MANAGEMENT & *TAX CONCEPTS*

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Rental real estate

DETERMINING IF A PROPERTY IS A BUSINESS OR AN INVESTMENT

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It's one way to boost your cash flow

ATCHLEY & ASSOCIATES LLP
CERTIFIED PUBLIC ACCOUNTANTS & BUSINESS ADVISORS

1005 La Posada Drive • Austin, TX 78752
512-346-2086 • Toll free: 877-977-6850 • Fax: 512-338-9883
www.atchleycpas.com

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Rental real estate

Determining if a property is a business or an investment

If you own rental real estate, its classification as a trade or business rather than an investment can have a big impact on your tax bill. The distinction is even more important now, considering the 20% qualified business income (QBI) deduction for certain sole proprietors and pass-through entity owners.

The QBI deduction is available for income from an eligible trade or business, but not for investment. So, assuming you otherwise meet the requirements, qualifying your rental real estate activities as a trade or business may yield substantial tax savings. Fortunately, a recent IRS Revenue Procedure establishes a safe harbor.

Other advantages of trade-or-business status include the ability to deduct losses against ordinary income and avoidance of the 3.8% net investment income (NII) tax. However, special rules apply to rental real estate owners, who generally must qualify as "real estate professionals" to fully enjoy these benefits. (See "Are you a real estate professional?" on page 3.)

A BRIEF REVIEW

The QBI deduction is too complex to cover fully here. But, in general, it allows owners of sole proprietorships and pass-through entities (for example, partnerships, S corporations, LLCs) to deduct as much as 20% of their net business income, without the need to itemize.

Otherwise eligible owners are entitled to the full deduction so long as their taxable income doesn't exceed an inflation-adjusted threshold (for tax year 2020, $163,300 for individuals; $326,600 for joint filers). Above the threshold, the deduction may be reduced or eliminated for businesses that perform certain services or lack sufficient W-2 wages or depreciable property.

RENTAL REAL ESTATE GUIDANCE

According to the IRS, for purposes of the QBI deduction, an enterprise is a trade or business if it qualifies as such under Internal Revenue Code

Section 162. That section doesn't expressly define "trade or business" — it's determined on a case-by-case basis based on various factors. Generally, a trade or business is an activity conducted "on a regular, continuous and substantial basis" with the aim of earning a profit.

Uncertainty over whether rental real estate qualifies, especially for taxpayers with one or two properties, prompted the IRS to issue Revenue Procedure 2019-38 to establish a safe harbor. Under the Revenue Procedure, a rental real estate enterprise (RREE) is deemed a trade or business if the taxpayer (you or a "relevant pass-through entity" in which you own an interest):

- Maintains separate books and records for the enterprise,
- Performs at least 250 hours of rental services per year (for an enterprise that's at least four years old, this requirement is satisfied if you meet the 250-hour test in at least three of the last five years),
- Keeps logs, time reports or other contemporaneous records detailing the services performed, and
- Files a statement with his or her tax return.

The Revenue Procedure lists the types of services that count toward the 250-hour minimum and clarifies that they may be performed by the owner or by employees or contractors. It also defines an RREE as one or more rental properties held directly by the taxpayer or through disregarded entities (for example, a single-member LLC). Generally, taxpayers must either treat each rental property as a separate enterprise or treat all similar properties as a single enterprise. (Commercial and residential properties can't be combined in the same enterprise.)

PLANNING OPPORTUNITIES

There may be opportunities to restructure rental activities to take full advantage of the safe harbor. For example, Marilyn owns a rental residential building and a rental commercial building and performs 125 hours of rental services per year for each property. As noted, she can't combine the properties in a single enterprise, so she doesn't pass the 250-hour test. But if she were to exchange the residential building for another commercial building for which she provides 125 hours of services, she could treat the buildings as a single enterprise and qualify for the safe harbor (provided the other requirements are met).

DON'T TRY THIS AT HOME

The tax treatment of rental real estate is complex. To take advantage of the QBI deduction or other tax benefits for rental real estate, consult your tax advisors. •

Are you a real estate professional?

Ordinarily, taxpayers who "materially participate" in a trade or business are entitled to deduct losses against wages or other ordinary income and to avoid net investment income (NII) tax on income from the business. The IRS uses several tests to measure material participation. For example, you materially participate in an activity if you devote more than 500 hours per year, or if you devote more than 100 hours and no one else participates more.

