Tax Implications of Real Estate
**Mission Statement**

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**Our Commitment to You**

This text has been prepared with due diligence; however, the possibility of mechanical or human error does exist. The text is not intended to address every situation that may arise. Consult additional sources of information, as needed, to determine the solution of tax questions.

This publication is designed to provide accurate and authoritative information on the subject matter covered. It is presented with the understanding that the National Association of Tax Professionals is not engaged in rendering legal or accounting services.

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Course Objectives

- Understand the tax aspects of acquiring, owning, and disposing of personal residential, rental, investment, and trade or business real property.
- Learn which expenses are deductible or nondeductible, and which must be capitalized, when property is purchased, refinanced, or developed.
- Identify deductible rental expenses and tax credits available to property owners.
- See how the passive activity rules limit rental losses.
- Discover how exchanges and installment sales can defer taxation of gain.
- Understand the tax effects of casualty losses, condemnations, divorce, and repossessions.

Understanding these concepts will allow the land professional to better serve clients and use them as marketing tools to increase real estate sales.

The text is divided into three main sections: Acquisition, Ownership, and Disposition of real estate. It also contains discussions of the taxation of real estate professionals, and recent legislation. Topics may therefore be discussed in various sections. For example, depreciation in general is discussed in the section on Ownership, but depreciation recapture is discussed in the section on Disposition. The reader should consult the Index for subjects of interest.
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Basis

A taxpayer’s investment in real estate, as with other types of property, is measured by its basis. This basis is critical for measuring the tax consequences of owning and disposing of the property. How the beginning basis is determined depends on how the property was acquired: by purchase, exchange, gift, or inheritance.

Purchase Expenses and Closing Costs

The basis of purchased property is the cost of such property (IRC §1012). However, the treatment of out-of-pocket expenses, in addition to the actual purchase price, depends on the type of expense and the intended use of the property.

Points are a form of prepaid interest and do not increase basis. Points paid in connection with the purchase of business or rental property must be amortized and deducted over the life of the loan. However, points paid for the purchase, construction, or improvement of a principal residence are deductible when paid in certain circumstances. The IRS has advised that payment of a loan origination fee can be viewed as a payment for the use of money and therefore treated as points (Rev. Proc. 94-27).

In addition to points (including loan origination fees), mortgage lenders typically charge other loan fees such as mortgage appraisal fees, document preparation fees, commitment fees, mortgage survey fees, and closing fees. These fees are not currently deductible if they are payments for services rather than payments for the use of money. Instead, the buyer of business or rental property must amortize the fees over the life of the loan. They do not increase basis. A loan commitment fee which does not represent prepaid interest is not deductible by the buyer of a personal residence or second home.

The buyer may also incur fees for recording documents, attorney fees for title opinions, or owner’s title insurance fees. These types of expenditures are added to the property’s basis whether it is a personal
residence, business, or rental property if the benefits extend for an indefinite period [Reg. §1.263(a)-2]. Otherwise, they may be a deductible business expense.

**Example:** Jed Clampett owns a field of oil wells. He pays an attorney and a title insurance company to determine the validity of a local assessment against his property. The payments are deductible as an ordinary and necessary expenses in connection with property held for the production of income because they are paid for the management, conservation, or maintenance of property held for the production of income and do not result in the acquisition of any asset. [Farwell, Byron, (1960) 35 TC 454, acq 1961-2 CB 4].

Transfer taxes paid by the buyer are added to the basis of a personal residence, but deducted as a business or rental expense if the property is not a personal residence or second home.

The cost of real estate does not include real estate taxes which are treated under §164(d) as imposed on the taxpayer. In the year a property is sold, real estate taxes must be apportioned between the buyer and seller based on the number of days each held the property during the real property tax year. Real estate taxes apportioned at closing are deductible for the portion of the tax year the property is owned and not added to basis, regardless of the tax accrual dates under local law and whether the buyer or seller actually paid the tax [§164(a)(1)]. However, real estate taxes the seller paid on behalf of the buyer (without reimbursement) reduces the buyer’s basis, and the real estate taxes the buyer pays on behalf of the seller (without reimbursement) increases the buyer’s basis.

The following settlement fees or closing costs are added to the basis of acquired property:

- Abstract fees (abstract of title fees).
- Accounting fees.
- Charges for installing utility services.
- Engineering services.
- Legal fees (including fees for the title search and preparation of the sales contract and deed).
Recording fees.
Sales taxes.
Survey fees.
Termite and pest inspection costs.
Transfer taxes.
Owner’s title insurance.
Commissions and finders fees.

Settlement costs do not include amounts placed in escrow for the future payment of items such as taxes and insurance. The following settlement fees and closing costs are not included in the basis of property:

Casualty insurance premiums.
Rent for occupancy of the property before closing.
Charges for utilities or other services related to occupancy of the property before closing.
Charges connected with getting a loan, such as points (discount points, loan origination fees), mortgage insurance premiums, loan assumption fees, cost of a credit report, and fees for an appraisal required by a lender.
Fees for refinancing a mortgage.

Assumed Liabilities

Any amounts the seller owes that the buyer agrees to pay, such as back real estate taxes, mortgage interest, recording fees, mortgage fees, charges for improvements or repairs, and sales commissions, are added to basis. Some of these amounts can arise long after the original purchase.
Example: Simon is the owner-landlord of a building he rents to Debra. Debra wants to make improvements to the building but does not have enough collateral to get a loan. Simon agrees to subordinate his interest in the property to a mortgage executed by Debra to cover her construction loan. Debra later defaulted on the loan and Simon assumed the mortgage. Simon’s basis is increased by the amount of the excess of the mortgage over the fair market value (FMV) of the improvements. The amount of the assumed mortgage is apportioned between the building and the land for purposes of determining basis (Rev. Rul. 68-362).

Option Costs

The cost of an option or right to purchase property is considered part of the cost of the property itself in determining the buyer’s basis [Moore v. Comr., 425 F.2d 713, 714 (9th Cir. 1970)].

Acquired for Services

The basis of real estate received as payment for services rendered is the FMV at the time the property is acquired plus any cash or other consideration paid by the transferee. The person receiving the property reports the FMV of the real estate as income.

Example: Brian agrees to help a real estate developer sell improved lots. For Brian’s services, the developer transfers a parcel of land to him as a commission (instead of cash). The FMV of the land is Brian’s ordinary income and becomes the basis of the land in his hands.

