Tax Impact

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CERTIFIED PUBLIC ACCOUNTANTS

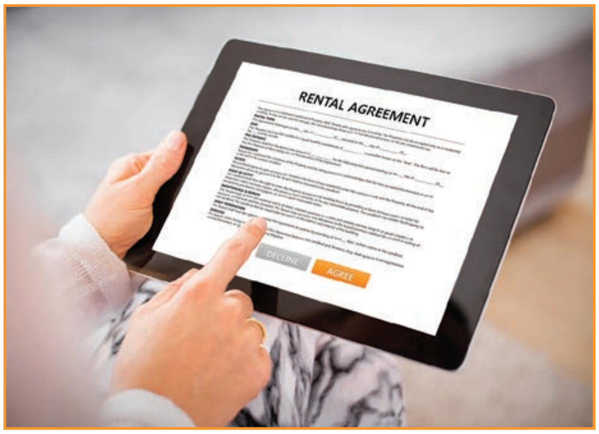
Landlords and COVID-19: What are the tax implications?

The COVID-19 pandemic has had a significant impact on landlords. Many tenants have struggled to meet their financial obligations, often resulting in late or unpaid rent or negotiated lease modifications. As the end of 2020 quickly approaches, landlords should review the tax implications of their leasing activities.

Cash versus accrual

The tax impact of late rent depends on your method of accounting for tax purposes — typically either cash or accrual. If you're using the cash method, rental income is recognized when it's received (actually or constructively), and expenses are deductible when paid. If you're on the cash method and tenants miss rental payments this year, you're not subject to tax until they actually make the missed payments.

If you're using the accrual method, rental income is recognized when it's earned and expenses are deductible when they're incurred, regardless of the timing of cash receipts or payments. When is income earned? The IRS applies the "all events test," under which income is earned when 1) all events have occurred that fix your right to receive income, and 2) the amount can be determined with reasonable accuracy.



Most leases are clear when it comes to the amount and timing of rental payments. So, if you're on the accrual basis and tenants miss rental payments this year, you'll likely recognize income according to the schedule set forth in the lease, regardless of when the payments are actually made (although, as discussed below, you may be entitled to a bad debt deduction for rent that becomes uncollectible).

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Some leases are subject to special accounting rules, regardless of the landlord's usual method of accounting. (See "Lease modifications: Watch out for Sec. 467" on page 3.)

Writing off bad debts

The bad debt deduction is relevant only to accrual-basis landlords. Cash-basis landlords aren't taxed on rent until it's received, so there's no danger of paying tax on income that's never received. If you're using the accrual method, however, you may be required to recognize rental income when it's earned, even if it's never paid. To avoid tax on this "phantom income," landlords can claim a business bad debt deduction.

To qualify for the deduction, you must establish that the receivable has become worthless (for example, if there's no reasonable expectation of payment under

Lease modifications: Watch out for Sec. 467

The tax treatment of rental income generally depends on your accounting method (cash or accrual). But be aware of Internal Revenue Code Section 467, which may require you to use the accrual method for certain leases, regardless of your regular accounting method.

The rules are complex, but in general Sec. 467 applies to leases that call for total payments over $250,000 and provide for prepaid, deferred or stepped (increasing or decreasing) rent. In addition to accelerating the recognition of rental income in some cases, Sec. 467 may also require you to treat certain deferred rent arrangements as loans, requiring you to recognize interest income.

Even if a lease isn't subject to Sec. 467, if lease modifications are substantial enough, it may be deemed a new lease that could trigger Sec. 467 if the modifications result in significant deferred or stepped rent.

the relevant facts and circumstances). There's no special test for determining whether a receivable is worthless. It's up to you to identify and document the factors that support your claim, such as:

- The tenant's business has closed permanently,
- The tenant has filed for bankruptcy or become insolvent,
- The tenant has died or disappeared, or
- You've taken all reasonable steps to collect the unpaid rent.

Often, the last factor provides the best evidence of worthlessness. Which steps are "reasonable"? Again, it depends on the relevant facts and circumstances. In some cases, for example, it would be reasonable to pursue your remedies in court and attempt to enforce a judgment against the tenant. But you need not incur the expense of litigation if there's reason to believe that doing so would be fruitless.

Modifying or terminating leases

Some landlords accommodate struggling tenants by modifying leases (such as by lowering or deferring rent or decreasing the amount of leased space) or letting tenants out of leases. It's important to understand the tax implications of these actions.

For example, costs associated with lease modifications (such as legal fees) generally must be capitalized and amortized over the remaining lease term rather than expensed. And any early termination fees paid by a tenant (including forfeited security deposits) are generally taxed when received.

What about unamortized expenses, such as leasehold improvements you made for a tenant? If the lease is terminated, you can write off these expenses immediately if the improvements are "irrevocably disposed of or abandoned." Generally, that means physically removing the improvements, unless you can show that the improvements were so highly customized for the departing tenant that they would be unusable by a future tenant.