Rental real estate, however, is generally deemed to be a passive activity — that is, one in which you don't materially participate — regardless of how much time you spend on it. There's an exception, however, for "real estate professionals." To qualify, you must spend at least 750 hours per year (and more than half of your total working hours) on real estate businesses (such as development, construction, leasing, brokerage or management) in which you materially participate. (The hours you spend as an employee don't count, unless you own at least 5% of the business.)

Stock options — the right carrot in today's job market?

According to the U.S. Bureau of Labor Statistics, the U.S. unemployment rate dipped to 3.5% in December, which matched a half-century low. With nationwide unemployment so minimal, your company may be struggling to fill staff positions.

Offering equity-based compensation to job candidates is one recruitment strategy to consider. Stock options have proved to be an effective tool for attracting executives and other employees, as well as retaining and motivating them.

GETTING A HANDLE ON ISOs

Stock options confer the right to buy a certain number of shares at a fixed price for a specified time. Typically, they're subject to a vesting schedule. This requires recipients to stay with the company for a certain amount of time or meet certain performance goals.

Incentive stock options (ISOs) offer attractive tax advantages for employees. Unlike nonqualified stock options (NQSOs), ISOs don't generate taxable compensation when they're exercised; the employee isn't taxed until the shares are sold. And if the sale is a "qualifying disposition," 100% of the stock's appreciation is treated as capital gain and is free from payroll taxes.

To qualify, the ISOs must meet certain requirements:

- They must be granted under a written plan that's approved by the shareholders within one year before or after adoption.
- The exercise price must be at least the stock's fair market value (FMV) on the grant date (110% of FMV for more-than-10% shareholders).
- The term can't exceed 10 years (five years for more-than-10% shareholders).

Additionally, the options can't be granted to nonemployees; employees can't sell the shares sooner than one year after the options are exercised or two years after they're granted; and the total FMV of stock options that first become exercisable by an employee in a calendar year can't exceed $100,000.

IDENTIFYING THE DOWNSIDE OF ISOs

ISOs also have drawbacks. Unlike NQSOs, qualifying ISOs don't generate tax deductions for the employer. Plus, with ISOs there is a potential AMT issue upon exercise.

Incentive stock options offer attractive tax advantages for employees.

WHAT ABOUT NONQUALIFIED STOCK OPTIONS?

NQSOs are simply stock options that don't qualify as ISOs. Typically, the exercise price is at least the stock's FMV on the grant date (to avoid tax complications that won't be discussed here). Generally, the NQSO itself isn't considered taxable compensation; there's no taxable event until exercise. At that time, the spread between the stock's FMV and the exercise price is treated as compensation.

Even though NQSOs are taxed as ordinary income upon exercise, they have several advantages over ISOs. For one thing, they're not subject to the ISO requirements listed above, so they're more flexible. For example, they can be granted to independent contractors, outside directors or other nonemployees. Plus, they generate tax deductions for the employer and don't expose recipients to AMT risks.

AND THEN THERE'S RESTRICTED STOCK

Another choice is to grant employees restricted stock — nontransferable stock that's subject to forfeiture until it vests (based on performance, years of service, or both). Restricted stock generally will retain at least some value even in volatile times, unlike options, which may become worthless if the stock's price declines below the exercise price.

Generally, the FMV of restricted stock is taxable to the employee (as ordinary income) and deductible by the employer when it vests. However, the employee can potentially reduce the tax by filing an "83(b)" election to pay tax when the stock is received, converting all future appreciation to capital gains upon sale of the stock. But this strategy can be risky: If the stock is forfeited, the employee will have paid tax on income that is never received.

SEEK ADVICE

If you're considering an equity-based compensation plan, it's important to review the pros, cons and tax implications of various approaches. Talk with your tax advisor or benefits consultant about whether ISOs are right for your company. •

Oops, you overfunded your 529 plan — now what?

Some might consider it a good problem to have: saving *too much* money for college. But if the money is held in a Section 529 college savings plan, there could be tax consequences to overfunding the account.

THE TAX MAN GIVETH

529 plans are tax-advantaged accounts designed to help families save money for college education expenses. Savings grow on a tax-deferred basis, and withdrawals are made tax-free if the money is used to pay for qualified education expenses such as tuition, fees, books, and room and board. Further, some states offer tax incentives for contributions to 529s.

