

Federal and Pennsylvania Tax Laws



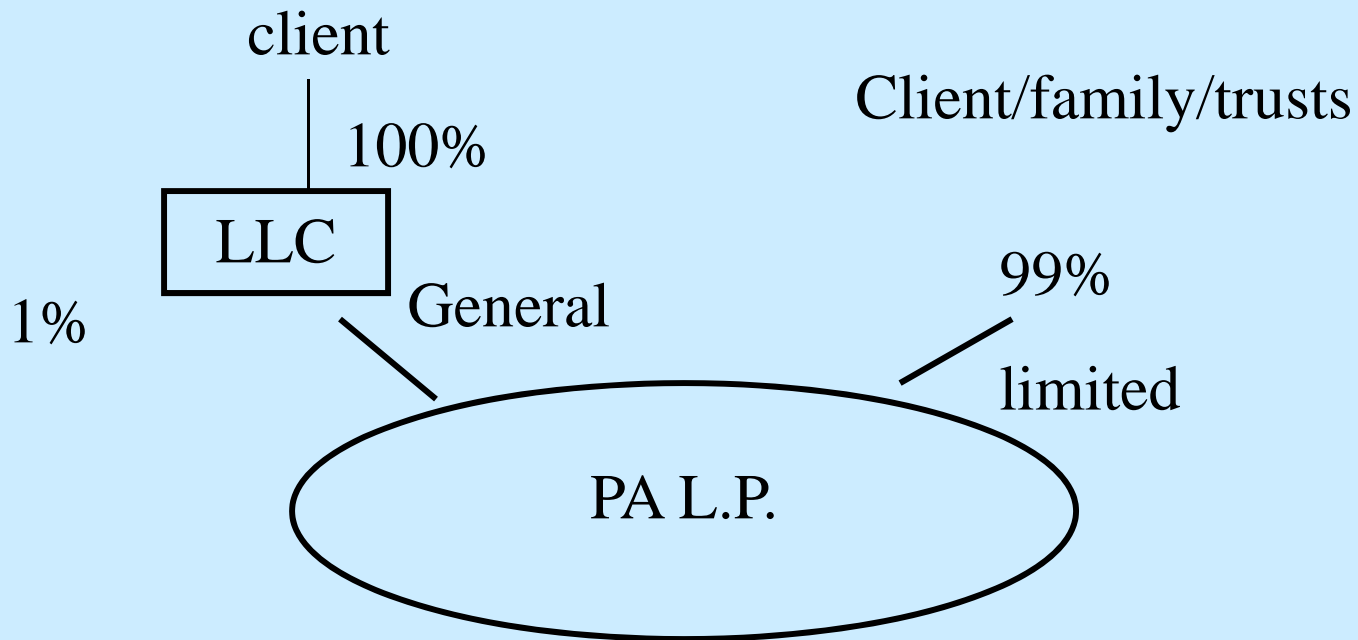
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How Do I Own Real Estate in PA?

- Real Estate in Pennsylvania should be owned by a limited partnership with a limited liability company as the sole general partner



Diagram



Why?

- No PA capital stock tax
- Note: although there is some relief from PA Capital Stock Tax for distributions to members who are active in LLC operations, that relief is useless for non active members.



- Given that real estate in PA should be owned by a limited partnership!
- How is real estate taxed?



Tax Rates Applicable to Real Estate

Test: Real Estate

In 2002 Purchased for 2,500,000

Allocated 500,000 to land

1,800,000 to bldg.

200,000 to pers. property



Tax Rates Applicable to Real Estate

In 2011	Worth 3.5M		
		↙	
		Sale Price	
	<u>Tax Basis</u>	<u>Allocate</u>	<u>Gain</u>
Land =	500,000	700,000	200,000
Bldg =	1,700,000	2,650,000	950,000
Personal Property =	<u>120,000</u>	<u>150,000</u>	<u>30,000</u>
	2,320,000	3,500,000	1,180,000

Multiple Choice

- (a) 35%
- (b) 25%
- (c) 15%
- (d) 5%
- (e) all of the above
- (f) none of the above

Answer

- 30,000 personal property \bowtie ordinary income = 35%
- 950,000 $\left\{ \begin{array}{l} 100,000 \text{ (= depreciation)} \\ 850,000 \end{array} \right.$ $\left. \begin{array}{l} = 25\% \\ = 15\%* \\ = 15%* \end{array} \right\}$ Long term rates!
- 200,000 land = 15%*

* For individuals in the 10% or 15% bracket, the 15% rate becomes 5%

How Do I Get These Long Term Rates?

