such as real property for real property) also held for use in a trade or business or for investment. This allows the taxpayer to defer any capital gain which would otherwise be recognized, except for cash received in the transaction.

A simple example would work as follows: A taxpayer has a building held for investment which was originally purchased for $100,000 five years ago which now has a fair market value (FMV) of $300,000. The taxpayer decides to sell the building and purchase a new building that costs $250,000. An outright sale would generate a capital gain of $200,000 ($300,000 FMV - $100,000 Cost) on which the taxpayer would have to pay tax in the year of the sale. However, in a 1031 exchange, the taxpayer could utilize the $300,000 proceeds to purchase the new building at a cost of $250,000 with remaining cash of $50,000. The cash called "boot," is recognized as gain because it is not reinvested and the remaining gain of $150,000 ($200,000 gain less $50,000 boot) would be deferred. The deferment would result in his basis in the new building being the same as the basis in his old building; $100,000 ($250,000 – $150,000).

Section 121, applicable to personal use property works with Section 1031, which is for property held in a trade or business or for investment because of Rev Proc 2008-16, which lays out specific guidance and provides a safe harbor for which the IRS will not challenge whether a dwelling unit qualifies as property held for use in a trade or business or for investment for purposes of Section 1031.

There are several hurdles to be cleared with Rev Proc 2008-16, many of which are in line with what already exists for old and new property to qualify as like kind property under Section 1031. The additional important items to note relate to the relinquished property are as follows: (a.) The dwelling unit is owned by the taxpayer for 24 months prior to the exchange and (b.) within the qualifying use period, in each of the 12 month periods immediately preceding the exchange, (i.) the taxpayer rents the dwelling unit to another person at fair rental for 14 days or more and (ii.) the taxpayers personal use of the property does not exceed the greater of 14 days or 10% of the number of days the dwelling is rented at fair rental.

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The replacement property must meet the same criteria but for the 24 month period after the exchange.

When these two are combined, the time frames become very important. Remember under Section 121, a taxpayer must own and use a dwelling for two out of five years prior to the sale as a principal residence. Rev Proc 2008-16 provides a safe harbor for a dwelling to be considered business use in a 24 month period. An example would be as follows:

A taxpayer purchases a house in 2009 for a purchase price of $250,000. The taxpayer and spouse own and occupy the property as their principal residence until December 31, 2014 when the property has appreciated in value to $600,000 and they want to move closer to grandchildren. They feel the house will appreciate more in the coming years and decide rather than selling it, they would prefer to rent it to generate additional cash flow income. They convert the property to a residential rental on January 1, 2015 and report the income and expenses related to the rental on their individual return.

In June of 2017, the taxpayers are approached to sell their home which is now worth $800,000. They have enjoyed having a property that generates cash income each month and would like to continue that income stream. After consulting with their CPA, they decide to sell the property and use the Section 121 exclusion and 1031 exchange to minimize the tax impact of the transaction.

The taxpayers sell the home (which two of the last five years was their primary residence) for a sales price of $800,000. The property has been rented at fair market rent for the last 30 months and not used personally. Since it has been rented out for the last 30 months, depreciation has been taken on the house for a total of $20,000, which reduces their adjusted basis from $250,000 to$230,000. The calculated gain on the sale is $570,000, which can either be deferred or will be recognized to the extent of cash received. The taxpayers decide to receive cash of $400,000 and use the remaining $400,000 to purchase a new rental property using the rules of Section 1031. The cash received, which would otherwise be taxable boot, is excludable from gross income under Section 121 and the new property purchased has a basis of $230,000 ($400,000 purchase price – $170,000 total gain less recognized gain).

While this is a simplistic example of combining Section 121 with Section 1031, the tax rules and regulations are complex. If you have any questions about this topic, please contact our office to speak more specifically about your individual situation. Always remember before engaging in any tax strategy, you should consult the advice of qualified advisors. ■

ACA and Form 1095

This year, all taxpayers must report their health insurance coverage on their tax returns. Every individual will receive a Form 1095, which can be considered to be "proof of insurance", and is provided by whoever provides coverage. There are three versions of the Form 1095.

