CHOICE OF ENTITY AND RELATED TAX ISSUES FOR REAL ESTATE OWNERSHIP

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I. INTRODUCTION

A. Three Principal Taxing Authorities

1. Federal Government
2. New York State
3. New York City

B. Tax Base for any Business

The "taxable income" of a taxpayer engaged in business is generally net profits rather than gross receipts or gross income. Reasonable compensation and other business expenses are deductible in arriving at taxable income. For real estate, net rental income less depreciation plus net gains from dispositions of real property is the general base for arriving at taxable income.

II. CHOICE OF ENTITY—THE TAX PERSPECTIVE

A. Owning Real Estate in Your Own Name: Sole Proprietorship

Not all clients want or can afford a separate legal entity.

1. Simplest form of business organization from tax perspective: the business is not a taxpayer separate from owner. Instead, the owner enters income and expenses of the business or real estate rental on schedule C or schedule E of his or her Form 1040.

2. Exception: NY City "unincorporated business tax": The City imposes this on business 'entities' that most other jurisdictions do not treat as separate taxpayers, such as sole proprietorships and partnerships. This does not apply to passive real estate investment activities.

3. A client can generally form a distinct entity later without incurring tax.

B. Corporations

1. C Corporation

Not an obvious entity of choice for real estate, but useful to discuss with clients to help them put other choices in context.

a. Classification: A corporation is treated as a "C" corporation unless it properly elects to be treated as an "S" corporation. The election is for income tax purposes only—it does not change the corporation in any other way.

b. Two Levels of Tax: C corporations generally incur the most tax because their earnings are subject to both *corporate* and *personal* income tax.

c. Double taxation mitigated by expenses/losses and "distribution" of income as compensation: Business expenses, losses and wages to shareholders can reduce or eliminate corporate taxable income.

c. Rates of Tax on Corporate-level Income:

- Federal: corporate income tax rates: 15% on first $50,000, 25% of next $25,000, 34% of taxable income in excess of $75,000.

- N.Y. State: corporation franchise (income) tax: Nominal per year minimum tax, or more if either a capital-based formula or a net income based formula give a higher tax amount. The income-based formula has rate of 7.5%.

    - Exposure of inactive companies: the minimum tax is $800 if the corporation does not have at least gross payroll of $1,000, total earnings of $1,000, **or** assets worth $1,000

    - Dissolution by proclamation: if NYS corporate tax returns are not filed or taxes not paid, the State will dissolve the company for failure to pay franchise tax. To be able to transfer real property owned by the corporation, the unfiled tax returns must be filed and taxes paid. The tax department will then consent to the "reinstatement" of the corporation to allow the closing to go through. This process can take 90 days or more, so check into corporate tax compliance early in the real estate sale transaction process.

- N.Y. City: general corporation tax: minimum of $25, more if a capital or net-income based formula gives a higher tax amount. The income-based formula has rate of 8.85%.

2. S Corporation

Traditionally a favored vehicle for small businesses not seeking flexibility in types of investors and allocations of income and losses.

a. Election/Restrictions

(1) Corporation must file two timely elections (federal and N.Y. State) to be treated as an S corporation.

(2) No more than 100 shareholders.

(3) No corporations, partnerships or LLCs as shareholders.

(4) No nonresident aliens as shareholders.

(5) No separate classes of stock.

(6) Corporate tax returns still required to pass through the appropriate amount of income to shareholders.

(7) Corporate level debt does not increase basis in stock.

(8) Death of a shareholder increases basis in stock but not the corporation's basis in corporate-owned assets.

b. No federal-level taxes. (This "pass-through" model holds true for partnerships and LLCs, at least at the federal level). The entity's income, deductions and credits are divided are among, and passed through to, its owners.

c. N.Y. State tax. NYS tax will not exceed the minimum tax discussed above in most cases, and the $800 minimum discussed above does not apply.

d. N.Y. City tax. New York City corporate tax applies to S corporations. There is no S election available for NYC corporate income tax purposes. For this reason, the S corporation is a less preferable structure for real estate investments located in NYC.

C. Partnership

Pass-through taxation; considerable flexibility in terms of allocation of economic rights; complex accounting.

1. No tax law restrictions on kinds of investors: Unlike S corporation shareholders, partners can be corporations or non-residents.

2. "Pass-through" federal and State tax treatment: No federal or N.Y. State entity-level tax. Pass-through of income similar to S corporations (see II(B)(2)(b)). Differences include treatment of entity-level debt and the flexibility to allocate profits and losses in varying proportions for different partners described below.

3. Unincorporated business tax payable to N.Y. City Same rates as sole proprietor; returns filed and estimated tax paid by the partnership. In turn, partners file individual UBT returns to pay the tax on the aggregate of all of their unincorporated businesses including their share of the partnership's income and estimated tax remitted on their behalf by the partnership.