- Hold asset for more than 12 months
- Not be a “dealer” in real estate



What if I Had Sold But Took Back An Installment Note?

- The date the Installment Payment is received, not the date of sale, determines what tax rate!



Exclusion and Deferral Opportunities

- Principal Residence Exclusion (\$500,000)
- Effective for sales/exchanges after 6/5/97
- One bite every 2 years
- If you don't meet rules you are O U T!



Exclusion and Deferral Opportunities

O - Ownership (either spouse)

U - Use (both spouses)

T - Two Year - residence must be owned
and used as principal residence for 2
out of 5 years prior to sale or exchange

- Neither spouse has used the exclusion in the last two years.

Residence Jeopardy

- How many homes do you have?
- How do I count years?
- What if I vacation a lot?
- Elect out?
- Can I flip flop?
- Spouses?
- Adjacent land?

Residence Jeopardy

- Depreciation
- I can't stand my neighbor?
- I'm in a nursing home?
- Trusts/LLC?
- Prin Residence acquired in like kind exchange?
- The PA Rule?

The Gov Giveth and Taketh Away Reduced Home Sale Exclusion

Home sale after 12/31/08

and

“bad use” on or after 1/1/09

Exclusion is reduced



You Can Take a Loss on a Principal Residence “Carefully”

Example

- Buy house 5 years ago for 500,000
- And put 200,000 of improvements in 200,000
- Total tax basis 700,000
- Put it on the market for 600,000
- Ultimately sold for 400,000
- Unenlightened (non deductible loss) (300,000)
- Enlightened (deductible loss) (200,000)

You Can Take a Loss on a Principal Residence “Carefully” (cont’d)

- Pre-sale convert the residence to income producing activity.
- The residence must be used for such purposes up to sale.
- At time of conversion, get appraisal.
- Lower of tax basis/FMV at conversion is greater than ultimate sale price.

Converting Personal Residence to Income Producing Purposes

- Abandon the residence – no personal use
- Offer to rent
- Offer to sell
- Fair rental

Make sure that establish value at the time of
conversion!

Deferral

Involuntary Conversion

Involuntary Conversion – destruction in whole or part by fire, theft, seizure, requisition or condemnation or threat thereof

	Condemnation	Fire
Replacement Standard	“like/kind”	“similar in service or use”
Time to replace	3 years	2 years
Stock in controlled entity	No	Yes

Allocation of Interest

Pshp/Sub-S/LLC owns real estate
Rent = 5.0M go out and borrow 5.0M
Exp = 4.0M distribute 5.0 to partners
Net = 1.0M assume loan 5.0 is at
FMV = 10.0M interest at 10%

Is the 500,000 interest deductible?

And the Answer is: It Depends

Show me the \$\$

- If a partner buys
 - Boat
 - Treasury
 - Residence
 - Muni
 - Business
 - A rental property
- Then interest deduction is
 - Personal not deductible
 - Investment
 - Housing
 - Not deductible
 - Deductible
 - Passive deduction

And the Answer is: It Depends

- General Rule
 - Trace at partner (owner) level
- Optional Rule
 - Trace at entity (passive) level



Traps For The Unwary

Sell real estate for	10.0M
tax basis	<u>3.0M</u>
	7.0M gain

Take back 10.0M note payable over ten years with adequate interest

Trap One Dealer property

Trap Two Sell real estate to related person and related person resells

Trap Three Sell depreciable real estate to a related person

Traps For The Unwary

Trap Four Pledge 10 note for a 5.0 loan

Trap Five 5.0M x 7.0 x 15% x
10.0M underpayment rate



Cost Segregation

Making an Accountant a friend for life

100,000

?

Write off

39 years

PV Benefit =

8,274

100,000

?

Write off

15 years

PV benefit =

15,818

100,000

?

Write off

7 years

PV benefit =

23,152

Separate land

Building

from

tangible pers. Property

Not

“inherently permanent”

- Buy, build or renovate

The Big Eraser

RR80-58



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