If Brian accepted a note (that’s property, too) in lieu of a cash commission, the FMV of the note at the time it was acquired is taxable to Brian as ordinary income. Brian must report the FMV of the land, or the note, as ordinary income when he acquires it, not when he sells the land or collects on the note. The amount reported as ordinary income becomes his basis in the land or the note.
Assessments

Assessments for local improvements are considered capital expenditures for income tax purposes, not deductible taxes. Accordingly, after proper allocation between land and buildings, these assessments are added to the cost basis of the property benefited [National Lumber & Tie Co v. Com., (1937, CA8) 19 AFTR 824, 90 F2d 216, 37-2 USTC ¶9308; Minchew, Benjamin, (1953) PH TCM ¶53320].

Allocation of Basis

When buildings and underlying land are purchased, or a tract of land is divided into individual lots, an allocation of cost basis must be made [Reg. §1.61-6(a)]. The cost of improved real estate is allocated between the depreciable building and the nondepreciable land. Likewise, a subdivider’s sale of lots requires an allocation of basis if various parts of the tract differ in value.

Example: Truman, a dealer in real estate, acquires a 10-acre tract for $10,000, which he divides into 20 lots. The $10,000 cost is equitably apportioned among the lots so that on the sale of each lot he can determine his taxable gain or deductible loss. The term “equitably apportioned” means that the cost is to be divided according to the FMV of the separate parts.

Any reasonable method of valuation can be used to allocate a lump-sum purchase price among several assets or portions thereof, such as a comparison of assessments by local authorities, comparative market prices, reproduction costs, or expert valuations. An allocation based on arm’s length negotiations between two unrelated parties might seem to be controlling, but such an allocation is often suspect because it may reflect their tax hopes and fears rather than FMV. The parties may be held to their allocation, but if the IRS chooses to disregard it, the buyer or seller must provide independent evidence of its reasonableness.
An investor can hire a qualified real estate appraiser to allocate basis between components. With farm and ranch properties it may be necessary to bring in other experts such as agriculture agents and equipment dealers to assist in valuation of certain assets. In the absence of evidence provided by the taxpayer, the IRS will turn to their own appraisals or the tax assessor’s valuations made for property tax purposes.

In some cases it may be impossible to allocate the total basis among the property’s components. If the taxpayer can show that the total basis of the affected property exceeds the amount received but cannot be apportioned among its components, the basis of the entire parcel may be affected.

**Example:** A group of sportsmen pay $61,000 for land to use for a fishing preserve. They receive $50,000 from a mining company for an easement to divert its polluted waters into a stream bordering the fishing preserve. Because it is impossible to allocate the cost basis between the adversely affected property and the rest of the land, the $50,000 is a return of capital allocated to the entire parcel. The excluded amount reduces the basis in the property from $61,000 to $11,000, thus increasing the potential gain (or reducing the potential loss) on a future disposition of the property.

If the taxpayer’s aggregate basis can be allocated among several components and the amount received is paid for rights or damages to only one component, that part’s share of the total basis is used in applying the cost recovery principle.

**Example:** Ina Dell receives $50,000 from a power company for an easement to construct and maintain electric poles across 20 acres of her 600-acre farm. The 600 acres has a basis of $600,000, but she can use only $20,000 of basis—the portion of the cost basis allocable to the 20 acres directly affected by the easement, to offset the payment. As a result, she realizes $30,000 of gain.
Gain or loss must be computed and reported separately on each component at the time of sale. It is not deferred until the entire property has been disposed.

**Exchange Basis**

If property is acquired in a §1031 like-kind exchange, in which gain or loss is not recognized, then the basis of the replacement property is the same as that of the original property exchanged, decreased by any money or other unlike property received by the taxpayer and increased by gain or decreased by loss that was recognized by the taxpayer on such exchange.

If the property acquired was partly like-kind and partly of other than like-kind property (boot), the basis is allocated between the properties received (other than money) based on their FMVs at the date of the exchange. If, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer, such assumption is treated as money received by the taxpayer on the exchange.

To sum up, the basis of like-kind property received in a §1031 exchange is computed as follows:

\[
\text{Adjusted basis of like-kind property relinquished} \\
+ \text{FMV of boot paid (if any)} \\
+ \text{Gain recognized on like-kind property relinquished (if any)} \\
- \text{Loss recognized (if any)} \\
- \text{FMV of boot received (if any)} \\
= \text{Basis of like-kind property received}
\]
Example: Wilma bought a lot for $100,000 in 1999 and built an apartment building on it for $1,000,000. The lot and building are now worth $2,000,000. Her adjusted basis in the building is $764,000, plus $100,000 basis in the lot. She exchanges them, plus $500,000 cash, for a commercial office building worth $2.5 million. She meets the §1031 exchange requirements and recognizes no gain or loss.

Wilma’s basis in the replacement property is:
$100,000 (her basis in the old lot)
+764,000 (her adjusted basis in the old building)
+500,000 (additional cash she paid)
=$1,364,000

If more than one property to which the nonrecognition rules apply is received, the basis is allocated among those properties in proportion to their FMV on the date of the exchange.

Example: Rula owns two improved lots. Lot A has a FMV of $25,000 and lot B a FMV of $40,000. She trades them to Leonard in exchange for improved lot C worth $65,000 that Leonard owns. His basis in lot C is $30,000. Rula and Leonard meet the §1031 exchange requirements and neither party recognizes any gain or loss.

Leonard’s basis in his two new lots A and B is the same as the basis in his old lot C allocated between the two properties received on the basis of their respective FMV on the date of the exchange.

Leonard’s basis in lot A is $11,538 \((25,000/65,000 \times 30,000)\).

His basis in lot B is $18,462 \((40,000/65,000 \times 30,000)\).

The holding period of property surrendered in a Section 1031 exchange carries over and “tacks on” to the holding period of the like-kind property received [§1223(1)]. Any boot received has a new holding period that starts on the date of exchange rather than a carryover holding period.
CONSTRUCTION AND DEVELOPMENT COSTS

Until a building project is completed, all expenses in connection with the project should be added to cost and not currently deducted. Such expenses include not only materials and labor, but may also include compensation for services paid to an officer who acted in a supervisory capacity or as an architect [Reg. §1.263(a)-1; Reg. §1.263(a)-2], or the cost of defending or protecting title to the property [Reg. §1.263(a)-2(c)]. Construction costs include:

- Costs of acquiring outstanding leases to permit construction.
- Engineering.
- Insurance on buildings during construction.
- Officers’ and clerks’ salaries during construction.
- Office supplies.
- Accounting and auditing for construction contracts.
- Cleaning and making ready for opening.
- Legal expenses, inspection and examination fees.
- Wages paid employees.
- Costs of using equipment where you do your own construction.

