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Monthly Updates

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Alert: A Massive New FinCEN Filing Requirement Is Coming

Do you own a corporation, limited liability company (LLC), limited partnership, limited liability partnership, limited liability limited partnership, or business trust? Or are you planning to form one of these entities?

If so, be alert. There's a new federal filing requirement coming.

Back in 2021, Congress passed a new law called the Corporate Transparency Act (CTA) that requires corporations, LLCs, and other business entities to provide information about their owners to the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN), which is a unit separate from the IRS.

The CTA is part of a government crackdown on corruption, money laundering, terrorist financing, tax fraud, and other illicit activity. It targets the use of anonymous shell companies that facilitate the flow and sheltering of illicit money in the United States.

Businesses subject to the law will have to file a "beneficial owner report" with FinCEN, including each beneficial owner's full legal name, date of birth, and residential street address, as well as an identifying number from a legal document such as a driver's license or passport. FinCEN will include the information in a database for use by law enforcement, national security and intelligence agencies, and federal regulators that enforce anti-money-laundering laws. The database will not be publicly accessible.

Violations of the CTA can result in a $500-a-day penalty (up to $10,000) and up to two years' imprisonment.

The CTA did not take effect immediately. Rather, Congress gave the FinCEN time to write regulations governing how the CTA should be applied and to give businesses a heads-up about the new law. FinCEN has now issued its proposed regulations, and they take a fairly hard line on how the law will be applied.

Here are four things the new regulations make clear.

1. The filing requirement may begin soon. The CTA goes into effect when the proposed regulations become final, which is expected to occur sometime in mid-to-late 2022. As soon as it goes into effect,

- **new** corporations, LLCs, and other entities will have to comply with the filing requirement within 14 days of being formed, and
- **existing** entities will have one year to comply.

2. Millions of small businesses are affected. The reporting requirements will apply to almost every small business that is not a sole proprietorship or general partnership, including corporations, LLCs, limited liability partnerships, limited liability limited partnerships, business trusts, and most limited partnerships—over 30 million in all.

Larger companies with more than 20 full-time employees and $5 million in gross receipts are exempt.

3. There will be many beneficial owners. The proposed regulations make it clear that a company can have multiple beneficial owners, and it may not always be easy to identify them all. There are two broad categories of beneficial owners:

- any individual who owns 25 percent or more of the company, and
- any individual who, directly or indirectly, exercises substantial control over the company.

4. Law and accounting firms are not exempt. Neither the CTA nor the proposed regulations contain any exemption for legal or accounting firms, except for the relatively few public accounting firms registered under Section 102 of the Sarbanes-Oxley Act of 2002. Thus, any law or accounting firm that is a professional corporation or an LLC will have to file a beneficial owner report unless it has more than 20 employees and $5 million in annual income.

Are Self-Directed IRAs for Real Estate a Good Idea?

The stock market is tanking while real estate continues to skyrocket.

If your retirement savings have taken a hit, you may be wondering if this is the time to invest in real estate through your IRA, Roth IRA, or SEP-IRA.

You can’t invest in real estate with a traditional IRA or Roth IRA (or SEP-IRA) you establish with a bank, brokerage, or trust company. These types of IRA custodians typically limit you to a narrow range of investments, such as publicly traded stocks, bonds, mutual funds, ETFs, and CDs.

But you can invest in real estate if you establish a self-directed IRA with a custodian that allows self-directed investments. There are dozens of such IRA custodians.

Real estate is the single most popular investment in self-directed IRAs. The self-directed IRA can be used for all types of real estate investments: multi-family rental properties, single-family homes, commercial rentals, raw land, farmland, international real estate, tax lien certificates, trust deeds and mortgage notes, and private placements.

Investing in real estate through a self-directed IRA is one way to diversify your retirement holdings. There are also some tax advantages.

And there are several disadvantages and complications you should carefully consider.

First, you need to understand that owning real estate in a self-directed IRA is not like owning it any other way, because you and your self-directed IRA must be totally separate—self-dealing is not allowed.

You, the self-directed IRA owner, should not benefit from your self-directed IRA other than through distributions from the self-directed IRA. And your self-directed IRA itself should not benefit from you other than through contributions you make to the account.

In practical terms, this means you, your relatives, and certain other "disqualified persons" cannot do business with your self-directed IRA. For example, you can't

- sell property you personally own to your self-directed IRA,
- purchase or lease property from your self-directed IRA,
- personally guarantee loans taken out by your self-directed IRA to purchase property,
- receive rental income from a rental property held in a self-directed IRA, or
- repair or improve any self-directed IRA property.

