Costly Tax Mistakes

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INTRODUCTION

U.S. tax laws are quite complex. It is usually prudent to retain either a CPA or a licensed tax attorney or both. The following are examples of tax problems which could easily have been avoided, or at least postponed, with proper tax planning. The purpose of my talk is to alert you to situations which can be very costly from a tax standpoint. Although you probably don't do your own tax planning or effect the transactions that are discussed, but if I have alerted you to situations presenting a *hidden* tax problem, I have achieved my objective. Rather than discussing the technical parts of the various Code sections, I will use illustrations of actual transactions to highlight the inherent tax problem(s).

1. Failure to Wait for a Stepped-Up Basis: Section 1014(b)(6)

Example: Home bought for $100,000 now worth $2 million; if it passes through either spouse's estate, and the property is community property, the survivor can sell it without a capital gain tax, and probably no estate tax if the spouse is the beneficiary of the estate plan.

<u>Cf</u>. lifetime *Gifts*, which carry over their basis for income tax purposes. In effect, the gift of an appreciated asset is also a transfer of a tax liability. The $1.9 million difference between the cost long ago and the current market value would still be taxable on a later sale, less a $500,000 exemption.

2. Gifts of Tangible Personal Property to Charity (Section 170(e)

Normally: a gift of appreciated capital gain property to a charity does not realize the gain inherent in the donated property, and the donor receives a fair market value deduction. This might well be worth 50% of its value in federal and state tax savings. However "in the case of a charitable contribution of tangible personal property" the donee must use the property "for the purpose or function constituting the basis for its exemption under Section 501". The statute also provides that if the donated property is sold, exchanged or otherwise disposed of by the donee before the last day of the taxable year at which the contribution was made, a certificate is required under 170(e)(7)(D). Also, the donation cannot be made for the "use of a private foundation"; and, patents, copy rights, trademarks and software are not eligible gift assets.
Example: KQED, a public charity, for many years had a public wine auction. The advertisement stated that this was a good way for the donor to "thin his cellar" and to receive "a full deduction of its value for tax purposes". However, the fact that KQED was not going to <u>*use*</u> the property disqualifies it to the extent of the fair market value; only the donor's cost is deductible.
Example: Gift of a rare bottle of Chateau Lafite, bought for $100 many years ago, now worth $2000, donated to KQED will give the donor $100 deduction. There is no tax benefit for the $1,900 appreciation.

Finally, if the property had been sold and the sale would have resulted in ordinary income (rather than capital gain), the amount of the charitable deduction is reduced by the amount of ordinary income.
Example: an individual uses a truck for business and depreciates a $10,000 vehicle for several years until his cost basis is reduced to zero. He then donates the property to charity. Since the sale of this property would have resulted in ordinary income under Section 1245, the charitable deduction is his cost basis, in this case, zero.

3. Inventory

If an individual is considered a "dealer" under Section 1221 of the Code, then any sale at a profit would result in ordinary income, not capital gain, no matter how long the property has been held.
Example: a car dealer donating an automobile to charity can deduct only its cost, not the fair market value, because the difference between cost and market would have been taxed as ordinary income. But if a dealer takes the item out of inventory, classifies it as an investment, and holds it for the requisite statutory time, then it becomes a capital asset and its sale would produce a capital gain.
Example: a Ford dealer has an old Model A Ford which is not for sale to customers, but is displayed in the showroom to attract customers. This is not inventory and its sale would result in capital gain treatment, so its donation produces a full charitable deduction.

4. "Long Term Holding"

The statute (Section 1221) requires a taxpayer to hold an asset "*more* than one year". So, an asset acquired today, April 11, 2017 is not "long-term" until April 12, 2018.
Example: It was argued in the U.S. Tax Court that an asset sold a few *hours* after the date, i.e., March 11, 2018 at 5 p.m. would "be long-term", but the Court disagreed.

5. The importance of Balancing Gains and Losses

Example: an individual has $100,000 of short term capital gains in year 1 which is taxed at a maximum rate (approximately 51% federal and state). He then has $100,000 loss short term in year 2. He / she will receive only a $3,000 reduction against ordinary income in year 2, with the balance carrying forward at the rate of $3,000 a year. If he / she has no capital gains they would have to wait 32 years to use the carryover; and it expires with their death. But if the situation were reversed and the individual had $100,000 of short-term capital loss in year 1 and $100,000 in short-term gain in year 2, then the $97,000 would be a carryover from year 1 to 2 and the individual could use it all in the second year.

This is probably the most unfair provision in the Internal Revenue Code. My efforts over the years to change it to make it more fair have not been successful.