4. Flexible Allocation of Income, Loss and other tax items: Allocations need not be proportional to capital (or services) contributed. It is possible, within limits, to allocate losses to partner who is in best position to use them. Several annual computations must be done to account for these variances, as well as contributions/distributions made by or to a partner.

5. All partners are liable for partnership debts.

D. Limited Liability Company (LLC)

Same tax advantages & flexibility in income- and expense-sharing as partnership, combined with limited liability for all owner/investors.

1. "Pass-through" federal and N.Y. State tax treatment: An LLC is treated as a partnership for federal and state purposes. It generally has the same tax advantages as a partnership, with the added non-tax advantage of limited liability to all members.

2. Single-member LLC: An LLC having only one member is disregarded for tax purposes. Its activities are treated in the same manner as a sole proprietorship, and the owner does not file a separate tax return for the LLC. Compare: single-shareholder S corp must still file entity-level returns and pay NYC corporate level tax. Partnership must have at least two partners.

III. OPERATIONS

A. Accounting and Recordkeeping

Tax reasons why a small businesses needs a good accountant:

a. identify source of receipts;

b. properly record business transactions; and

c. accounting methods are involved in calculating tax liability and availability of tax benefits.

B. Federal

1. Employer Identification Number: A business must have one if wages are paid to any employee, although it's a good idea to get one even if there are no employees. Advise/help business in formation stage to apply for one as early as possible (using IRS Form SS-4 – can be obtained in minutes, online at www.irs.gov, by phone or by fax).

2. Taxes On Payments To Employees: These consist generally of two kinds of taxes:

   A. Withholding of Employee's Income Tax

   B. Payroll taxes

C. *Different Payroll Tax Obligations*:

(1) Payments to ordinary employees -- Social Security and Medicare Taxes: Subject to limits based on amount of yearly wages of an employee, an employer is required to withhold from the employee's paycheck 6.2% for Social Security and 1.45% for Medicare. In addition, the employer is also responsible for making separate contributions of 6.2% for Social Security and 1.45% for Medicare on behalf of the employee. Additional 0.9% Medicare tax for high-earning employees.

- *Example*: W receives $100 of wages from his employer E. The government will receive $15.30 of payroll taxes from the employer on that amount: W is liable for $7.65, but it is E who withholds and contributes W's portion. E must in addition put up another $7.65, which does not come from W. W's take-home wages before income tax withholding, if any, are $92.35.

(2) Payments to ordinary employees -- Federal Unemployment Taxes ("FUTA") and NY State Unemployment Taxes

(i) The employer (and never the employee at all) is liable for paying FUTA taxes in any tax year in which it (1) pays wages of $1,500 or more during any quarter in that year or the preceding year, or (2) employs at least one person on at least one day in each of 20 different weeks during the tax year or the preceding tax year.

(ii) The employer pays FUTA for each employee in an amount equal to 6.2% of the first $7,000 paid to each employee, subject to a tax credit of 5.4% for amounts paid for New York unemployment taxes paid – FUTA tax rate after the credit will be .8% of the first $7,000 paid to each employee.

(iii) FUTA taxes are deposited quarterly (using one of the 2 deposit methods discussed below) - by the last day of the first month after the quarter ends, unless the FUTA tax liability for the quarter is less then $100 (then taxes owed may be carried over to the next quarter).

(iv) NYS unemployment tax is assessed against the employer only at varying rates on an "unemployment wage base", which for 2016 is the first $10,700 of income paid to each employee in the year. The tax rate can increase if the employer has unemployment benefits claimed by former employees, so this is a reason to prefer that an employee leave voluntarily rather than be terminated or laid off.

(3) Payments to Family Members

(i) *Payments to Children of Sole Proprietor*: payments for the services of a child who works for his or her parent are not subject to Social Security or Medicare taxes until the child reaches the age 18 and are not subject to FUTA until the child reaches age 21. However, the payments to the child will be subject to income tax withholding.

(ii) *Payments to a Spouse* – the wages of a spouse who works for his or her spouse are subject to income tax withholding and Social Security and Medicare taxes, but not to FUTA tax.

(iii) *Payments to a Parent employed by his or her Child* – wages are subject to income tax withholding and Social Security and Medicare taxes, but not to FUTA tax.

(4) Payments to independent contractors: Although no tax need be withheld on such payments, there are information reporting requirements. A business generally must report to the Federal government (on Form 1099) payments of $600 or more the business makes to any independent contractor during the year. The IRS and even more so the NYS Department of Labor are actively auditing whether a payee is really an independent contractor or should be reclassified as an employee subject to the employer-side taxes and FICA/income tax withholding. If that is determined to be the case, the employer cannot retroactively seek to claim the employee-side tax payments from the employee.