If you do any of these things, your self-directed IRA could lose its tax-deferred status. If that happens, you then pay taxes on the value of all the property the IRA owns.

When your self-directed IRA owns real estate, you also don't benefit from real estate tax deductions such as depreciation and the 20 percent qualified business income (QBI) deduction.

It may not be pleasant to think about, but upon your death, there is no step-up in basis for real estate held in the self-directed IRA. Instead, your beneficiaries pay tax at ordinary rates on any money or property distributed from a traditional self-directed IRA. This eliminates one of the most valuable tax benefits for real estate owners.

Don't get the idea that self-directed IRAs are all bad. None of the income from property held in a self-directed IRA is taxable to you personally. Likewise, if you sell property in a self-directed IRA, you need pay no personal tax on any profit. You pay tax only when you withdraw money from a traditional IRA. With a self-directed Roth IRA, you pay no tax at all on withdrawals after age 59 1/2, provided your IRA held the property for at least five years.

But you need to balance these benefits with all the potential drawbacks.

The IRS Wants to Know about Your Crypto

Cryptocurrency such as bitcoin is all the rage these days. Crypto is not legal money. It is property, similar to gold. Like gold, its use can result in taxable income.

The IRS is concerned that you and millions of Americans are using crypto without paying tax on the earnings. To clarify that it expects you and other taxpayers to report crypto earnings, the IRS added the following question about cryptocurrency to the top of Form 1040:

> *At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency?*

You must answer this question under penalty of perjury, even if you have never heard of bitcoin and don't know what cryptocurrency is. You can't leave the field blank.

Unfortunately, this is something of a trick question. It is so broadly worded; you'd think any transaction involving digital currency requires a "yes" answer. But that is not the case.

IRS guidance makes clear that it is interested only in virtual currency transactions that result in taxable income (or loss) that must be reported on a taxpayer's return.

Thus, for example, if you simply purchased bitcoin during the year and held on to it, you should answer "no" to the crypto question. The same goes if you received crypto as a gift, or transferred crypto from one wallet to another.

You should answer "yes" to the crypto question if you purchased or sold goods or services with crypto, received new crypto through mining or staking activities, exchanged crypto for dollars or other crypto, or got new crypto from a hard fork. All these activities result in taxable income (or loss).

What should you do if you answered the crypto question wrong? If you answered the crypto question "yes" when you should have answered "no," you don't have to do anything. There is no need to amend your tax return.

On the other hand, if you answered "no" when it should have been "yes" and you did not report your taxable virtual currency transactions, you need to file an amended or superseding return. If you fail to do so, you may get a letter from the IRS advising you to file an amended return and pay any taxes due. The IRS began sending out such letters in 2019.

Property tax increases for partial transfers

A change in ownership of real property results in a reassessment for property tax purposes for the portion of the property that changed ownership, unless an exclusion applies. This is true whether the property is transferred by sale, gift, inheritance, or any other transfer of ownership. But the rules are a little different when the property is owned directly, versus when it's owned through an entity.

When property is held through a legal entity, if there's a change of more than 50% of ownership of control of that entity, all of the real property owned by the entity is reassessed for property tax purposes.

It's important for clients to understand the differences in these rules before they put their property in an entity, especially if they're considering selling or gifting interests later.

Changes in direct ownership

When a property is held directly and any portion of that ownership is transferred, the new owner's interest is reassessed to fair market value for property tax purposes. Even if more than 50% of the ownership is transferred, only the new owner's portion is reassessed.

For example, assume Abby, Brian, and Chris own a property as joint tenants. The property has a fair market value of $900,000, and an assessed value for property tax purposes of $600,000. This means each joint tenant has an assessed value of $200,000 for property tax purposes.

Brian sells his interest to Dawn for $300,000. Dawn received an undivided one-third interest in the property, and only her one-third interest is reassessed to $300,000. Abby and Brian each still hold a one-third interest with an assessed value of $200,000.