The tax consequences come into play if 529 funds are used for anything other than qualified education expenses. Specifically, earnings on investments held in the account will be taxable and a 10% penalty will be assessed if the money is used for noneducation-related expenses.

Note that only the earnings portion of the account will be subject to taxes and penalties. Funds you've contributed to the account (or principal) won't be taxed upon withdrawal regardless of what they're used for, because contributions were made with after-tax dollars.

YOUR ALTERNATIVES

So what should you do if your child graduates from college this spring and there are funds left in your 529 account? Here are a few options to consider:

Change the beneficiary. The flexibility that characterizes 529 plans includes the ability to name someone else as the account's beneficiary. So if you have other children in college now or are planning to attend college after high school, you can simply make them the beneficiaries of the account.

You can even change the beneficiary to yourself. This would allow you to use the funds for your qualified expenses.

Use the funds to pay for private school education. The Tax Cuts and Jobs Act changed the 529 plan rules so funds can now be used for private K-12 education expenses. Therefore, if you have younger children, you can use 529 plan funds to send them to a private school.

Investigate nonqualified 529 plan withdrawal options. The law specifies certain situations where nonqualified withdrawals can be made from 529 plans penalty-free. These include a child's death or disability and a graduate's attendance at a U.S. military academy.

Also, if your child is awarded an academic or athletic scholarship, you can use withdrawals up to the scholarship amount for expenses that aren't education-related and avoid the 10% penalty on earnings. But you'll still have to pay income tax on the earnings when you file your federal tax return.

There's also a new provision that allows — subject to restrictions, of course — 529 plans to be used to repay student loans.

Leave the money alone. There's no deadline for 529 account withdrawals, so you can leave funds in the account to pay for future education expenses. The money will continue to grow tax-deferred as long as it stays in the account.

So if your child decides later to attend graduate school, funds can be used to help cover these expenses. You can even keep funds in the account for the long term to help pay education expenses for your future grandchildren. This will give your children a good head start on college saving for their kids.

You can change the beneficiary to yourself. This would allow you to use the funds for your qualified education expenses.

IF ALL ELSE FAILS

If none of these strategies are ideal for your situation, you may just have to withdraw excess 529 funds and pay the taxes and penalties due. Since they only apply to the earnings portion of the account, the tax hit may not be too severe. •

Consider a cost segregation study

It's one way to boost your cash flow

If your business is planning to buy, build or substantially improve real property, a cost segregation study can help you accelerate depreciation deductions, reducing your taxes and boosting your cash flow. Even if you've invested in real property in previous years, you may have an opportunity to do a lookback study and catch up on the deductions you missed.

HOW IT WORKS

Generally, commercial real property (other than land) is depreciable over 39 years, and residential real property is depreciable over 27.5 years. A cost segregation study identifies real estate components that are properly treated as personal property depreciable over, say, five or seven years, or land improvements depreciable over 15 years. By allocating a portion of your costs to these shorter-lived assets, you can accelerate depreciation deductions and substantially reduce your tax bill. And if these assets qualify for bonus depreciation, the tax savings can be even greater.

In some cases, assets that qualify as personal property are apparent. Examples include furniture, fixtures, equipment and machinery. But often, property eligible for accelerated depreciation is less obvious. For example, building components that ordinarily would be treated as real property depreciable over 39 years may be classified as five- or seven-year property if they're essential to special business functions.

An example: A manufacturing company builds a $20 million factory and places it in service in June 2019. To accommodate its manufacturing processes, the design calls for a reinforced foundation, specialized electrical and plumbing systems, and other structural components closely related to manufacturing functions. A cost segregation study supports allocation of $6 million of the factory's cost to these components, which are depreciable over seven years rather than 39 years. As a result, the company increases its depreciation deductions by approximately $774,000 in year one, $1.05 million in year two and $895,000 in year three (not counting any available bonus depreciation).

RECOVERING DEDUCTIONS

Suppose you invested in a building several years ago but allocated the entire cost to real property. Depending on how much time has passed and the documentation you have available, it may be possible to conduct a lookback study and reallocate a portion of the cost to shorter-lived personal property. Applying to the IRS for a change in accounting method may allow you to claim a catch-up deduction for the extra depreciation deductions you missed over the years.

IS IT RIGHT FOR YOU?

Are you wondering if a cost segregation study would pay off for your business? Ask your tax advisor to help you weigh the potential tax savings against the cost of a study. •

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