

DUE DILIGENCE ISSUES

TAX CONSIDERATIONS: LOOK AT ALL THE ANGLES

I. STATE TAX CONSIDERATIONS

A. INTANGIBLE PERSONAL PROPERTY TAXES

(i) ANNUAL INTANGIBLE PERSONAL PROPERTY TAX

The intangible personal property tax has been repealed for the 2007 tax year, effective January 1, 2007.¹ In Florida, an intangible personal property tax was imposed on the market value of intangible personal property owned on January 1 of each year by Florida residents and companies doing business in Florida. Some of the intangible personal property to which this tax applies are stocks, interests in limited liability companies, mutual funds, and notes.

There is an exemption for the first \$250,000 of intangible property. This exemption amount is \$500,000 for married persons filing jointly. The value of intangible personal property exceeding the exemption amount is subject to tax at the rate of \$.50 on each one thousand dollars of value. Prior to the repeal of this intangible tax, it was imperative to consider the tax when using a limited liability company or corporation for the holding of real property. When these entities are used for holding real property, depending on the value of the property, the member or shareholder of the entity would be subject to this tax for the value of their membership interest or stock in the entity.

(ii) NONRECURRING INTANGIBLE PERSONAL PROPERTY TAX

¹. Chapter No. 2006-312, Florida House Bill No. 209 and Chapter No. 2006-291, Florida House Bill No. 7131.

In Florida, there is an intangible personal property tax imposed on a note that is secured by a mortgage or other lien upon real property.² This intangible personal property tax is a one time nonrecurring tax.³ The tax applies to a note or obligation only to the extent it is secured by a mortgage, deed of trust, or other lien upon real property situated in Florida.⁴ This tax does not apply to the portion of the note that is secured by personal property or by real property situated outside this state.⁵

The tax must be paid prior to recording the mortgage. The tax imposed on the note which is secured by a mortgage shall be due and payable when the mortgage is presented for recordation.⁶ The tax is paid to the clerk of the circuit court in the county where the instrument is recorded.⁷ The mortgagee or lender is solely liable for payment of the tax.⁸

The amount of the tax is equal to 2 mills on each dollar of the just valuation of the note or other obligation.⁹ The note is valued on the principal amount of the indebtedness evidenced by such obligation.¹⁰ For example, if the principal amount of the note is equal to \$125,000, then the amount of the intangible personal property tax imposed on the note is \$250 ($\$125,000 \times .002$).

². F.S. 199.133(1).

³. F.S. 199.133(1).

⁴. F.S. 199.133(2).

⁵. F.S. 199.133(2).

⁶. F.S. 199.135.

⁷. F.S. 199.135(1).

⁸. F.S. 199.135(4).

⁹. F.S. 199.133(1).

¹⁰. F.S. 199.155.

B. STATE INCOME TAX

If the real property is held by an entity, the sale or transfer of the property may subject the entity to the Florida state income tax. Florida imposes a tax in an amount equal to five and one-half percent (5 2) on the taxpayer=s net income for the taxable year.¹¹ In general, this income tax is imposed on corporations that are taxable as corporations under subchapter C of the Internal Revenue Code commonly referred to as AC Corporations.@ If the entity selling the property is a C corporation, then it will incur this tax.

The statute provides that corporations include all domestic corporations, foreign corporations qualified to do business in this state or actually doing business in this state, limited liability companies, common-law declarations of trust, corporations not for profit, professional service corporations, foreign corporations not for profit which are carrying on their activities in this state; and all other organizations, associations, legal entities, and artificial persons which are created by or pursuant to the statutes of this state, the United States, or any other state, territory, possession, or jurisdiction.¹² The statute excludes from the term Acorporation@ proprietorships (even if using a fictitious name), partnerships of any type, limited liability companies that are taxable as partnerships for federal income tax purposes, estates of decedents or incompetents, testamentary trusts, or private trusts.¹³ Taxable income in the case of an S corporation only includes those amounts subject to tax as built-in gains or passive investment income.¹⁴ An S

¹¹. F.S. 220.11.

¹². F.S. 220.03(e).

¹³. F.S. 220.03(e).

¹⁴. F.S. 220.13(2)(i).

corporation will not be subject to built-in gains or passive investment income, if it has never been a C corporation nor acquired assets from a C Corporation. A limited liability company is only subject to the state income tax if it is taxable as a corporation for federal income tax purposes.¹⁵

C. AD VALOREM TAXES: REAL PROPERTY TAXES

Florida imposes ad valorem tax on the real property. These taxes become a lien on the property as of January 1 of the calendar year. The taxes are paid in arrears at the end of each year for the taxes due on the property from the period beginning on January 1 through the end of the year on December 31. If the taxes are paid early in November, then the property owner is entitled to a four percent (4%) discount on the taxes. These taxes will be reassessed upon the sale of the property.