Act now

If you're a landlord dealing with late or unpaid rent, or if you've modified or terminated leases this year, it's a good idea to review the tax implications as soon as possible. There may be actions you can take before year's end, such as documenting collection efforts or removing leasehold improvements, to preserve valuable tax deductions. ■

Perfect timing

Why now is as good a time as any to create a dynasty trust

A dynasty trust can preserve substantial amounts of wealth — and shelter it from federal gift, estate and generation-skipping transfer (GST) taxes — for generations to come. Leveraging your GST tax exemption is a key to the success of a dynasty trust.

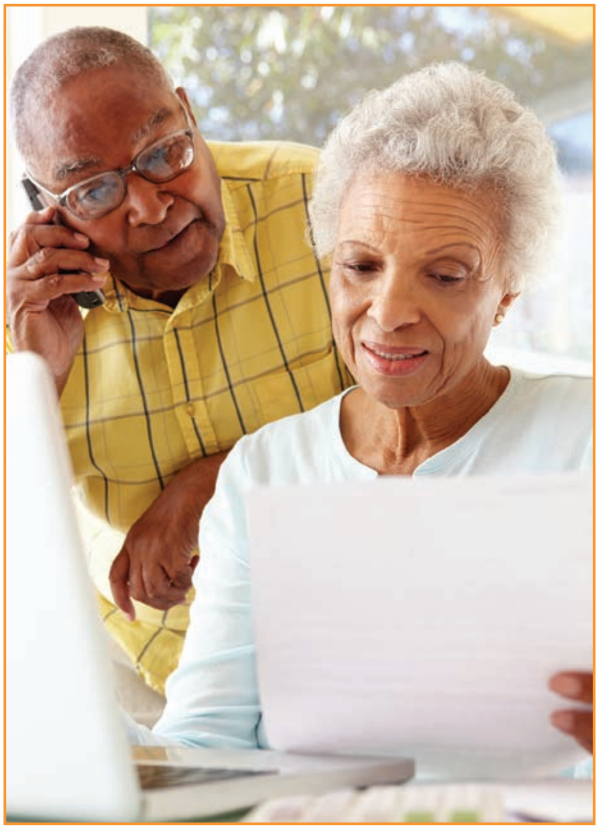
The good news is that this trust type is now more appealing than ever thanks to the current record-high GST tax exemption ($11.58 million for 2020). However, that amount is due to drop to $5 million, subject to an adjustment for inflation, at the end of 2025, so that's an important fact to keep in mind as you consider whether a dynasty trust is right for you.

Leveraging the GST tax exemption

A dynasty trust allows substantial amounts of wealth to grow and compound free of federal gift, estate and GST taxes, providing tax-free benefits for your grandchildren and future generations. The longevity of a dynasty trust varies from state to state, but it's becoming more common for states to allow these trusts to last for hundreds of years or even in perpetuity.

Avoiding GST tax liability is critical to a dynasty trust's success. An additional 40% tax on transfers to grandchildren or others that skip a generation, the GST tax can quickly consume substantial amounts of wealth. The key to avoiding the tax is to leverage your $11.58 million GST tax exemption.

For example, let's say you haven't used any of your $11.58 million combined gift and estate tax exemption. In 2020, you transfer $10 million to a properly structured dynasty trust. There's no gift tax on the transaction because it's within your unused exemption amount. And the funds,



together with all future appreciation, are removed from your taxable estate.

Most important, by allocating your GST tax exemption to your trust contributions, you ensure that any future distributions or other transfers of trust assets to your grandchildren or subsequent generations will avoid GST taxes. This is true even if the value of the assets grows well beyond the exemption amount or the exemption is reduced in the future.

Nontax benefits

Regardless of the tax implications, there are several nontax reasons to set up a dynasty trust. First, you can designate the beneficiaries of the trust assets spanning multiple generations. Typically, you might provide for the assets to follow a line of descendants, such as children, grandchildren, great-grandchildren, etc. You can also impose certain restrictions, such as limiting access to funds until a beneficiary earns a college degree.

Second, by placing assets in a properly structured trust, those assets can be protected from the reach of a beneficiary's creditors, including claims based on divorce, a failed business or traffic accidents.

Steps for building a dynasty trust

A dynasty trust can be established during your lifetime as an inter vivos trust or as part of your will as a testamentary trust. An inter vivos transfer to a dynasty trust may have additional benefits associated with transferring assets that have greater appreciation potential out of your taxable estate.

After creating the trust, you must determine which assets to transfer to it. Because the emphasis is on protecting appreciated property, consider funding the trust with securities, real estate, life insurance policies and business interests. Retain enough assets in your personal accounts to continue to enjoy your lifestyle.

Finally, you must appoint a trustee. Your choices may include a succession of family members or estate planning professionals. Consider, also, whether to include a reputable trust company with a proven track record as one of the successors, as opposed to ultimately assigning this duty to family members who aren't yet born.

Is this trust right for you?

By leveraging your GST tax exemption, a dynasty trust can grow and compound transfer-tax-free for decades to benefit your grandchildren and future generations. However, a currently effective dynasty trust is irrevocable. This means that you're unable to revise it should life changing events, such as a divorce, take place. Contact your estate planning advisor for help. ■

Does working from home entitle you to a tax break?

