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Tax Newsletter

Max Out Tax Benefits of Installment Sales
Special tax rules for real estate gains

When you intend to sell appreciated commercial real estate at a huge profit, you may have to compromise. For instance, if you refuse to budge much on price, you might have to make other reasonable concessions, such as agreeing to an installment sale for a buyer with limited liquidity. As the name implies, the buyer pays you the amount due in a series of installments, instead of providing all the cash up-front.

This could actually be beneficial from a tax perspective if payments are made over two years or more. In that case, not only can you defer some of the tax due on the appreciation in value, you may reduce your overall tax liability.

Background: With an installment sale of real estate, you generally are in line for preferential tax treatment. First, the gain is taxed as a long-term gain if you have owned the property for longer than one year, resulting in a maximum capital gain rate of 15% (20% for certain high-income individuals). Even if you are also liable for the 3.8% net investment income tax (NIIT), the maximum combined tax rate on the federal level is currently 23.8%.

Second, only a portion of your gain is taxable in the year of the sale. The remainder is taxable in the years that payments are received. By spreading out the tax over several years, you might pay less tax overall because more of the capital gain may be taxed at the lower 15% rate.

The taxable portion of each payment is based on the "gross profit ratio." Gross profit ratio is determined by dividing the gross profit from the real estate sale by the price.

Example: Suppose you acquired a small building ten years ago that has an adjusted basis of $600,000. You agree to sell the property now for $1.5 million in three annual installments of $500,000 each. Because your gross profit is $900,000 ($1.5 million - $600,000), the taxable percentage of each installment received is 60% ($900,000 divided by $1.5 million). When you report the sale on your 2021 tax return, you have to pay tax on only $300,000 of gain (60% of $500,000).

Any depreciation claimed on the property must be recaptured as ordinary income to the extent it exceeds the amount allowed under the straight-line method. The adjusted basis of the property is increased by the amount of recaptured income, thus decreasing the gain realized in future years.

But watch out for a little-known tax trap. If the sales price of your property (other than farm property or personal property) exceeds $150,000, interest must be paid on the deferred tax to the extent that your outstanding installment obligations exceed $5 million.

Final words: If it suits your purposes, you can elect to forego installment sale treatment when you file your 2021 tax return. This could be advantageous if 2021 is an unusually low-income year for you. Consult with your tax advisor concerning the details.

Estate Planning for Blended Families
Combining several astute techniques

It is no longer unusual to have a spouse, children and grandchildren from a second or third marriage encompass a "blended family." But these additions to the clan can complicate estate planning. Keeping that in mind, the following techniques may be beneficial for blended families:

- **Will:** Your will is the centerpiece of your estate plan and should be coordinated with other devices such as trusts. It can be amended through a codicil for minor changes or be completely rewritten to reflect major changes. For example, you might rework a will to include your spouse and your children from a second marriage or even your current spouse's children from a prior marriage.

- **Living trust:** Often viewed as a supplement to a will, a living trust enables you to maintain control over disposition of assets. If the trust is revocable, you retain the ability to change the beneficiaries or allocations or otherwise amend it during your lifetime. However, assets in an irrevocable trust are removed from your taxable estate. Because a living trust avoids probate, this can be valuable to someone who wants to avoid public scrutiny.

- **Prenuptial agreement:** This is no longer the exclusive domain of the rich-and-famous. A "prenup" is often designed to protect assets before entering a second marriage and preserve wealth for the children of your first marriage. It may also be coordinated with other rights and responsibilities (e.g., conditions for a second spouse to act as executor of your estate).

- **Power of attorney:** A power of attorney is a legal document authorizing the "attorney-in-fact" to act on your behalf. With a durable power of attorney, the power continues if you become incapacitated. The decision as to whom to designate as the attorney-in-fact can be a critical one for blended families.

- **Retirement plans and IRAs:** It is likely that much of your wealth is socked away in qualified retirement plans, such as a 401(k) and traditional and Roth IRAs. Prior beneficiary designations should be updated due to certain life events like a divorce, marriage or remarriage or birth. These plan and IRA designations supersede any declarations in your will or other documents.

- **Life insurance:** As with retirement plans and IRAs, you may be encouraged to amend your beneficiary designations. Alternatively, you might revise the percentages of proceeds going to the respective parties. Once again, these beneficiary choices supersede other designations.