Adjustments to cost basis in connection with the acquisition of real property include the cost of plotting and subdividing the land [Frischkorn Real Estate Co, (1929) 15 BTA 463, acq, app dismd (1931, CA6) 51 F2d 1077].

The cost of land donated for public use is also included in the basis of the remaining land [Com. v. Laguna Land & Water Co, (1941, CA9) 26 AFTR 632, 118 F2d 112, 41-1 USTC ¶9302].

Example: In order to operate his automobile agency in a new location, the taxpayer has to have the land rezoned to permit commercial use. During the rezoning negotiations, the local government indicates it wants him to dedicate to the city a road across the parcel and to pave it. The cost of the roadway dedicated to the city in order to obtain the variance is added to the basis of the land [Ackerman Buick Inc, (1973) TC Memo 1973-224, PH TCM ¶73224].
Carrying Charges

Carrying charges are costs of holding or improving property, such as mortgage interest and real property taxes. Often these costs have little or no tax benefit because the property is generating no income. A taxpayer may elect to capitalize these costs. The capitalized costs increase the property’s basis, reducing gain upon sale of the property and increasing depreciation or depletion, if applicable. By capitalizing these costs, a taxpayer defers the tax benefit to future years when greater tax benefit may be realized. The election applies only to items that are otherwise deductible.

Mortgage interest, property taxes, and other true carrying charges for unimproved and nonproductive real property may be deducted currently or the taxpayer may elect to capitalize them.

Expenses incurred during real estate development or construction of improvements up to the time the development or construction is completed can also be capitalized. Eligible expenses include interest, taxes (but not income taxes), and other necessary expenses incurred in either the development or construction phase. The election can be made for the development or construction of a taxpayer’s personal residence just as for commercial properties.

⚠️ Caution! Capitalization of many of these items is required under other Code sections such as the §263A uniform capitalization (UNICAP) rules for parcels being developed or improvements being constructed.

The election does not have to apply to all possible carrying charges, but an election to capitalize one type of expense must include all such items for that particular project.

Example: Acme Inc. is building an office tower. Acme has loans from several lenders to finance various phases of the construction process. If Acme elects to capitalize the interest charges on one of the loans, it must capitalize the interest charges on all of the loans.
An election to capitalize annual carrying costs with respect to unimproved and nonproductive real property can be changed from year to year. However, an election with respect to real property being developed continues in effect until the development is completed.

**Development Costs**

Land must be prepared for building before real estate development begins. Subdividers, developers, or contractors sell the improved lots or parcels to others. After some physical activity on the property occurs, such as clearing, grading, and excavation, the related interest expenses must be capitalized. Prior to that point the interest can either be deducted currently or added to the basis of the land. However, other development costs, such as obtaining permits, zoning variances, and similar items, must be capitalized even if the project is delayed or becomes financially unfeasible. Real estate and similar property taxes must be capitalized from the purchase date if it is reasonably likely that the property will be subsequently developed [Reg. 1.263A-2(a)(3)].

Preparing land for sale or development can involve expenses that provide benefits common to all of the lots, such as water lines, utilities, roads, greenbelts, parks, and recreational facilities. These costs are included in the tax basis of the developed land. They can be allocated among the parcels according to the appraised value of the lots, the assessed value for real estate taxes, square footage, the relative sales value (a Generally Accepted Accounting Practice or GAAP concept allocating costs to parcels based on their relative FMVs), or any other reasonable method. Bear in mind the IRS may challenge any allocation if it skews or defers income.

**Estimated Costs to Complete**

Sometimes lots are sold prior to the point when the subdivider or developer has completed common improvements, such as streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts, and swimming pools. How does a developer determine when the costs of those common improvements, not yet constructed, are added to the basis of properties sold? In general, under §461, common improvement costs may not be added to the basis of benefited properties until the common improvement costs are incurred within
the meaning of §461(h) when the property is actually provided by the taxpayer. Common improvement costs that have not been incurred under §461(h) when benefited properties are sold, may not be included in the basis of the properties in determining gain or loss from sales.

The IRS in Rev. Proc. 92-29 has provided a procedure for a real estate developer to obtain IRS consent to use an alternative to the general method under §461(h), effective for sales of property after December 31, 1992.

Under the alternative cost method, a developer may include in the basis of properties sold their allocable share of the estimated cost of common improvements without regard to whether the costs are incurred under §461(h), but subject to certain limitations.

For purposes of Rev. Proc. 92-29, “common improvement” means any real property or improvements to real property that benefit two or more properties that are separately held for sale by a developer. The developer must be contractually obligated, or required by law, to provide the common improvement and the cost of the common improvement must not be properly recoverable through depreciation by the developer.

Generally, under the alternative cost method, the estimated cost of common improvements, as of the end of any tax year, is equal to the amount of common improvement costs incurred under §461(h) as of the end of the tax year, plus the amount of common improvement costs the developer reasonably anticipates it will incur under §461(h) during the 10 succeeding tax years.

**Example:** A developer sells five lots from a tract of 50 lots during the current year. He estimates the project’s total common improvement costs will be $1 million over five years. Only $200,000 of these costs were actually incurred by year-end. Under the general economic performance rules of §461(h), the developer would be able to add only $20,000 (10% of actual costs incurred) to the basis of the lots sold. However, if he complies with Rev. Proc. 92-29, 1992-1 CB 748, he can add $100,000 (10% of the total estimated common improvement costs) to the basis of lots sold.
There is a limit on the amount of costs that can be included in the basis of the parcels sold during the year. A developer cannot include an amount in excess of the common improvement costs actually incurred under §461(h) by the end of any tax year.

Example: A subdivider estimates he will have $200,000 in costs over the next six years for common improvements. At the end of the first year, he has incurred only $20,000 in actual costs but has sold 30% of the lots. Since the addition for estimated costs cannot exceed the actual costs incurred to date, the addition to the basis of lots sold will be limited to $20,000 rather than $60,000 (30% of the estimated $200,000 cost of common improvements).