These taxes should be determined for the most recent tax year. If the current year's taxes are not available, then the taxes for the prior tax year will typically be used. Since the taxes are paid in arrears, the seller of the property will owe the property tax on the property for the period beginning on January 1 of the year of sale through the date of sale. Therefore, the taxes will need to be prorated between the seller and the buyer of the property.

EXAMPLE: The prior year's ad valorem taxes on the property are equal to \$6,200. The sale of the property occurs on June 30. The amount of the taxes should allow for the 4% discount for an amount due of \$5,952. The seller's portion of the taxes will equal \$2,935.23 ($\$5,952/365 \times 180$).

The seller and purchaser will be entitled to deduct these real property taxes on their

¹⁵. F.S. 220.13(2)(j).

federal tax returns. Under the Internal Revenue Code, the apportionment of taxes allowable by the seller and the purchaser on their tax returns is determined in the same manner. As set forth in section 164(d) of the Code, the general rule states that if real property is sold during any real property tax year, then (A) so much of the real property tax as is properly allocable to that part of such year which ends on the day before the date of the sale shall be treated as a tax imposed on the seller, and (B) so much of such tax as is properly allocable to that part of such year which begins on the date of the sale shall be treated as a tax imposed on the purchaser.¹⁶

D. DOCUMENTARY STAMP TAX

In Florida, there is a documentary stamp tax imposed on deeds, notes, and mortgages. Therefore, if any of these types of documents are executed within the state, then a documentary stamp tax is due for the execution of such document.¹⁷ See Transaction Costs: A. Transfer Tax for more detailed information on this tax.

II. FEDERAL TAX CONSIDERATIONS

A. CAPITAL GAINS TAX

In general, on the sale of real property, the seller will recognize capital gains. A capital gain is recognized on the sale of a capital asset.¹⁸ The sale of a principal residence and investment property are capital assets. Real property used in a trade or business is excluded from the definition of a capital asset.¹⁹ Depending on the time period that the seller owned the

¹⁶. I.R.C. 164(d).

¹⁷. F.S. 201.01.

¹⁸. I.R.C. 1221.

¹⁹. I.R.C. 1221(a)(2).

property, the capital gain tax rate may vary. If the property has been held for one year or less than one year, then it will be considered a short term gain or loss.²⁰ If the property has been held for a period greater than one year, then the gain will be considered long term capital gain.²¹

Generally, long term capital gains are subject to a fifteen percent (15%) rate of tax.²² A net short term capital gain is taxed as ordinary income. If there is any prior depreciation on the real property that is not recaptured as ordinary income pursuant to section 1250 of the Code, then the long term capital gain is taxed at a rate of twenty-five percent (25%).²³

To determine the gain on the sale of property, the basis in the property is subtracted from the sales price. The basis of the property is equal to the seller's cost for the property.²⁴ The basis in the property includes expenses incurred in connection with acquiring the property. These expenses may consist of financing costs, attorney's fees, appraisal fees, and architect services. Additionally, improvements to the property are included in the basis of the property.

If the property is acquired by gift, then the recipient's basis in the property is equal to the donor's basis at the time of the gift.²⁵ In general, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall be

²⁰. I.R.C. 1222(1),(2).

²¹. I.R.C. 1222(3),(4).

²². I.R.C. 1(h)(1)(C).

²³. I.R.C. 1(h)(1)(D).

²⁴. I.R.C. 1012.

²⁵

. I.R.C. 1015(a).

the fair market value of the property at the date of the decedent's death.²⁶ This increase in basis is typically referred to as a step-up in basis. If the property received from a decedent was held as a tenancy by the entirety, then under the federal tax laws, the beneficiary receives a step-up in basis for the interest received from the decedent.

EXAMPLE: Husband and wife purchase property in 1970 for a cost of \$50,000. The property is held as tenancy by the entirety. Through the years, husband and wife spend \$50,000 on improvements for the property. In January 1990, Husband and wife's tax basis in the property is equal to \$100,000. Wife dies in February of 1990. The fair market value of the property in February of 1990 equals \$1,000,000 at the time of Wife's death. Husband receives Wife's interest in the property at the time of her death. Husband's new basis in the property is equal to \$50,000 (one-half of the original tax basis of \$100,000) plus \$500,000 (one-half of the fair market value of the property at the time of Wife's death of \$1,000,000) for a total of \$550,000. If the property is sold by Husband in February of 1990 for \$1,200,000, then Husband's gain on the property is equal to \$650,000 (\$1,200,000 minus the new tax basis of \$550,000).