- **Q-Tip trust:** A Qualified Terminable Interest Property (Q-Tip) trust is comparable to a regular marital trust. However, if the surviving spouse is entitled to a portion of your assets upon your death, he or she receives regular income payments, but not any principal. When the surviving spouse dies, the remainder passes to the designated beneficiaries, thus providing estate tax benefits.

These are just several techniques that are often utilized in planning for a blended family. Other options may be available for your situation. With assistance from your professional advisors, create an overall plan that meets your objectives and hopefully provides family harmony.

Spreading the Tax Cheer at Work
Enjoy tax break for holiday party

We certainly do not need any extra reasons to celebrate at the end of this year. To reward loyal workers and boost morale, you may be thinking about throwing a holiday party or organizing some other company-wide gathering of employees in December.

Practical advice: Go right ahead as long as you take all the proper precautions. What's more, be aware that your business may be in line for a generous tax break, despite a recent tax law crackdown. If you handle things the right way, you can write off every last penny spent on the event!

For years, the tax law allowed an employer to deduct 50% of its qualified entertainment expenses that were "directly related to" or "associated with" the trade or business. For example, if you wined and dined a client after a substantial business meeting, you could deduct half of the cost as entertainment—even if you never brought up business during the evening.

But then Congress rained on the parade. Effective for 2018 and thereafter, the Tax Cuts and Jobs Act (TCJA) repealed the entertainment expense deduction. The change is permanent, barring any subsequent legislation.

Saving grace: Your company can take advantage of another longstanding tax break. Under a special tax code provision, a business can write off *100%* of the cost of a holiday party or similar get-together if certain requirements are met. The TCJA did not touch this write-off—it is still part of the tax law.

To qualify, the party cannot be overly lavish or restrictive. In other words, you may not limit the guest list to certain officers and managers. The entire staff has to be included.

Another wrinkle: If you invite other people to the party—say, a few friends—you cannot deduct the costs attributable to these "social guests." It will not jeopardize the deduction unless you are merely disguising a private party. Keep track of the expenditures allocable to social guests.

Example: You make arrangements to host a holiday party for your small company at year-end. All 25 of your employees attend plus 20 of their significant others. (You can count yourself and your spouse or companion.) Plus, you invite five friends to join in the festivities.

In this case, five of the 50 attendees are social guests, or 10% of the total. If the party costs, say, $10,000, you can deduct 90%, or $9,000. The remaining $1,000 is nondeductible.

Note: The American Rescue Plan Act (ARPA) creates a deduction for business meals equal to 100% of the cost for 2021 and 2022 if the food and/or beverages are provided by a restaurant or comparable facility. But this new law break is moot when it comes to the tax law exception for holiday parties. Your business can deduct 100% of the cost whether or not you use a restaurant or other facility.

Lights out: Make sure you are on firm tax ground when you plan the party. Verify all the tax consequences with your professional advisor. And be responsible!

Locking In Tax Breaks for Home Security

If you are self-employed and your home is your principal place of business, you may store valuable items in a home office or a separate structure adjacent to the home, like a detached garage or shed.

Tax-saving idea: Install a home security system for protection. As a result, you can claim a depreciation allowance for the system, plus current deductions for maintenance and monitoring. The deductions are based on the percentage of business use of the home.

Remember to keep accurate records in case the IRS ever challenges your deductions.

Facts and Figures
Timely points of particular interest

Foreign Matters—The IRS remains committed to closing the "tax gap." To this end, it is putting more resources into investigating taxpayers who fail to file Reports of Foreign Bank and Financial Accounts (FBARs). Generally, you must file a FBAR if the aggregate value of your assets in foreign bank accounts exceeded $10,000 in the prior year. Note: For 2021, the penalty for a "willful violation" equals the greater of $129,210 or 50% of your account balances.

Missing Refunds—Are you still waiting for a tax refund from your 2020 tax return? It may be a small comfort, but you are not alone. The IRS recently reported that it was facing a backlog of about 35 million returns that still have to be manually processed. The delay is being attributed mainly to the pandemic and a myriad of tax law changes. For an update of your personal status, refer to the IRS "Where's My Refund?" online tool, but do not call the agency.