Form 1095-A is for health insurance that was purchased through the Marketplace. This year, Form 1095-A was supposed to be delivered by February 2nd, but some states will not get them out until the end of February. Additionally, an estimated 800,000 people received an incorrect 1095-A and will need to wait for a corrected version before filing their return. Taxpayers who have insurance that was not purchased from the Marketplace, will receive either a 1095-B or 1095-C.

Form 1095-B are filed by companies who offer insurance to their employees and are self-insured. They are also sent out by insurers who provide coverage for a company's employees and for individuals who have non-Marketplace coverage.

Form 1095-C is filed by larger employers (Applicable Large Employers) who have 50 or more employees and are required to offer minimum essential coverage. The 1095-C outlines the coverage the company had available to its employees. This means that self-insured companies who have 50 or more employees must provide both a 1095-B and 1095-C to their employees.

It is important to note that these forms are not required to be sent with your return; they are for your tax records and to assist in preparing your return. The due date for employers and insurers to send these forms is March 31, 2016. If you are unsure of when you were covered in 2015, it is best to wait to file your return until you have received your 1095. ■

ABLE Act

With the goal of providing financial resources for the benefit of disabled individuals, the Stephen Beck, Jr., Achieving a Better Life Experience Act (ABLE Act) was enacted in December of 2014. Under §529A of the Internal Revenue Code, this act allows states to establish and maintain a new type of tax-favored savings program to assist in saving for qualified disability expenses for a designated beneficiary who is a resident of that state or of a contracting state.

§529A(e)(5) defines qualified disability expenses as expenses that relate to the designated beneficiary that maintains or improves his or her health, independence, or quality of life. Under the ABLE Act, qualified expenses are not limited to medically necessary items, and can include expenses that improve basic living. Such expenses include, but are not limited to, expenses for education, housing, transportation,

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ABLE Act Continued - employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, and funeral expenses. Any expenses that occur at a time when the designated beneficiary is not disabled will not be considered qualified expenses.

Generally, contributions to an ABLE account are subject to both an annual and cumulative limit of $14,000 for 2015 (but inflation adjusted). Any amount contributed in excess of this limit must be returned to the contributor, or it will be subject to a 6% excise tax. When a contribution is made by a person other than the designated beneficiary, it is treated as a non-taxable gift to the designated beneficiary. Distributions made from an ABLE account for qualified expenses of the designated beneficiary are not included in his or her gross income, however, the earnings portion of distributions from the ABLE account in excess of the qualified disability expenses is includible in the beneficiary's gross income. ■

Household Employees

As the new year begins, it is a good time to revisit the topic of household employees, i.e. nannies, senior caregivers, housekeepers and even private chefs. In general, if an individual is paid $2,000 or more during 2016, and otherwise qualifies as an employee (versus independent contractor) the employer is obligated to withhold payroll taxes (social security and Medicare) from employee pay, pay employer taxes, file state and federal tax returns remitting such taxes at the appointed times during the year and, at year end, provide the employee with Form W-2 and file necessary annual tax reporting forms.

There are basic rules for determination if a worker is an employee or contractor. From the IRS Publication 926, Household Employer's Tax Guide, "a worker is your employee if you can control not only what work is done, but how it is done." A worker is not your employee "if only the worker can control how the work is done", and "usually provides his or her own tools and offers services to the general public in an independent business." Recently the U.S. Department of Labor also included the permanence of a position and the economic dependence of a worker on a position as additional factors in worker classification. If questions remain about worker classification, the IRS has provided Form SS-8 that may be completed and submitted for assistance with determination of a worker's status.

The tax consequences of having a household employee are only one facet of the considerations necessary when hiring. It may be beneficial to contact an expert to determine how the Department of Labor (DOL) laws and regulations factor into an employment decision. Among the DOL rules to contemplate would be the application of minimum wage, overtime and paid time off or sick time regulations as well as requirements for worker compensation and disability insurance. ■

Small Business Corner

As a new business is formed, it is typical for the entity to be registered with the Secretary of State as names are selected and articles of organization are filed. Not so frequently do these same businesses think to apply for a business license within the state or local jurisdiction in which it operates.