Change of ownership of entity

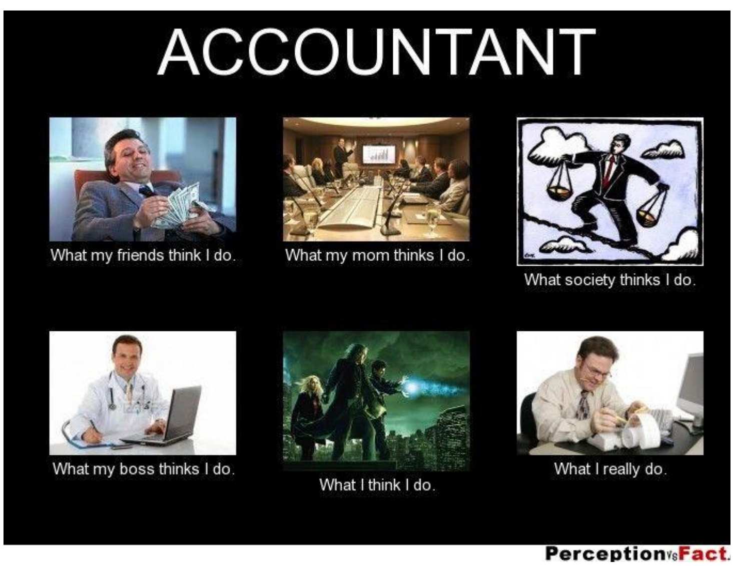
When any legal entity or any person directly or indirectly obtains control or ownership of more than 50% of the total ownership interests or voting shares of another legal entity, there's a change in ownership, and all of the California real property owned by that entity is subject to reappraisal. This is true even if the percentage change in ownership happens through multiple transfers. Once the total cumulative change from the original ownership is more than 50%, a reassessment is triggered.

For example, assume that Missy and John each own 50% of the stock of Corporation X, which owns an apartment complex. In 2020, Missy sells 30% of the stock in the corporation to Frank. There's no reassessment on this transfer because not more than 50% of the ownership in the entity has been transferred.

In 2021, John sells 25% of the stock in the corporation to Edward. Now a total of 55% of the original ownership has been transferred (Missy's 30% + John's 25%), so the apartment complex will be reassessed for property tax purposes.

Planning pointer

For those who are considering transferring assets to their children should consider not only income and estate tax ramifications, but also property taxes. With the elimination of the parent–child property tax exclusion for real property that's not a principal residence, property tax increases have become a much larger concern for families passing real property from one generation to the next.



Pitfalls of holding property in a corporation

Holding property in an entity provides asset protection from creditors, but the type of entity holding the property will have a big tax impact; for example, partnerships have an edge over C or S corporations when it comes to getting the property back out of the entity. When you are weighing the pros and cons of different entities, whether real estate will be held in the entity should be a major consideration.

Debt basis rules

Under Internal Revenue Code Subchapter K (which contains the partnership rules), a partner gets basis for his or her share of all of the partnership's debts, including those owed to third parties such as banks. But, under the S corporation rules, the shareholder gets basis only for those loans made directly from the shareholder to the corporation. A loan made to an S corporation by a non shareholder, even if it's guaranteed by the S corporation shareholder, does not provide debt basis to the shareholder.

This is why it's generally **not a good idea** to hold in an S corporation any debt-financed rental real estate (which is most rental real estate).

Also, losses from a C corporation don't flow to the shareholders. This means that debt incurred by a C corporation has no beneficial effect to the C corporation shareholder the way it does for a partner in a partnership.

Taxable transactions

Distributions of property from an S corporation can result in a taxable event, whereas this is not the case for partnerships. So when trying to get the property back out of the entity, if it's held in a partnership or an LLC taxed as a partnership, that transaction is generally tax-free, and the partner takes the property from the partnership with transferred basis.

For partnerships, it's possible to recognize gain if there's a cash distribution in excess of basis, and in other situations, for example:

- Certain payments to retiring partners;
- Disproportionate distributions involving unrealized receivables; and
- Distributions to a partner that contributed built-in gain property.

But if the property is held by an S corporation, a distribution of property is treated as a **deemed sale** and **the gain is taxable** to the S corporation, which then flows to the S corporation shareholder on their K-1. The S corporation shareholder will then have a higher basis in the property going forward, but they'll have to grapple with a large taxable gain in the year of the distribution.

In the case of a C corporation, if a shareholder receives a distribution of property, then the C corporation is deemed to have sold the property for its fair market value at the date of distribution, and the shareholder also receives a taxable dividend equal to the fair market value of the property on the date of distribution.

So it's important for clients to consider these differences before deciding what type of entity to hold their property in.

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