3. Taxes On The Income Of The Business

a. Taxes at the Level of the Business Entity

(1) *General overall tax liability for the year*: Entity-level taxes discussed in "Choice of Entity" above.

(2) *Estimated Taxes*: Any C corporation that anticipates a federal tax bill of $500 or more must estimate its income tax liability for the current tax year and pay four quarterly estimated tax installments in advance, or be subject to interest charges on the underpayment.

(3) *Returns*: C corporations and S corporations with respect to NYC file income tax returns; other entities file informational tax returns to assist their owners in reporting their shares of entity-level income.

b. Taxes at the Level of Partners/LLC Members/S Corporation Shareholders/Sole Proprietors

(1) *Basic Income Tax*—Sole proprietors and owners of partnerships, LLC's and S corporations must include their share of the income, deductions, or losses of the business on their personal 1040.

(2) *Estimated tax and withholding & payroll taxes*

(i) Estimated Tax: Estimated tax is the method of paying tax on income not subject to withholding (and on other income from which not enough tax is withheld). Because the earnings of a partnership, S corporation or LLC "flow through" to its investors, those investors generally must make estimated tax payments each quarter during the tax year.

(ii) Self-Employment Tax—If you work for someone else, your employer contributes one-half of the Social Security and Medicare taxes. If, as a sole proprietor, you work for yourself, you have to pay both halves, which is known as the self-employment tax. Rates are 14.235% for the first $118,500 of self-employment income in 2016, plus 2.9% of any self-employment income exceeding $118,500. An additional 0.9% tax applies when income exceeds $125,000 to $250,000 depending on filing status.

4. <u>IRS Publications</u>

   a. 334: Tax Guide for Small Business
   b. 505: Tax Withholding and Estimated Tax
   c. 533: Self-Employment Tax
   d. 535: Business Expenses
   e. 583: Starting a Business and Keeping Records

- For IRS small business and self-employed resources, see:

  http://www.irs.gov/businesses/small.

C. New York State

1. Taxes

a. Sole proprietorship & estimated taxes-- Sole proprietors must report their business income on their annual New York State income tax return. Estimated tax requirements apply if prior year tax owed was at least $300 and this year's income tax withholding on wages paid by an employer and credits won't cover most (90%) of anticipated tax owed.

b. Payments to Employees

(1) Employer must withhold State income taxes from employees' wages and report wages to Department of Taxation and Finance.

(2) Employer must register with Department of Labor.

(3) Employer must keep specified records for each employee. The records must show:

(i) the employee's name and Social Security number, and

(ii) for each payroll period:

- the beginning and ending dates,
- the days the employee worked and the earnings for each day, and
- all other payments made to the employee.

(4) Unemployment Insurance Contributions

(i) Employer is liable as of the first day of the quarter in which the employer pays wages of $300 or more. The tax is paid only on the first $10,700 of wages paid to each employee in 2016. The standard rate is 5.4%, but an employer's rate may vary from zero to 8.9%, depending on certain factors.

(ii) Wages for services of Spouse or child under 21 of Sole Proprietor are not subject to unemployment contributions.

(5) Tax Returns – Employer must file returns quarterly even if no wages are paid – Employers have to file Form NYS-45, Quarterly Combined Withholding, Wage Reporting and Unemployment Insurance Return, to report unemployment insurance, income tax withholding and wage reporting information.

c. Sales Taxes – NY State and City

(1) Retail sales of most tangible property are taxed, and sales of some services, such as film developing, printing, sales of food and beverages by restaurants and repair and maintenance, such as painting, fixing televisions, and car repairs.

(2) Seller is personally liable for the tax but usually collects it from the consumer at the time of purchase.

(3) Sellers of taxable goods and services MUST register with both the state and city before they do business.

(4) Sales Tax Returns - As a seller of goods and services subject to sales tax, a business must file a return summarizing its business activities, even if it did not have any taxable sales or purchases subject to tax during the period.

(i) If the businesses' total sales tax due is $3,000 or less for the 12-month period ending February 28 and it can reasonably expect to owe $3000 or less for the following 12 months, it may request permission to file annually by filing Form PR-102, Request to file Sales Tax Annually. If approved, it will file Form ST-101 annually.

(ii) All other vendors will file sales tax returns on form ST-100 quarterly (unless they have over $300,000 in taxable sales, then they pay according to a monthly schedule).

