CPA
Client Bulletin
Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor[sm]

October 2010

Choices for Holding Investment Property

Now that prices are off sharply from their peak levels of a few years ago, you may want to invest in real estate. If so, you are looking for a promising property at the right price. Assuming you find such an opportunity, you'll have to make still another crucial decision: how to hold your property.

Outright ownership

The simplest option is to hold the property in your own name. You'll have absolute control and flexibility. You can make the decisions on capital improvements, tenant selection, and so on; you can sell the property or refinance it.

You'll face some disadvantages with this form of ownership, however. Depending on the amount of capital you're willing to invest, you might be limited in what you can buy. You'll also have to be sure that you're adequately insured against any liability resulting from someone being injured on your property.

Joint ownership

Married couples especially might want to hold investment property as joint tenants with the right of survivorship. That way, when one owner dies, the surviving owner inherits automatically. The real estate won't go through probate, which can be expensive and time consuming.

The downside? When property is held as joint tenants with right of survivorship, no other heirs can inherit it. If you have remarried and hold property in this manner with your spouse, for example, you can't leave all or part of this investment to children from a previous marriage.

General partnerships

As another approach to real estate investing, you might pool your capital with others to form a general partnership.

Example 1: Tom Adams, Richard Baker, and Harriet Carter form a

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CPA
America Counts on CPAs®

Build America Bonds

Since their creation in 2009, taxable Build America Bonds have constituted over 20% of all municipal bonds issued.

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Trusted Advice

Passive Losses

- Under the tax code, a loss from investment real estate is usually a *passive loss*.
- Passive losses generally can only be deducted against passive income, perhaps from another real estate investment.
- Even without passive income, you might be able to deduct some passive losses. Typically, investors with adjusted gross income (AGI) of $100,000 or less can deduct up to $25,000 worth of passive losses from rental real estate activities per year.
- For every $2 that AGI increases over $100,000, your allowable passive loss deduction shrinks by $1. At $110,000 of AGI, for example, you can deduct up to $20,000 of passive losses: the $25,000 maximum loss minus the $5,000 that results from the income-based phase-out.
- No deduction is permitted if your AGI reaches or exceeds $150,000.
- Passive losses you can't deduct right away (suspended losses) can be carried forward and deducted if you have passive income in future periods or if you dispose of your entire interest in the property.

partnership to buy investment property. When they find something for sale that they all like, each will contribute one-third of the capital.

With this method, the partners will have access to more expensive real estate (compared to what they could have bought as individuals), and they will have extra hands to help oversee their investment. Any investment losses can be passed through to each partner.

Suppose that the partnership of Tom, Richard, and Harriet buys an office building. In 2010, the property posts a $30,000 loss for tax purposes. As per their partnership agreement, each of the co owners will report a $10,000 loss on his or her tax return for the year. That loss may be deducted now or in the future, depending on the taxpayer's adjusted gross income and the partner's adjusted basis in the venture.

As with anything, general partnerships are not without drawbacks. Conflicts may arise if the individual owners disagree among themselves on issues relating to the real estate. Also, each partner is personally liable for debts the partnership incurs. Even with insurance, the investors' personal assets might be at risk.

Limited partnerships

Some limitations to the general partnership might be more appealing. A *limited partnership* is a specialized form of partnership, with two types of partners.

Limited partners are usually investors with no say in the management of partnership assets. They are liable only for the capital they contribute and any notes they sign. Often, any real estate losses are allocated largely to the limited partners for tax purposes.

One or more general partners runs the business. In a real estate limited partnership, the general partner is responsible for managing the property or delegating that responsibility. The general partner bears liability for all of the partnership's obligations.

Limited liability companies

A limited liability company (LLC) might offer the best features of all the other structures. As an LLC investor (or member), you'll benefit from partnership taxation. That is, any losses from the real estate are passed through to each member's tax return. In addition, LLC members enjoy the same type of limited liability that corporate shareholders have, so their other personal assets are not at risk.

In these litigious times, you should not downplay the threat of personal liability from real estate investments. By recognizing the danger, you may be able to limit your exposure.

Example 2: Jane Clark invests in several rental properties. She has no coowners. To minimize her paperwork, Jane could create a single-member (one owner) LLC to hold all those properties. Instead, Jane creates a separate single-member LLC for each property. Therefore, if a tenant is severely injured at one of Jane's properties and sues for damages, the risk can be confined to that one property rather than affect all of the investment real estate Jane owns. ■

Did You Know?

Over 70% of students graduating from a private not-for-profit university with a bachelor's degree had some student loans. For graduates of public universities, that figure was over 60%. Among all recent graduates with student loans, 25% owed over $30,500 and 10% owed more than $44,500.

Source: The College Board

Taxes on Bonds Bought at a Premium or a Discount

The taxation of bond interest is relatively straightforward. Assuming the bonds are held in a taxable account, the interest on corporate bonds is generally subject to all income taxes: federal, state (if applicable), and local (if applicable). Treasury issues pay interest that's subject to federal income tax but not state or local tax. Most municipal bonds pay interest that's exempt from federal income tax. If you buy a bond issued in your home state, you probably will avoid all tax on the interest income.

Plus or minus

You may have a more difficult time figuring capital gain or loss on a bond, however. Bonds are issued at so-called par value (for example, $1,000 per bond). Then prices fluctuate as interest rates move up or down. Therefore, when you buy a bond, you may be buying at a premium or a discount to par.

Example 1: Corporation ABC issued bonds at a $1,000 par value. The interest rate was 5%, or $50 per year, per $1,000 bond. Since then, interest rates on similar issues have moved up to 6%. Therefore, investors are less interested in ABC's bonds; they'll pay less for a bond with a below-market yield. To attract investors, ABC's bonds sell for $940. Investors can buy the bond at a discount to par value.