The alternative cost limitation must be applied on a project-by-project basis. Thus, the common improvement costs incurred with respect to one project may not be included in the alternative cost limitation of a second project. A developer may use any reasonable method to define a project in light of the common improvements to be provided.

The alternative cost method does not affect the application of general capitalization rules to developers of real estate. Thus, common improvement costs incurred under section 461(h) of the Code are allocated among the benefited properties and may provide the basis for additional computations [e.g., interest capitalization under §263A(f)].

**Basis of Gifted Property**

The basis of property received by gift is the same basis as that of the donor (§1015).

Example: Mona gave her self-portrait to her granddaughter. At the time she had the painting done, her cost was $100. After Mona’s death, her granddaughter sold the painting to a local art dealer for $1,000,000. The granddaughter’s basis in the painting was $100.
If the adjusted basis is more than the FMV of the gift:

- The basis for computing gain is the adjusted basis of the property.
- The basis for computing loss is the FMV of the property.

**Example:** John purchased shares of stock in XYZ Corporation at $200 per share in 1999. On March 14, 2006, when the FMV was $14.48 per share, John gave the shares to his son, Frank, who hoped to take advantage of the resurgence of the industry XYZ Corporation was in. However, after careful consideration, Frank decided to direct his portfolio in a different area by selling the stock. If Frank sells the stock at $9 per share, his basis for determining loss is $14.48 per share. Therefore, he has a loss of $5.48 per share on the sale.

Had John sold the stock and given the money to Frank instead, John would have reported a loss of $185.52 per share and passed the cash of $14.48 per share to his son.

If using the donor’s adjusted basis to compute gain results in a loss and using the FMV to determine loss results in a gain, there is no gain or loss upon the disposition of the property.

**Example:** Before Frank sold his XYZ Corporation stock he had a change of heart. He decided to give it a chance. Since his basis is $200 per share for gain purposes, but $14.48 per share for loss, if the stock sold at a price between $14.48 and $200, Frank would have no gain or loss to report.

If the sales price is $100 per share, his basis for determining gain is $200, which results in a loss [$100 - $200 = -$100 (loss)]. His basis for determining loss is $14.48, which results in a gain [$100 - $14.48 = $85.52 (gain)]. Therefore, no gain or loss is recognized.

The basis of property is increased by all or a portion of the gift taxes paid. For gifts made after December 31, 1976, the basis is increased
by the portion of the gift tax attributable to the net appreciation of the gift. The net appreciation is the amount by which the FMV of the gift exceeds the donor’s adjusted basis immediately prior to the gift [IRC §1015(d)(6)].

The basis of property received in a transaction that is in part a gift and in part a sale is the sum of:

- The greater of the amount paid for the property or the transferor’s adjusted basis of the property at the time of the transfer; plus
- The amount of increase, if any, allowed due to the gift tax paid.

**Example:** Roger decided to sell his mansion to his daughter, Polly. The mansion was worth $1,000,000, but she could only afford to pay $550,000. Roger’s basis in the property was $300,000.

<table>
<thead>
<tr>
<th>Sale</th>
<th>Gift</th>
<th>Donee’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>$550,000</td>
<td>$450,000</td>
<td>$550,000 + a portion of gift tax</td>
</tr>
</tbody>
</table>

If Roger’s basis in the property had been $750,000, the following would apply:

<table>
<thead>
<tr>
<th>Sale</th>
<th>Gift</th>
<th>Donee’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>$550,000</td>
<td>$450,000</td>
<td>$750,000 + a portion of gift tax</td>
</tr>
</tbody>
</table>

The depreciable basis of a gift is the donor’s adjusted basis. The donee not only receives the gift, but also the depreciation method, life, and accumulated depreciation. Any improvements or additional cost associated with acquiring the gift will be depreciated as if it were a new asset (§1016).
Example: In 2006 Jane was gifted a rental condo her uncle purchased January 2, 1988. The property was being depreciated under MACRS 27.5 years. Her uncle paid $85,000 for it and had $46,236 of accumulated depreciation. Jane’s basis for depreciation is the $85,000. The accumulated depreciation belongs to her as well. She continues depreciating the property where her uncle left off. If Jane renovates the property, the cost is treated as an improvement with a new depreciable life.

If the donor’s basis is greater than the sales price, the basis is allocated first to the sales price, resulting in no gain or loss. Any remaining basis is allocated to the gift.

Example: If Allen transfers property to his son for $30,000, and such property at the time of transfer had an adjusted basis in Allen’s hands of $60,000 (and a FMV of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Allen’s basis for the sale would be the $30,000 resulting in no gain or loss. The remaining $30,000 would be allocated to the gift. Therefore, the son’s basis would be Allen’s adjusted basis of $60,000 ($30,000 + $30,000).

The basis of a life interest and a remainder interest are calculated with reference to the “uniform basis” and the age of the donor. The uniform basis is the basis of the donor at the time of the gift. The life interest and the remainder interest factors change with time. As the donor gets older, the remainder factor increases while the life interest factor decreases. (Life interest factor + remainder factor = 1)
INHERITED PROPERTY

Before the Year 2010

The basis of inherited property is determined as of the date of death of the decedent. The basis of inherited property, other than income in respect of a decedent (IRD) items, is the FMV on that date (§1014). If the alternative valuation date is selected, the basis is the value used on that date.

If property is gifted with a retained life estate, the remainder interest will receive a basis equal to the property’s FMV on the date of death of the decedent, if the property is not disposed of prior to the death of the decedent.

Example: John gifted his son land valued at $125,000 at the time of the gift, but retained a life interest in it. John paid $100,000 (uniform basis) for the property. When John died, the property was worth $250,000.

If John and his son sold the life and remainder interest before John’s death, the basis of $100,000 would be apportioned between the two men based on the factors found in Table S in the IRS regulations.

Since the property was not sold until after John’s death, his son’s basis will be $250,000, the FMV on the date of John’s death.

The depreciation method and life are the same as that of a new asset. The decedent’s basis, as well as the accumulated depreciation prior to death, has no effect on the inherited property.
Example: Fay Tality inherited a fully depreciated rental property from her brother Mort. Mort purchased the property for $25,000 including the land. The depreciation on the property amounted to $20,000. When Mort died, the property was valued at $95,000 including $15,000 for land. Fay has a depreciable basis in the rental of $80,000. The $20,000 prior depreciation has no effect on Fay. It dies with the original owner.