B. RECAPTURE OF DEPRECIATION

In general, the seller will be required to recognize ordinary income on the sale of real property to the extent that the seller has taken depreciation on the property. For example: Property was purchased for a cost of \$100,000 and the seller deducted \$20,000 while owning the property. The property is then sold for \$150,000. The seller held the property for more than one year. The seller will recognize \$70,000 (\$150,000 - (\$100,000 cost of the property - \$20,000

²⁶. I.R.C. 1014(a).

depreciation taken on the property) of gain on the sale of the property. The seller will be taxed at the 15% capital gains rate for \$50,000 of the gain and will be taxed at the ordinary income rates for the \$20,000 which was previously taken as depreciation on the property.

If there is any excess depreciation taken under special provisions of the code, then the excess of the actual amount of depreciation previously claimed for the property over the amount of depreciation that would have been allowable under the straight-line method is subject to recapture, limited to the amount of gain realized on the disposition.²⁷ Any of this section 1250 recapture is subject to the 25% capital gains rate.²⁸

C. ORDINARY INCOME

i) INTEREST INCOME

If any part of the sale of the property is seller financed, then the interest earned will be ordinary income to the seller. Likewise, the interest to be paid by a purchaser will be deductible as an expense and offset against income for each tax period.

ii) DEPRECIATION RECAPTURE - SALE OF PRINCIPAL RESIDENCE

If the seller of a principal residence previously deducted depreciation expense on the property due to business use of the home or previous rental use of the property, then the seller may not be allowed to exclude that portion of the gain from the sale of the property. This rule applies only to depreciation taken after May 6, 1997.²⁹ The exclusion of gain does not apply to so much of the gain from the sale of any property that is attributable to depreciation adjustments

²⁷. I.R.C. 1250.

²⁸. I.R.C. 1(h)(1)(D); I.R.C. 1(h)(6).

²⁹. I.R.C. 121(d)(6).

attributable to periods after May 6, 1997, in respect of such property.³⁰

D. INSTALLMENT SALES

A seller may be able to defer some of the tax in the year of sale, if the seller finances the sale of the property and payments are to be made over a period of time. Under the Internal Revenue Code, an installment sale is a disposition where at least one payment is to be received after the close of the taxable year in which the disposition occurs.³¹ This provision of the Code provides that the seller only has to recognize gain on the sale when payments are received in each separate tax period. The installment sale provisions are mandatory.³² The seller may elect to not have the installment method apply to a sale.³³ The seller must make this election for the reporting period when the sale occurs.³⁴ The seller may want to elect out of the installment sale rules if there is an offsetting loss in the year of the sale.

If interest is earned, then that portion must be recognized as ordinary income for each tax period. The payments received in each period will be prorated between the percentage of gain on the sale of the property. The amount of gain that is reported each year is that portion of the installment payment based on the gross profit ratio.³⁵ The gross profit on the sale is determined by subtracting the cost of the property and any qualifying expenses of sale from the contract

³⁰. I.R.C. 121(d)(6).

³¹. I.R.C. 453(b)(1).

³². I.R.C. 453(a).

³³. I.R.C. 453(d).

³⁴. I.R.C. 453(d).

³⁵. Reg. Section 15A.453-1(b)(2)(i).

price for the sale. The gross profit ratio is calculated by dividing the gross profit by the contract price.³⁶ This percentage is used to determine the amount of gain that is reported for the payments in each tax period. In general, this gain is treated as capital gain income.

EXAMPLE: In 1980, A, a calendar year taxpayer, sells Blackacre, an unencumbered capital asset in A's hands, to B for \$100,000: \$10,000 down and the remainder payable in equal annual installments over the next 9 years, together with adequate stated interest. A's basis in Blackacre, exclusive of selling expenses, is \$38,000. Selling expenses paid by A are \$2,000. Therefore, the gross profit is \$60,000 (\$100,000 selling price - \$40,000 basis inclusive of selling expenses). The gross profit ratio is $\frac{3}{5}$ (gross profit of \$60,000 divided by \$100,000 contract price). Accordingly, $\frac{3}{5}$ of each \$10,000 payment received is gain attributable to the sale and \$4,000 (\$10,000 - \$6,000) is recovery of basis. The interest received in addition to principal is ordinary income to A.³⁷

E. PRINCIPAL RESIDENCE

In general, there is an exclusion of gain from the sale of a principal residence up to \$250,000 or \$500,000 for married couples filing a joint return.³⁸ The property qualifying as a principal residence must be owned and used as the principal residence for two years during the five year period ending on the date of the sale.³⁹ To qualify for the \$500,000 exclusion amount, at least one spouse must have Aowned@ the property for the requisite period and each spouse

³⁶. I.R.C. 453(c).