In general, a business license, or occupational tax registration certificate, is required of all businesses. While some operations are clearly undertaken with a profit motive and it is obvious that the business would be subject to regulation, there are circumstances under which the requirement is not so clear.

For example, if a partnership is formed to manage real estate investments outside of the local municipality, the management office is a room in a residence, and the principal owners have full-time employment elsewhere, is a business license required? Does this fit the definition of business for this purpose?

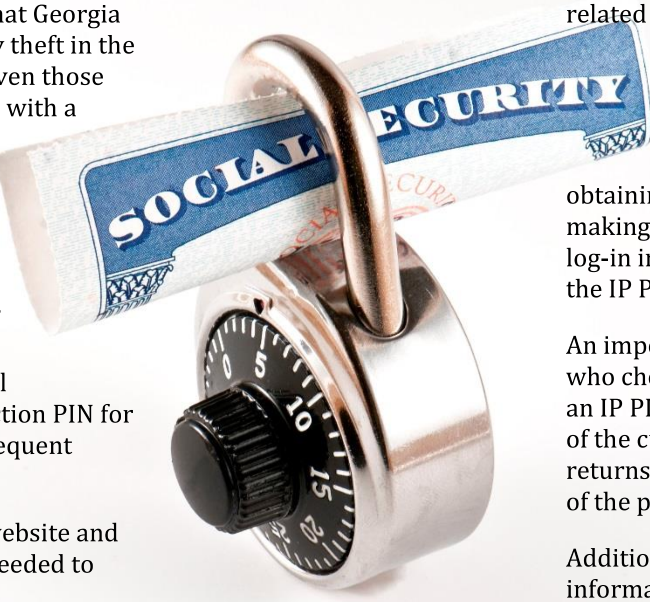
It may be in the owners' best interest to contact the local regulators to determine ahead of formation or operations if a business license will be required.

In addition, at the beginning of each year, businesses are required to renew these licenses and registrations to continue operations in compliance with local and state regulations. The registration renewal with the Georgia Secretary of State is due between January 1 and April 1 of each year and can be renewed online.

Typically, a business license is due for renewal within the first month or two of the year and requires information about prior year revenues and statements regarding compliance with other requirements to operate a business within the jurisdiction. The renewal fee is calculated and assessed with payment due at a given later date. For example, if operating within the City of Atlanta, the tax assessed is due on or before April 1.

Identity Theft Update

Many taxpayers have recently received threatening telephone calls or emails from scammers pretending to be from the Internal Revenue Service. It probably isn't surprising that Georgia has one of the highest rates of identity theft in the country and as a result, the IRS has given those taxpayers who filed their 2014 return with a Georgia address (also Florida and the District of Columbia) the opportunity to "opt-in" to a program started several years ago in an effort to stem that trend.



In general, the IRS requests victims of identity theft complete an Identity Theft Affidavit. Once filed, the IRS will respond by issuing an Identity Protection PIN for use in the electronic filing of the subsequent individual income tax return.

To apply for an IP PIN, go to the IRS website and search "Get an IP PIN." Information needed to apply is:

- Social Security number,
- Date of Birth,
- Email address,
- Filing status, and
- Mailing address from the most recently filed tax return.

The process will require confirmation of the email address so current access to the email will be required. Additional questions related to tax returns filings will be used to confirm identity prior to assigning an IP PIN.

If a prior account has been established with the IRS for obtaining a transcript of a return or for making an online payment, the same account log-in information will need to be used for the IP PIN application process.

An important point to note is that for one who chooses to participate in this program, an IP PIN will be required for electronic filing of the current year return and all future returns. It is currently impossible to opt out of the program.

Additionally, our office also offers informational booklets from Federal Trade Commission on what to do if your identity is stolen.

For questions or assistance with this process, please contact our office at 404-389-1700. ■

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Certified Public Accountants

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.