Special Use Valuation

If certain conditions are met, an estate may elect under §2032A to value qualified farm or other closely-held business real property, which is included in the decedent’s estate, on the basis of its actual use as a farm or in the closely-held business, rather than its FMV based on highest and best use. If such an election is made, the basis of the real property is its value determined for purposes of the special use valuation election (rather than its FMV).

A qualified heir may make an irrevocable election to have the income tax basis of qualified real property acquired from a decedent increased if the additional estate tax, plus related interest, is imposed due to the sale of the property to nonfamily members or its ceasing to be used for farming or other closely-held business purposes within 10 years after the decedent’s death. The election is made by attaching a statement to Form 706-A, Additional Estate Tax Return. If the election is made, the basis of the property is increased to the FMV of the property on the date of the decedent’s death (or alternate valuation date, if decedent’s estate elected to use that value) [IRC §1016(c)]. If the qualified heir does not make the election, no adjustment is made to the basis of the property.

The downside of making the election is that the heir must pay interest on the recapture tax from the original due date of the decedent’s Form 706 to the due date of Form 706-A (i.e., six months after the date of the event triggering the recapture). Thus, the interest due must be compared to any tax benefit resulting from the basis increase.
After the Year 2009

The basis as determined by FMV on the date of death (DOD), is repealed with respect to decedents dying after December 31, 2009 [§§1014 and 1022].

- Property acquired from a decedent will be treated the same as property acquired by gift. The recipient’s basis in property received will be a basis equal to the lesser of the decedent’s adjusted basis in the property or the FMV on the date of the decedent’s death.

- The decedent’s estate may then increase the basis for a limited amount of property on an asset-by-asset determination. This property is defined by what it is not. Property acquired by the decedent by gift within three years of the date of death is not eligible for this increase, except if received by gift from a spouse.

The increase is limited to $1,300,000, adjusted for inflation after 2010, and increased by the decedent’s unused NOL, capital loss carryovers, and certain built-in losses that would have been allowable under §165 if inherited property had been sold at FMV immediately before the decedent’s death.

An additional increase of $3,000,000 is available for qualified spousal property transferred to a surviving spouse.

These increases cannot increase the basis of any property above its FMV on the DOD.

The basis increase available to a noncitizen, nonresident of the U.S. is up to $60,000 and no addition is allowed for the decedent’s unused capital losses, NOLs, or built-in losses.

Inherited Community Property

A surviving spouse’s share in community property is treated as property acquired from the decedent spouse if at least one-half of the community property was includible in the deceased spouse’s estate [§1014(b)(6)]. This is true even though an estate tax return for the estate of the decedent wasn’t required or, if required, no estate tax was payable [Reg. §1.1014-2(a)(5)].

As a result, both the surviving spouse’s and the decedent’s shares of the community property (included in the decedent’s estate) are
treated as property acquired from the decedent so that both shares get a basis of the FMV as of the date of death (or the alternate valuation date).

It’s important to know how the decedent’s assets were titled in order to determine what portion is eligible for a FMV basis at death. The following table summarizes the effect of titling of both community and non-community property assets.

<table>
<thead>
<tr>
<th>Manner of Holding Title</th>
<th>Basis FMV At Death?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decedent’s Name Only</td>
<td>YES</td>
</tr>
<tr>
<td>Joint with Spouse, Acquired Before 1977</td>
<td>All except part, if any, due to consideration furnished by the surviving spouse</td>
</tr>
<tr>
<td>Joint with Spouse, Acquired After 1977</td>
<td>Decedent’s half only</td>
</tr>
<tr>
<td>Joint with Non-spouse, Right of Survivorship</td>
<td>All except part, if any, due to consideration furnished by the other joint owner(s)</td>
</tr>
<tr>
<td>Tenancy-in-Common</td>
<td>Decedent’s portion only</td>
</tr>
<tr>
<td>Community Property</td>
<td>Yes, Both halves</td>
</tr>
<tr>
<td>Community Property with Right of Survivorship</td>
<td>Yes, Both halves</td>
</tr>
<tr>
<td>Separate (Non Community) Property Per Spousal Agreement or State Law</td>
<td>YES</td>
</tr>
<tr>
<td>Grantor Trusts (including Totten Trusts)</td>
<td>YES</td>
</tr>
<tr>
<td>Non-grantor Trust</td>
<td>NO</td>
</tr>
</tbody>
</table>

**ENVIRONMENTAL CLEANUP COSTS**

The IRS considers costs of environmental cleanup activities to be capital expenditures which are added to basis. Such costs generally include but are not limited to:

- Expenditures for assessment.
- Remediation.
- Oversight costs required as part of the cleanup operations pursuant to state orders and administrative agreements.
- Transportation and disposal of contaminated soil.
- New soil.
These costs, however, are added to the basis of the improvements and not to the basis of the land itself if the cleanup operation constitutes a general plan of rehabilitation and restoration of improvements which benefit them for the duration of their useful life (PLR 9315004).

Costs that are not be attributable to the plan of rehabilitation, such as costs to assess contamination of property, may be deducted currently if it is determined that an assessed site will not undergo rehabilitation.

Legal fees with respect to environmental claims against the land owner by state and federal agencies and private third parties, and litigation between the owner and insurance companies, are deductible to the extent that they were incurred to defend the owner’s business or secure contractual rights. These costs are not added to basis if they do not contribute to, or facilitate, the environmental cleanup.

**DEMOLITION EXPENSES**

Amounts spent to demolish any structure, and losses sustained on account of the demolition, are added to the basis of the land on which the demolished structure was located (§280A). If a casualty damages or destroys a structure and the structure is thereafter demolished, the basis must be reduced by the casualty loss allowable under §165 before the loss sustained on account of the demolition can be determined.
Example: In 2005, Asher bought an apartment building for $1,500,000. To determine basis, Asher properly allocated $1,000,000 of the purchase price to the building and $500,000 to the land. By 2008, the building’s FMV was $2,000,000; its adjusted basis was $100,000. The land’s FMV was $1,000,000; its adjusted basis was $500,000.