2. Helpful Publications And Website

(a) Publications

- PUB-20: New York State Tax Guide for New Businesses.
- NYS-50: Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax.
- PUB-16: New York Tax Status of Limited Liability. Companies and Limited Liability Partnerships.
- PUB-35: New York Tax Treatment of S Corporations and their Shareholders.
- PUB-750: A Guide to Sales Tax in New York State and Vendor Registration Form.

(b) Website for NY State Dept. of Taxation and Finance: www.tax.state.ny.us.

D. New York City Taxes

1. Taxes on the Business

    a. Unincorporated Business Tax

        (1) Applies to sole proprietorships, partnerships and LLCs at a graduated rates, with a top overall rate of 4% on net income over $100,000 (compare: NYC corporate rate is 8.85% and exemption does not apply, though salaries to owners are deductible to a limited extent on the NYC return)

        (2) Tax Return: Business must file a return (on Form NYC-202) if it has gross income (before deductions) over $95,000.

        (3) Estimated tax requirements apply (if annual estimated tax liability is $1,800 or more). To pay estimated taxes, the taxpayer must file Form NYC-5 UBTI each quarter.

        (4) Partial credit may be available for NYC residents against their NYC personal income tax liability.

    b. Corporate Income Tax

        (1) "C" and "S" corporations only

        (2) File annual NYC Corporate Income Tax Return

        (3) $300 minimum tax

        (4) 8.85% of net income

        (5) Certain alternative tax computation methods may apply

2. Helpful Publication and Website

    a. The New York City Tax Guide for Business and Excise Taxes.

    b. NYC Dept. of Finance Website: www.ci.nyc.ny.us/html/dof/home.html.

E. Other States

1. When does a New York business need to register, file returns and pay tax in another state? Requirements vary, but generally if it:

   a. "Does business" in the state (i.e., has employees in the state, regular sales in the state);

   b. Has an office in the state; or

   c. Owns or leases property in the state.

   d. Generally not if internet, telephone, mail-order sales only. However, taxation of such activities is a developing area of tax law (see *Amazon* decision looking at independent agents within NYS and subsequent related cases) and you should keep current as to any changes that may occur periodically.

2. State & Local Taxes

   a. Varies, but similar to NY State in most respects.
   b. Most states do not impose corporate tax on "S" corporations.
   c. Most cities do not impose municipal corporate or unincorporated business taxes.
   d. Sales tax collection obligations
   e. Each state has a formula to divide revenues between the states where a business operates to avoid paying tax on the same income in more than one state. However, since state formulas differ from one another, there may be some overlap.

3. Publications

   a. Multistate Tax Commission Website: www.mtc.gov/txpyrsvs/actualpage.htm
   b. IRS Link to State Websites: www.irs.gov/businesses/small/article/0,,id=99021,00.html

F. Treatment of Real Estate Losses

1. Passive Loss Rules

When an individual owner does not “materially participate” in the passive rental of real estate, the losses cannot be used to currently offset non-passive income. Material participation is a difficult standard to satisfy for real estate investment, and generally requires that the owner be in the business of real estate by satisfying an hours per year test that also looks at hours spent on non-real estate activities, or a “facts and circumstances” test.

Exception: “mom and pop” real estate exception allows for offset of up to $25,000 of passive real estate losses against other income in a year if the owner “actively participates” in the real estate activity. While also a facts and circumstances based test, the primary factors that would make it hard to qualify for this exception would be using a managing agent to care for the property and tenants on a day-to-day basis and using a broker to find tenants. This exception begins to phase out at adjusted gross income of $50,000 or $100,000 per year, and completely phases out at AGI of $75,000 or $150,000 per year.

When the activity is disposed of (i.e. property is sold), the accumulated losses are deductible against both any gain from the property and any non-passive income in the year of sale.

There is a similar passive activity loss limitation for C corporations.

2. Net Operating Losses

Certain taxpayers can carry back or carry forward net operating losses from real estate that is deemed to be a trade or business to the extent that the loss is not fully “absorbed” by other income in the year to which the loss relates.

3. C Corporations

When a C corporation is liquidated, the shareholder is entitled to a loss from the disposition of the stock measured by the excess of the basis in the stock over the fair market value of the assets received. To the extent that the corporation has accumulated corporate-level income tax losses (e.g. from the depreciation of a real estate investment), that corporate-level loss cannot be used against other personal income of the shareholder.

Similarly, if a C corporation has a capital loss (e.g. from selling one property at a loss), it can use the capital loss or carry it forward to use against other capital gains at the corporate level, but those capital losses cannot be used against other capital gains realized by a shareholder in the future. In contrast, when an S corporation, partnership or LLC passes through capital losses to an owner, they can be used against $3,000 per year of the owner’s non-capital gain income, or against other capital gains of the owner (whether from another property holding, or from securities completely unrelated to real estate) and carried forward by the owner.

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