Common Tax Issues in a Down Economy, IRS Red Flags & Transactions in Property

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Pedram Ben-Cohen is an Attorney-at-Law and Certified Public Accountant licensed by the State of California who practices in all areas of Tax Law. Mr. Ben-Cohen's experience stems from practicing Tax Law at Latham & Watkins, LLP and Gibson, Dunn & Crutcher, LLP where he represented high net worth individuals, public and private corporations, partnerships, s corporations, and tax-exempt organizations in connection with a broad range of tax-related matters including tax disputes with the Internal Revenue Service and Franchise Tax Board, taxable and tax-free acquisitions and dispositions, joint ventures, entity formation, and estate planning. He also gained tax experience working at Deloitte & Touche, LLP and the Tax Division of the U.S. Attorney's Office.

Mr. Ben-Cohen earned his law degree *cum laude* from Georgetown University Law Center. While at Georgetown, Mr. Ben-Cohen was a member of *The Tax Lawyer*, where he published The Real Estate Exception to the Passive Activity Rules in *Mowafi v. Commissioner* and the New Burden Shifting Statute, 55 *TAX LAW*. 961 (2002). Mr. Ben-Cohen has also published Public Civil Defenders: A Right to Counsel for Indigent Civil Defendants, 10 *GEO. J. ON POVERTY L. & POL'Y*, 1 (2003).

He earned a B.S. degree *cum laude* from the University of Southern California, where he majored in accounting.

Additional articles published by Mr. Ben-Cohen include:

- "Payments by Majority Shareholders to Minority Shareholders to Secure Change in Control: Ordinary Income or Capital Gain?," *Daily Tax Report*, August 17, 2005
- "Consideration of Subject Matter Jurisdiction of District Courts Required When Preparing Cases Where Taxpayers Seek Solely Statutory Interest." *Daily Tax Report*, November 30, 2004

Topics of Discussion

I. Deductibility of Bad Debts

II. Cancellation of Indebtedness Income

III. Red Flags that can Increase the Likelihood of an Audit

IV. Transactions in Property

I. Deductibility of Bad Debts

- Debt must be “bona fide” debt:
  - arise from a debtor-creditor relationship;
  - based upon a valid and enforceable obligation; and
  - to pay a fixed or determinable sum of money
- Deductibility depends on whether the debt is business or nonbusiness debt
- Business debts: ordinary deduction; allowed for partial worthlessness
- Nonbusiness debts: short-term capital loss; only allowed if totally worthless

I. Deductibility of Bad Debts cont.

- Nonbusiness debt is any debt other than:

  - ➢ Debt created or acquired by the creditor in connection with the creditor's trade or business; or
  - ➢ Debt the loss from the worthlessness of which was incurred in the creditor's trade or business

- May be able to take an ordinary deduction for a theft loss, must look at all facts and circumstances surrounding the debt, including:

  - ➢ terms of the note
  - ➢ ponzi scheme; and
  - ➢ whether debtor has been criminally convicted or under investigation

II. Cancellation of Indebtedness Income

- General Rule: Taxable income will arise from the retirement of debt at a discount (“COD” income)

- Rationale: Borrowing does not result in taxable income at time of receipt of funds; if repayment is subsequently cancelled or the obligation is diminished, the borrower obtains an economic benefit

II. Cancellation of Indebtedness Income cont.

- Some Exceptions to COD income:

  - Discharge is a gift (might result in gift tax);
  - Debt is discharged in a bankruptcy or if debtor is insolvent;
  - The Mortgage Forgiveness Debt Relief Act of 2007 created an exception for discharged qualified principal residence indebtedness. This does not apply to home equity loan used to pay off credit cards, purchase a car, buy jewelry, etc. Also must determine whether debt is recourse or non-recourse; and
  - Qualified real property indebtedness incurred in connection with real property used in a trade or business

III. Common IRS Red Flags

- Overestimating the Value of Donated Amounts

  - ➢ Value donated items at less than 30% of the original purchase price
  - ➢ Items valued at $5,000 or more require an appraisal

- Income reported should be reasonable as compared to home mortgage interest deduction; also only interest on up to $1.1 million of debt incurred to purchase a principal residence is deductible

- Account for all W-2s & 1099s

- Reasonableness of deductions for taxpayer's industry

- Schedule C versus S Corporations, C Corporations, and LLCs

- Home Office Deductions

IV. Transactions in Property

- Interest on obligations of a state or one of its political subdivisions (*e.g*. municipal bonds) is generally excluded from income

- Capital gains and losses result from the sale or exchange of capital assets. Long-term vs. short-term, up to 15% vs. up to 35%

- Can deduct up to $3,000 net capital loss in arriving at adjusted gross income

- Sale or exchange of principal residence:

  - An individual may exclude from income up to $250,000 of gain ($500,000 for individuals filing jointly) that is realized on the sale of a residence, if the individual owned and occupied the residence as a principal residence for an aggregate of at least two of the five years preceding the sale.

  - A loss from the sale of personal residence is not deductible.

IV. Transactions in Property cont.

- Loss is disallowed on the sale or exchange of property to a related taxpayer

- Example:

In August 2007, Bob sold investment real estate with a basis of $400,000 to his brother Ray for $300,000, its fair market value. In June 2008, Ray sold the investment real estate to an unrelated party for $450,000. Bob's loss of $100,000 is disallowed; Ray recognizes a short-term capital gain of $450,000 - $300,000 -$100,000 (disallowed loss) = $50,000.

IV. Transactions in Property cont.

- 1031 Like-Kind exchange:

  - Exchange of business or investment property for property of a like-kind
  - Property held for business use may be exchanged for investment property or vice versa
  - Does not apply to property held for personal use, inventory, stocks, bonds, notes, or interests in a partnership

IV. Transactions in Property cont.

- Example:

Cyrus owned an apartment building that he bought in 1995. In 2008, when Cyrus' adjusted basis for this property was $2 million, he traded it for an office building having a fair market value of $6 million. The apartment building has 100 *dwelling* units, while the office building has 40 units rented to *business enterprises*. The properties are NOT located in the same city.

Is Cyrus' exchange considered "Like-Kind" resulting in no gain recognition?