In 2008, an earthquake destroyed the building, reducing its FMV to zero. In addition, the earthquake reduced the land’s FMV to $800,000 by burdening the land with rubble and a useless building. Asher pays a contractor $200,000 to demolish the building and remove the rubble. Asher may not deduct the $200,000 demolition expense. Under §280B he must charge that expense to a capital account with respect to the land. His basis in the land after the demolition is $500,000, calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis before casualty</td>
<td>$500,000</td>
</tr>
<tr>
<td>Less: Deduction allowed in 2008 for casualty loss to land</td>
<td>-200,000</td>
</tr>
<tr>
<td>Basis before demolition</td>
<td>$300,000</td>
</tr>
<tr>
<td>Plus: Demolition expense</td>
<td>+200,000</td>
</tr>
<tr>
<td>Basis after demolition</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

Other than in a casualty loss, no tax benefit is allowed from demolition expenses until the property is sold, and no loss is allowed on the demolition. Any remaining basis in the demolished structure is added to the basis of the land.

On the other hand, the cost of moving a building intact from one location to another has been considered an improvement to the building which should be added to the basis of the building, and not to the basis of the land, in the absence of proof that moving the dwelling was either essential to, or for the basic purpose of, effectuating the sale or exchange of the original lot [Stuart M. Hughes, 54 TC 1049 (1970)].
IRA Real Estate Investments

The IRS does not “approve” assets in which retirement plans may invest, but they do indicate which assets are not allowed. The following assets are prohibited:

- Life insurance.
- Works of art.
- Rugs or antiques.
- Metals or gems.
- Stamps or coins.
- Alcoholic or other beverages.
- Any other tangible personal property specified by the IRS.

Single family and multi-unit homes, apartment buildings, condominiums, co-ops, commercial property, and improved or unimproved land, whether leveraged or unleveraged, may be purchased by an individual’s IRA.

IRA owners must make sure they do not engage in self-dealing prohibited transactions when investing their IRA assets in real estate. They must make sure the real estate transactions are “arm’s length” or third-party transactions. This means that an IRA owner cannot invest in property he or she, a relative, or his or her business, already owns.

Self Dealing

Self-dealing occurs when an IRA owner uses an IRA for personal enrichment beyond the intent of the tax law. This is known as a prohibited transaction. If an IRA transaction does not fit precisely into pre-established guidelines, the IRS or Department of Labor (DOL) scrutinizes the “facts and circumstances” to determine whether it qualifies.

The IRA owner or a “disqualified person” with control over the assets, receipts, disbursements and investments or who has the ability to influence investment decisions, including members of the IRA owner’s family (spouse or lineal descendants) can initiate a prohibited transaction.
There is no absolute, “line in the sand” definition for most self-dealing transactions. IRS Publication 590 and IRC §4975 provide information on what is generally considered a prohibited transaction. Anything that implies self-interest or occurs between disqualified persons has the potential to be considered a prohibited transaction.

- Borrowing money from an IRA — IRAs are prohibited from making loans to IRA owners and any disqualified person.
- Using the IRA as a security for a loan — IRA owners are not allowed to use the IRA as collateral for a loan, as the amount they pledge as security will be deemed a distribution by the IRS.
- Selling assets to an IRA — If the IRA owner sells property to their IRA, the sale is a prohibited transaction.
- Buying property for personal use (either by the IRA owner and/or a family member), such as a lake cabin or a condo in the mountains, is strictly prohibited.
- Purchasing property from a relative.
- Issuing a mortgage on a relative’s new residence.

If a taxpayer violates the prohibited transaction rules, he or she jeopardizes the IRA’s tax-free status. In a worst-case scenario, the entire IRA becomes taxable based on the total account value as of the beginning of the year in which the transaction took place. A 10% early withdrawal penalty may also apply. This is much harsher than the penalties applied to qualified plans, which generally are restricted to a 10% penalty on the prohibited amount.

**Prohibited Transactions**

Pursuant to IRC §4975(c), the following transactions between an IRA and a disqualified person are prohibited transactions. IRC §4975(c)(1) defines a prohibited transaction to include any direct or indirect:

- Sale or exchange, or leasing, of any property between a plan and a disqualified person.
- Lending of money or other extension of credit between a plan and a disqualified person.
- Furnishing of goods, services, or facilities between a plan and a disqualified person.
- Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan.
■ Act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account.
■ Receipt of any consideration for his or her own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

**Disqualified Persons**

Although the §4975(e)(2) definition of what is a disqualified person is complex, the following entities will virtually always be considered disqualified persons with respect to IRA transactions:

- The IRA owner or the IRA owner’s spouse.
- The IRA owner’s ancestors and lineal descendants.
- Spouses of the IRA owner’s lineal descendants.
- Investment managers and advisors.
- Anyone providing services to the plan (IRA), e.g., the IRA trustee or custodian (see DOL Advisory Opinion 88-A).
- Any corporation, partnership, trust or estate in which the IRA owner has a 50 percent or greater interest. IRC §318 regarding ownership attribution applies. Consequently, ownership of the spouse, children, grandchildren or parents are also considered in determining the IRA owner’s ownership.

**Self Dealing**

Examples of self-dealing with IRA funds include:

- Borrowing money from an IRA — IRAs are prohibited from making loans to IRA owners and any disqualified person.
- Using the IRA as a security for a loan — IRA owners are not allowed to use the IRA as collateral for a loan, as the amount they pledge as security will be deemed a distribution by the IRS.
- Selling assets to an IRA — If the IRA owner sells property to their IRA, the sale is a prohibited transaction.
- Buying property for personal use (either by the IRA owner and/or a family member), such as a lake cabin or a condo in the mountains, is strictly prohibited.
Purchasing property from a relative.
Issuing a mortgage on a relative’s new residence.

**Financing the Purchase**

Some IRA custodians will only handle straight cash transactions, i.e., they do not allow financing or leveraging. Others may allow encumbered property. In such cases, do not be surprised if the IRA custodian requires a nonrecourse note (only the property is used as collateral for the loan). Also, financing any part of the purchase may create taxable income inside the IRA.

**Note:** If the property is leveraged, repayment of the underlying debt must come from contributions to or income from the property or other assets in the account.

Once a property has been chosen by an IRA owner, the custodian—upon direction by the individual—must actually purchase it. Only IRA funds may be used as good faith deposits, down payments, or purchase money. Ownership is always in the name of the account. Title might be worded as, for example: “First Regional Bank Cust fbo John Doe IRA.”