6. The Double Gift Tax

Example: an individual makes a gift to a donee of a valuable asset in year 1. After the close of that year, but before he or she files individual income and gift tax returns, the donor changes his / her mind and revokes the gift. The result is a gift tax on the value of the gift in year 1 and another one on the gift back in year 2! Therefore, make sure that what you give away is permanent.
Example: Lots of estate planning attorneys recommend to their clients to reduce their assets to avoid estate taxes by making large gift. But never give away more than you can spare.
Example: Mother gives her expensive, fully-paid for residence to her daughter to get it out of her estate. The daughter then advises her mother that she will have to pay rent to make the gift effective, which is correct. The rent increases every year. When the mother cannot pay it any more, the daughter evicts her mother. There is no remedy at law for this situation.

7. The Inadequate Marital Deduction

The tax law permits a deduction for the full value of any assets given or bequeathed from one spouse to another, irrespective of whether such property is separate or community.
Example: if Bill Gates has $1 billion worth of Microsoft stock, he can bequeath it to his wife and she will receive a stepped-up basis (discussed above), and can sell the asset for $1 billion and pay no federal income tax. [Query, what is Washington state law on this?] Not only that, but there is no estate tax in that situation if the provisions of Section 2056 are followed. This basically requires that the donee spouse have an unencumbered interest in the property, i.e., no other individuals (including the children) can have any interest in the gift or bequest.
Example: there are many cases where individuals have given or left the property to their spouse in trust, and given the donee both a life estate and a general power of appointment, as required by the statute. But the trust provides that in case of need, their children can invade the principal of the corpus for their health, education or welfare. Even if never exercised, this will destroy the marital deduction. In the above Bill Gates example, there would be a billion dollars of taxable estate (less the exemption)

and the tax would be 40% of the value. Therefore, review your estate plan with a competent estate planning counsel to make sure a marital deduction is available.

8. Percentage Limitations

Lots of provisions in the Internal Revenue Code limit the amount of an otherwise appropriate deduction. There are limits on casualty losses, medical expenses, charitable contributions, business expenses and other itemized deductions.
Example: Deductible business gifts are limited to $25.
Example: Usually those of us in reasonably good heath do not have enough medical expenses to deduct them.
Example: A portion of your California income tax is treated as a personal expense and is not deductible except after certain percentage limits.
Example: Casualty losses are deductible only to the extent that they exceed 10% of the taxpayer's adjusted gross income. So, it may be better to buy insurance to cover the non-deductible portion; or try to "bunch" a deduction, such as medical expenses: pay both you 1 and 2 expenses in 1 year or 2.

9. Tax-Free Home Exchanges §1034

There used to be a provision in the Internal Revenue Code that allowed an individual to sell his / her appreciated principal residence and re-invest the proceeds tax-free within certain time limits in another residence. So somebody who bought a house for $100,000 now worth $1 million could sell it and buy another residence for $1 million or more in another location and if it was his / her principal residence there would be no income tax. This section – 1034 – has been repealed and now only $500,000 is exempt for a residence for a married couple, $250,000 for an individual. In most parts of the country that may be sufficient; in Northern California, it obviously is not.

10. Investment Real Estate §1031

Many individuals assume that if they sell real estate held for investment, such as an apartment building, office building, warehouse, etc. and they reinvest the money within a certain period, there will be no tax. That was never the law, and is not the law now.

The law requires that there be an *exchange* of the properties, which usually involves an escrow of some type, with no money changing hands except for the difference of the value of the properties, if any. That money is considered "boot" and is taxable. This is an elaborate technical procedure which requires the assistance of qualified real estate counsel, a trustee; and a knowledgeable title company. It is not something one should undertake alone.

In the case of a principal residence, one could re-designate one's home as investment property by moving out and renting it for several years. Then, and only then, can it be exchanged for other *investment* property (not a residence unless that house also is going to be rented).
Example: one of my colleagues at Stanford bought a home 40 years ago for say, $100,000 and sold it in downtown Palo Alto for $6 million. If he had converted it to rental property he could have exchanged it for an apartment building, office building, triple-net leased property or any other kind of real estate investment. Without that, all but $500K of gain is taxable; and at ordinary rates in California as well!

Section 1031 also requires that the property disposed of, and the property acquired, be of a "like-kind". The Courts have interpreted that very liberally. So for example, an apartment building is considered "like-kind" to an office building or a warehouse. But shares of stock in a cooperative cooperation owning real estate is not "like-kind" to an office building or other investment property.

11. Tax Penalties

Many people incur tax penalties because they or their accountants are not sufficiently familiar with the procedural requirements of an Internal Revenue Code.

Example: there are penalties for underpaying estimated taxes if the payments are not made on a quarterly basis; paying a lump sum in the final quarter reduces the penalty somewhat but it does not eliminate it. There are other provisions in the Internal Revenue Code which require something to be done by a particular date.
Example: The election of a regular ("C") corporation to be taxed like a partnership – a so-called Subchapter S election - must be made on or before the 15th day of the third month of the taxable year, i.e., March 15 on a calendar year basis. There are also lots of rules with respect to the shareholders of an S corporation. For example, such a corporation cannot have more than 100 shareholders; they have to be individuals; have no non-resident alien shareholders; cannot have more than one class of stock and certain corporations such as financial institutions and insurance companies are ineligible. Once the election is made, it applies to all subsequent years until revoked. Once it is revoked it can't re-elect for a period of five years. Section 1362(g).