This year, as a result of the COVID-19 pandemic, more people worked at home than ever before. As 2020 draws to a close, many employees may be wondering whether any of the expenses they incurred to work at home qualify for tax breaks. For example, can they deduct the expense of new computer equipment or office furniture, more robust internet service, or increased utility costs?

The short answer is "no," remote employees can't deduct the cost of working at home. But it may be possible to achieve a similar result if an employer pays or reimburses employees for these expenses.

TCJA suspended employee expense deductions

A couple of years ago, employees could deduct certain unreimbursed job expenses — including costs associated with working at home — as "miscellaneous itemized deductions." The deduction was available to the extent that these expenses, together with other miscellaneous deductions, exceeded 2% of adjusted gross income. But the

Tax Cuts and Jobs Act of 2017 (TCJA) eliminated these deductions for 2018 through 2025.

Employer reimbursements may be deductible

Employee expenses paid or reimbursed by an employer may be deductible by the employer and excludable from the employee's income, provided certain requirements are met. This is the case, for example, if expenses are reimbursed through an "accountable plan." Under these plans, reimbursed expenses must have a business connection and employees must substantiate the expenses with receipts, canceled checks or other documentation.

Also, employees must be required to return any excess reimbursements within a reasonable time. If a plan isn't accountable, expense reimbursements are treated as wages, subject to income and payroll taxes.

Another possibility is for an employer to treat these reimbursements as disaster relief payments under Internal Revenue Code Section 139. It appears that the COVID-19 pandemic qualifies as a disaster, allowing employers to take advantage of this provision.

Sec. 139 allows employers to make tax-free payments to employees affected by a federally declared disaster, subject to certain requirements. An employer may pay "reasonable and necessary" expenses incurred by employees as a result of the disaster. This may include home office expenses as well as certain non-job-related expenses, such as health and dependent care costs. Qualifying payments are fully deductible by the employer and excludable from the employee's taxable income.

What about the home office deduction?

The home office deduction generally is reserved for self-employed business owners. Previously, employees could claim the deduction if they maintained a home office "for the convenience of the employer" and met certain other requirements. But under the TCJA, that deduction is unavailable for 2018 through 2025.

If, however, in addition to working at home for your employer you also do some freelancing or run a side business, it may be possible to claim a home office deduction, provided you otherwise meet the requirements. The two primary requirements are that 1) you use a portion of your home regularly and exclusively for conducting business, and 2) the home office is your principal place of business.

Employee expenses paid or reimbursed by an employer may be deductible by the employer and excludable from the employee's income, provided certain requirements are met.

If you qualify for the home office deduction, in addition to deducting direct expenses — such as computer equipment and office furniture — you also enjoy a deduction for a portion of certain household expenses, such as mortgage interest or rent, insurance, utilities, repairs, maintenance, and depreciation.

Do your homework

Were you required to spend a significant portion of this year working from home? If so, and if you incurred substantial expenses to make remote work possible, do your homework to determine whether you qualify for any of these tax breaks. Your tax advisor can help you with this determination. ■

Congress does a 180 on the kiddie tax

The "kiddie tax" was established in 1986 to discourage people from avoiding taxes by shifting income to their children in lower tax brackets. It achieved this goal by imposing tax at the parents' marginal rate on most of a child's unearned income, such as interest or dividends from investments. Under the Tax Cuts and Jobs Act (TCJA), however, beginning in 2018 this income was subject to tax at the rates applicable to trusts and estates. Because the highest tax rates for trusts and estates kicked in at low-income levels (between $12,000 and $13,000), this meant that the kiddie tax rate was often *higher* than the parents' marginal rate.

In late 2019, the Setting Every Community Up for Retirement Enhancement (SECURE) Act restored the pre-TCJA rules. The act also provided that taxpayers may choose between the TCJA and SECURE Act rules for the 2018 and 2019 tax years. If your children paid kiddie tax for those years, it pays to review those returns and amend them if the alternate computation would result in a lower tax bill.

Generally, the kiddie tax applies to children under age 19 (for full-time students, age 24) as of the last day of the tax year. It doesn't apply to children who are 1) married and file joint returns, or 2) age 18 or older with earned income that exceeds half of their living expenses. ■

Reporting paid sick and family leave

The Families First Coronavirus Response Act requires employers with fewer than 500 employees to provide paid sick leave or family and medical leave to employees who miss work for specified reasons related to COVID-19. An IRS Notice provides guidance on how employers should report these payments.

According to the notice, employers may report payments on Form W-2, box 14, or in a separate statement. Either way, an employer must separately state the total amount of 1) qualified sick leave wages paid because the employee was quarantined or diagnosed with COVID-19; 2) qualified sick leave wages paid because the employee was caring for a family member; and 3) qualified family leave wages. ■

Working remotely? Watch out for double taxation

This year, many people have been working remotely, in some cases in a different state than the one they usually work in. If you've been working remotely across state lines, investigate the potential impact on your state tax bill. You may find yourself with two states attempting to tax the same income: the state where your employer is located and the one where you're residing and working. Many states, but not all, offer credits for taxes paid to other states, so ask your tax advisor about this. ■