An IRA can sell its interest in the property to an unrelated party at any time. The proceeds of the sale must be returned to the retirement account. Since the transaction is within the retirement account, there are no capital gains to pay. Income in a retirement account is tax-deferred until the IRA account owner begins taking distributions from the account, usually after age 59½. As noted previously, financing any part of the purchase may result in taxable income being generated inside the IRA.

To buy real estate ownership through the IRA if there is not enough cash, one could purchase a fractional interest in the property. In the event the IRA owner has insufficient assets to pay the entire purchase price, the IRA owner can either consider borrowing the difference or co-investing with other individuals or entities. Each investor’s IRA percentage of ownership should be reflected on the title.
However, to prevent a prohibited transaction, the IRA owner should not have access to or use of the property while any part of the real estate is held by the IRA. Also, while fractional interests in real property may be purchased or sold, such interests may not be bought from the IRA owner or members of his family (except siblings), or from his business. All income and expenses related to the property needs to be divided and/or paid according to ownership percentage. In such cases, it is wise to have a third-party property manager handle these activities to ensure that no self-dealing transaction occurs.

- Neither the IRA owner, spouse, nor family members (other than siblings) may have owned the property prior to its purchase by the IRA.
- Neither the IRA owner nor family members (other than siblings) may have access to or use of the property while it’s in the IRA.
- The IRA owner cannot manage the property; however, he or she can hire a third party — a real estate broker or local manager — to collect rents and maintain or improve the property.
- Property-related expenses cannot be paid with personal funds and then be reimbursed by the IRA.
- The IRA owner’s business may not lease or be located in or on any part of the property while it’s in the IRA.
- All rental profits must be returned directly to the IRA.
- The IRA owner cannot earn a commission or fee on any transactions involving the retirement account.
- Property owned within an IRA is not able to take advantage of write-offs, such as depreciation or other property related expenses.
- The property must remain in the IRA until distributed or sold to a third party.

**Steps to Create a Real Estate IRA**

Buying real estate with an IRA should be done as follows:

**Step 1:** Locate a self-directed IRA custodian. Ask them to send you a self-directed IRA kit and the necessary investment authorization form(s) for real estate or visit the custodian’s website and download the applicable forms.

**Step 2:** Complete the new account paperwork. This will usually consist of an IRA agreement, fee schedule and disclosure statement. Read the documents carefully and fill in the requested information. Pay close
attention to the beneficiary designation. Failure to name a designated beneficiary will default to the ordering rules contained in the financial institutions IRA Agreement. Many IRA documents make the individual’s estate the designated beneficiary if no one is named. Individuals transferring or rolling over funds from another IRA also need to complete the IRA Transfer/Rollover Request form. Send these forms back to the IRA Custodian for processing, i.e., let the new IRA Custodian send the Transfer Request to the old custodian.

**Step 3:** Fund the new account, usually by a transfer or rollover from the old IRA. This will be a tax-free, nonreportable movement of assets between retirement plans. Generally, transfers occur between similar types of plans: for instance, from a Roth IRA to a Roth IRA. There is no limit on the number of transfers that may occur between retirement plans, but a transfer must occur between the custodians of the retirement accounts. This means that the assets are made payable to the custodian, not the retirement account owner.

To avoid delays be sure to take the following precautions:

- Complete the Transfer Form properly.
- Attach a copy of the most recent IRA statement from the old IRA custodian.
- Query the institution currently holding the IRA assets. Each company has its own procedures. Find out whether there are any “extra” requirements, such as signature guarantees that are needed.
- Know the exit fees. Some companies charge termination fees or backend loads to sell their funds. So while on the phone with the customer service representative for the IRA Custodian, get an estimate of what your exit fees might be, if any.

**Step 4:** Investment Authorization. Once the individual finds a property to acquire, he or she signs an Investment Authorization, a form that instructs the custodian to buy the property. The IRA owner must follow the instructions contained on the Investment Authorization and provide the IRA Custodian with copies of the requested documents prior to funding. The document requirements vary between IRA custodians, but may include a draft of the proposed deed to ensure that vesting is properly reflected. The custodian writes a check drawn from the IRA account or wires funds typically to a third-party escrow company and the title goes in the name of the IRA and the custodian.
**Unrelated Business Income**

One of the benefits of having an IRA is that earnings on investments are normally not taxed until distributed to the IRA owner. However, some types of investments may generate taxable income inside the IRA. This is known as “unrelated business income” (UBI) or “unrelated business income tax” (UBIT). One source of taxable income inside an IRA is debt-financed property. If property or investments are acquired or improved through debt financing, the income from that investment is generally taxable as unrelated business income.

If investments within an IRA that generate $1,000 or more of gross UBI the IRA must file Form 990-T, *Exempt Organization Business Income Tax Return*, with the IRS on or before the April tax-filing deadline, and all applicable taxes should be paid from IRA assets. Accounts that receive less than $1,000 of gross UBIT are not required to file.

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**Note:** Since the Real Estate IRA is self-directed, it is the IRA owner’s responsibility to monitor for UBIT and determine if filing Form 990-T is necessary. Individuals who maintain more than one IRA need to aggregate the UBIT generated in each account to determine if they surpass the $1,000 threshold. If filing is required, the IRA owner needs to complete Form 990-T (or have it prepared by their accountant). This form can be obtained directly from the IRS or downloaded from the website. This form is then sent to the IRA custodian for their signature with a letter from the IRA owner authorizing the payment of taxes from the account. The custodian then forwards it to the IRS along with a check from the IRA owner’s account.

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**Example:** Stacy decides to purchase a duplex for her retirement account at a cost of $100,000. She puts in $70,000 and borrows the remaining $30,000. On a simplified calculation with the UBIT, only 70% of the income is sheltered. The rest of the income from the property is subject to ordinary income tax rates within the IRA.
Rents from real property are excluded in the definition of income under unrelated business income, so purchasing rental real estate in an IRA and collecting rents does not create potential tax problems.

**HOMEBUYER’S DOWN PAYMENT ASSISTANCE**

Homebuyers who receive down payment assistance from §501(c)(3) tax-exempt charitable organizations may exclude the assistance from their gross income as gifts, since they are made out of detached and disinterested generosity rather than to fulfill any moral or legal duty (normal gift definition). In addition, they may include the assistance in the cost basis of their homes.