Example: A dental corporation wanted to be taxed as an S Corporation to avoid the double-taxation otherwise applicable to a ("C") Corporation. The accountant prepared the necessary forms and sent it to the company for filing with instructions to mail it, certified return receipt requested. The company then paid a very large dividend in reliance on the fact that it would only be taxed once, i.e., to the shareholders. On audit, the IRS maintained that the company had never filed the S Corporation election and therefore the dividend wasn't deductible by the paying corporation but was still taxable to the shareholders. In effect, the taxes and penalties wiped out the value of the dividend. The president said to the bookkeeper "I thought you mailed it" and vice-versa. Later they found that neither had mailed it and it was still in the file. Important documents should be sent registered mail and should be double checked to make sure they are timely and correct. [For example, envelopes at the Academy Awards.]

12. Excessive Reduction of your Taxable Estate

Several years ago Congress enacted a $5 million exemption for estate tax purposes, adjusted annually for inflation. For 2017 a married couple has $10 million of exempt assets and a cost-of-living adjustment of about $800,000. So there is no estate or gift tax savings to be achieved if the total estate of a married couple is roughly $11 million or less.

From a non-tax standpoint there is also the problem of giving away assets which the donors could still need and use. **Example**: Parents giving away their principal residence to their children requires them to pay rent at fair market value if they still occupy it, plus all the expenses of the house as if they still owned. Therefore, don't give away assets you need to use. Forget about the estate tax if you have $11 million of assets for a married couple or $5.5 million for a single individual.

13. Casualty Losses §1033

If property is destroyed or damaged by a "casualty" as defined in the law, and the taxpayer receives insurance to repair or replace the property, there is no income tax if he or she spends the insurance money to repair or replace the destroyed or damaged assets. To do that however, there are several requirements: (1) there must be an involuntary conversion, which is either an act of God, such as earthquake, fire, storm, etc., *or* (2) there must be a requisition or condemnation or threat or imminence therefore; this too is considered a compulsory or involuntary conversion. The tax payer will not recognize the gain if he or she replaces the property converted, or purchases stock in a corporation owning such property, condominium or cooperative. This has to be done in time, i.e., two years after the close of the first taxable year in which any of the gain was realized. But the IRS can allow requests for extension; Section 1033 (II)(B)(i).
Example: Taxpayer owns the house bought in San Francisco for $100,000 30 years ago, now worth $1 million. It burns to the ground and the insurance company pays him or her $1 million to replace the home. With a proper replacement election, the $900,000 gain is ignored for the time being and no tax is due on the transaction. However the cost basis remains $100,000, so on a later sale of the house it is the original cost not the $1 million replacement, which becomes the basis for the property, resulting in a taxable gain.

14. Securities Transactions

There are many rules relating to the sales of stocks and bonds, not just the long-term holding period discussed above.

A. **Wash Sales**: if an individual sells a stock or bond at a loss, and within a period of 31 days purchases an essentially similar stock or bond, the loss on the sale would be disallowed. One has to be "out of the stock or bond" for more than 31 days to allow the loss deduction. One can avoid the application of this rule by buying similar, but not the same, kind of property.
Example: Sale of General Motors at a loss and simultaneous purchase of Ford stock is not a wash sale.
Example: Sale of the common stock and purchase of the preferred of the same company is not a wash sale.
Example: A bond with a different maturity date than the one sold is not similar.

B. **Identification of Securities Sold**

If one buys stocks on three different dates at $100, $200 or $300, one can designate to the broker which lot is being sold. So a sale at $200 could produce a $100 gain or a $100 loss, or neither, depending on how the TP designates. Without that, the rule will be "first in first out". In this example, a $100 gain, which could have been avoided.

15. Differences Between California and Federal Law

Don't assume that a tax result which is achieved under federal law will also be available for California purposes. Our State law is somewhat modeled on the federal Internal Revenue Code, but there are substantial differences. The most important is with respect to the treatment of long-term capital gains. This State does not recognize a difference between ordinary assets and capital assets. To illustrate, if one sells an asset held for more than one year which results in capital gain treatment for federal purposes, the entire profit is taxed as ordinary income for California purposes. Welcome to the highest state tax in the union!

16. Caveats

The foregoing discussion represents *present* law. If President Trump amends or repeals any provisions of the Internal Revenue Code, the result would obviously change. For example, if the estate tax were repealed, it is highly likely that the step up in basis on death [§1014] would also be repealed. That would make lifetime gifts much more desirable than testamentary ones.

When dealing with any of the foregoing problems, please consult competent tax counsel. This paper is not to be considered tax advice for specific transactions.