³⁷. Reg. Section 15A.453-1(b)(5).

³⁸. I.R.C. 121.

³⁹. I.R.C. 121(a).

must have used the property for at least two years.⁴⁰ Otherwise, the exclusion amount will be limited to \$250,000 if only one spouse meets the use requirement.

EXAMPLE: Taxpayer A purchases a house that she uses as her principal residence. Twelve months after the purchase, A sells the house due to a change in place of her employment. A has not excluded gain under section 121 on a prior sale or exchange of property within the last 2 years. A is eligible to exclude up to \$125,000 of the gain from the sale of her house (12/24 x \$250,000).⁴¹

Ordinarily, if the seller fails to meet the two year requirement, then the seller is not entitled to the exclusion. However, under certain circumstances, the seller may be entitled to a reduced exclusion amount which is prorated based on the time that such residence was owned and used by the seller. The seller may be eligible for the reduced exclusion amount if the sale resulted due to a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.⁴²

EXAMPLE: A single seller purchases a principal residence in Florida in January of 2005 for a cost of \$100,000. In January of 2006, the seller is required to relocate from Florida to California due to a change in employment. In January of 2006, the principal residence in Florida is sold for \$200,000. Seller owned and used the Florida residence for the entire 12 month period while in Florida. Seller is entitled to exclude a portion of the gain from the sale since it resulted from a change in employment. Therefore, since Seller owned the property for a period of one

⁴⁰. I.R.C. 121.

⁴¹. Reg. Section 1.121-3(g).

⁴². I.R.C. 121(c).

year, the exclusion amount is calculated as follows: The gain of \$100,000 (the sales price of \$200,000 less the cost of the property of \$100,000) is multiplied by the time of ownership of 12 months divided by the 24 month required period of ownership. The exclusion amount is limited to \$125,000 (12 months/24 months times \$250,000 exclusion amount). Therefore, the Seller is entitled to exclude the entire \$100,000 of the gain on the sale of the property.

When the property is used for part residential and part commercial, the seller is required to allocate the gain on the property between the residential portion and the commercial portion of the property. The seller is only entitled to exclusion for the portion that is used as residential. To determine this percentage, the seller would apply the same method of allocation that was used for depreciation purposes on the property.

EXAMPLE: Taxpayer A owns a property that consists of a house, a stable and 35 acres. A uses the stable and 28 acres for non- residential purposes for more than 3 years during the 5-year period preceding the sale. A uses the entire house and the remaining 7 acres as his principal residence for at least 2 years during the 5-year period preceding the sale. For periods after May 6, 1997, A claims depreciation deductions of \$9,000 for the non-residential use of the stable. A sells the entire property in 2004, realizing a gain of \$24,000. A has no other section 1231 or capital gains or losses for 2004.⁴³

III. ENTITY LEVEL TAXES

A. C CORPORATIONS AND S CORPORATIONS

When property is transferred into a corporation, the transaction should qualify for tax free

⁴³. Reg. Section 1.121-1(e).

treatment if the requirements of section 351 of the Internal Revenue Code are met. However, when the property is sold or transferred out of the corporation, then the corporation must recognize any and all gain from the transfer. If the company is a C corporation, then this gain will be recognized by the corporation. If the company is an S corporation, then this gain will carry through to the shareholders.

B. LIMITED LIABILITY COMPANIES AND PARTNERSHIPS

When property is transferred into a limited liability company and/or partnership, there is no gain or loss on the transfer. A single member limited liability company is disregarded as an entity and a multiple member limited liability company is taxed as a partnership for federal income tax purposes. However, the limited liability company may elect to be taxed as a corporation. In that event, the limited liability company would be subject to the internal revenue statutes and regulations governing corporations. Additionally, if the property is distributed to the member or partner of such company, then, generally, the transfer does not trigger a gain or loss.

IV. TAX LIENS

The real property records should be thoroughly searched to determine that there are no tax liens recorded against the seller of the property. If the seller incurred any types of tax liabilities, including employment taxes, payroll taxes, income taxes, or property taxes, there may be a lien against any and all property of the seller. Therefore, the property subject to the sale may have a lien against it. A title company and the issuance of title insurance which requires a thorough search should inform the parties as to any tax liens against the property.