Example 2: Municipality XYZ issued bonds at $1,000 par value. The interest rate was 4%, or $40 per year, per $1,000 bond. Since then, interest rates on similar issues have moved down to 3%. Therefore, investors are more interested in XYZ's bonds. They'll pay more for a bond with an above-market yield. To reflect the increased demand, XYZ's bonds sell for $1,060. Investors must pay a premium over par value to buy these bonds.

Paying a premium

Today, most bonds have low effective interest rates, reflecting a low-yield environment. If you buy a bond issued years ago, chances are that you're paying a premium.

Example 3: Sue Walker buys $10,000 worth of Municipality XYZ's tax-exempt bonds for $10,600. The bonds mature in six years. Each year, Sue's basis in the bonds drops. The actual calculation is complicated and will be done by Sue's broker, but to simplify, assume that Sue's bonds are amortized (decline in basis) by $100 per year. She gets no tax benefit for the amortization of her municipal bonds.

After two years, Sue's basis in the bonds will drop by $200, from $10,600 to $10,400. If Sue sells those bonds then for $10,500, she will have a $100 long-term capital gain; if Sue sells them for $10,100, she will have a $300 long-term capital loss.

The rules on buying a taxable bond at a premium are different.

Example 4: Sue Walker buys $10,000 worth of Corporation UVW's taxable bonds for $10,600. These bonds mature in six years. With taxable bonds, you can choose whether to amortize the premium you've paid. If Sue chooses to amortize, she will recognize a partial loss each year, offsetting taxable interest income.

If you do not amortize a premium you've paid, the premium will be included in your basis, so you'll have a larger capital loss when you sell or redeem your bonds (or a smaller taxable gain if interest rates fall and you sell at a profit). You typically should make the election to amortize if you've bought taxable bonds at a premium because you'll get more tax savings.

Dealing with discounts

If interest rates rise from today's low levels, recently-issued bonds will lose value, and you'll be able to buy them at a discount. Bonds trading at a discount due to interest rate fluctuations are called *market discount bonds*. Regardless of whether you buy a taxable or tax-exempt bond at a discount, you'll owe tax at maturity.

Example 5: Jim Miller buys $10,000 worth of bonds for $9,400. They mature in 2016, and Jim collects $10,000. He will have $600 of ordinary income, taxed at the same rate as he would pay on investment interest. That's true for tax-exempt or taxable bonds.

Suppose, though, that Jim sells his bonds before maturity. He may have a capital gain or a loss, depending on how much of Jim's $600 discount has been accrued. Halfway to the maturity date, $300 of Jim's $600 discount will have accrued, so his basis in the bonds will have increased from the $9,400 purchase price to $9,700. Then, Jim

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would have a $100 gain on a sale for $9,800 and a $100 loss on a sale for $9,600. That gain or loss would be in addition to the $300 of ordinary income Jim would recognize from the accrual of the discount.

Investors who buy bonds at a discount have the option of recognizing the accrued income each year. The basis of the bonds is increased by the amount of market discount that you include in income each year, thus reducing the tax on sale or redemption of the bonds.

Our office can help you determine if recognizing accrued income at the end of each year will be advantageous. ■

Win the Giveaway Game

So far this year, the federal estate tax is not in effect. However, the federal gift tax is still in place. You are allowed to give up to $13,000 worth of assets to each of any number of recipients. If you make larger gifts, you'll have to file a gift tax return. Gifts over the $13,000 limit also may eat into a future estate tax exemption. (Direct payments of someone else's medical bills or school tuition won't count towards those gift tax limits.) In 2010, the gift tax rate is 35%, down from 45% in 2009.

If you decide to make gifts, cash gifts are best. They're simple to value and pose no tax traps. If you give away cash you're holding in a bank account or a money market fund, you'll give away the future income tax obligation on the interest income. When you make gifts to a lower-income recipient, such as a grandchild or an elderly parent, you'll probably lower the family's overall income tax bill.

Strategies for securities

If it's not practical to give cash, you can give away stocks, bonds, fund shares, or other securities. However, you should not give away assets trading at a loss. Instead, sell them first to take a capital loss; such losses can offset capital gains and provide deductions of up to $3,000 a year. After taking your loss, you can give away the cash from the sale.

When you give away highly appreciated securities, your holding period and your basis (your cost, for tax purposes) is transferred along with the asset.

Example: Miriam Goodwin holds shares of stock valued at $20,000, with a basis of $6,000. She gives $10,000 worth of the stock to her grandson Ned and $10,000 worth to her granddaughter Rachel. Each of the grandchildren has $3,000 of basis in his or her shares.

If either of her grandchildren sells the shares, he or she would have a $7,000 long-term capital gain. This way, Miriam avoids the tax and her grandchildren may owe less tax on the sale. At least through 2010, some taxpayers have a 0% tax rate on dividends and long-term capital gains. Single filers with up to $34,000 in taxable income and couples filing jointly with income up to $68,000 can use the 0% rate. ■

TAX CALENDAR

OCTOBER 2010

October 15

Individuals. If you have an automatic six-month extension to file your income tax return for 2009, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalties due.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in September if the monthly rule applies.

Electing large partnerships. If you were given an additional six-month extension, file a 2009 calendar year tax (Form 1065-B).

NOVEMBER 2010

November 1

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2010. Deposit any undeposited tax. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than $500.

November 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2010. This due date applies only if you deposited the tax for the quarter in full and on time.

November 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in October if the monthly rule applies.

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