Homebuyers who receive down payment assistance from organizations that do not qualify for exemption may exclude the assistance from their gross income as a rebate or purchase price reduction, not as a gift. The payments are not made from detached and disinterested generosity. They are made in response to an anticipated economic benefit, namely facilitating the sale of a seller’s home. Consequently, the assistance is not included in the cost basis of their homes since it is a rebate or purchase price reduction.

Either way, the down payment assistance is excluded from gross income. However, it is only included in the cost basis of the house if the assistance comes from a §501(c)(3) organization.

To qualify as a tax-exempt charity, the organization must be operated exclusively for charitable purposes, i.e., primarily to benefit a charitable class (such as low-income taxpayers). In this case, any benefit to other parties (such as home sellers) who participate in the transactions does not detract from the organization’s charitable purpose.

On the other hand, organizations do not qualify for tax-exempt status under §501(c)(3) if they rely on the home seller to provide the down payment assistance, since the benefit to the home seller is a critical aspect of the organization’s operations. The organization is not operated exclusively for charitable purposes.
Ownership

MORTGAGE INTEREST AND LOAN CHARGES

Interest on a mortgage on real estate generally is deductible as either trade or business, passive activity, investment, or qualified residence interest. The regulations require tracing the use of loan proceeds. Once loan proceeds are traced to a particular type of expenditure, the related interest expense assumes the character of that expenditure and is treated under the appropriate set of rules.

Loan Expenses

Borrowers may incur commissions, lender’s service charges, legal fees, and accounting fees that are not paid for the use or forbearance of money. These expenses are not interest even though they increase the cost of borrowing. The result of these payments is that the borrower had for a period of years, the use of another’s money as the basis of deriving income. They are treated like bond discounts, prepaid rent, or the costs of acquiring ownership. The loan expenses, therefore, spread over the life of the loan on the theory that they result in property of a sort, its cost is being exhausted proportionately over a period of years, and should be provided for on the basis of time, production, or otherwise. Since the loan expenses are not interest, they are amortized only if they qualify as business or investor expenses under §162 or §212; no deduction is allowable if the funds are used for personal purposes.

Qualified Residence Interest Expense

Qualified residence interest expense on up to $1 million ($500,000 for married filing separately) of acquisition indebtedness plus up to $100,000 ($50,000 for married filing separately) of home equity indebtedness is fully deductible for regular tax unless the itemized deduction phase-out rules apply.
Acquisition and home equity indebtedness must be secured by a qualified residence. Only for qualified residence interest is the property securing the debt important in determining the tax treatment of the related interest expense.

Mortgage interest is deductible only when paid by the taxpayer who is the owner of the property. However, that ownership can be explicit, as when legal title to the property is in the name of the taxpayer, or equitable [Reg. §1.163-1(b)]. An equitable owner has real and beneficial use of the property, even though legal title is in the name of another. Thus, a taxpayer cannot deduct interest he pays on the mortgage of another.

**Example:** The Prescott’s 25 year old daughter, Tanya, bought a house but was unable to make her mortgage payments after losing her job. If her parents make the mortgage payments directly to the bank for her, without any expectation of repayment from Tanya, they cannot deduct the mortgage interest because they are not the owners. The payments are a nondeductible gift to Tanya. Similarly, Tanya cannot deduct the interest if it is paid by another person.

However, interest paid on a taxpayer’s indirect debt obligation, combined with equitable ownership of the residence, is deductible.

**Example:** Luther is unable to finance the purchase of a home due to his poor credit rating. His parents buy the home, hold title in their names, and obtain a mortgage. Luther lives in the home as his primary residence, pays all the mortgage payments directly to the bank, pays the homeowners insurance premiums, does all the maintenance and repairs, and pays the property taxes. While Luther does not have legal title, he has equitable ownership. The interest he pays on the mortgage loan is deductible on Luther’s tax return.

If a mortgage loan is obtained from a private party and an itemized deduction is claimed for qualified residential interest paid to an
individual, the name, address, and taxpayer identification number (TIN) of the person to whom the interest is paid must be disclosed on Form 1040, Schedule A. Otherwise a $50 penalty can be assessed for failure to show the lender’s TIN on the taxpayer’s Schedule A or to provide the taxpayer’s TIN to the lender.

Sometimes, taxpayers try to accelerate deductions to the current year by making their January mortgage payment in December. However, under a de minimis rule, mortgage holders reporting mortgage interest on Form 1098 can include interest the borrower prepays in the year paid only if it accrues by January 15 of the following tax year [Reg. §1.6050H-1(e)(2)]. Thus, taxpayers who prepay their January mortgage payment in December to accelerate additional mortgage interest into the tax year will succeed only if all the interest on the payment accrues before January 15 of the following tax year. If any of the interest relates to the period after January 15, all of the interest accruing after December 31 is treated as paid in the following year.


To understand the qualified residence interest rules, one must be familiar with the definitions of a qualified residence, acquisition indebtedness, home equity indebtedness, and secured debt.

Qualified Residence

A qualified residence is the taxpayer’s principal residence and one other residence chosen by the taxpayer for the tax year [§163(h)(4)(A)]. Principal residence has the same meaning as §121 does for the home sale gain exclusion. When a taxpayer uses more than one home as a residence throughout the year, look first to see which home is used for the greater part of the year. That home,
generally, is the principal residence. If that test is not conclusive, other factors are examined to determine which is the principal residence:

- The taxpayer’s place of employment.
- Where the family members make their place of abode.
- The address shown on the taxpayer’s tax returns, driver’s license, automobile registration, and voter registration card.
- The mailing address for bills and correspondence.
- The location of the taxpayer’s banks.
- The location of religious organizations and recreational clubs with which the taxpayer is affiliated [Reg. §1.121-1(b)(2)].

If the taxpayer has more than one home besides the principal residence, the taxpayer can designate a different one as the second qualified residence each year [Temp. Reg. §1.163-10T(p)(3)(iv)]. The designation can be made on an original or amended return.

**Example:** Tom and Katie have a house in Beverly Hills (their principal residence), a beach house, and a condo in the mountains. All three are mortgaged, and the proceeds from the mortgage loans were used solely to buy the three properties. None of the homes are rented. Tom and Katie can treat the interest from the mortgages on their principal residence and one other residence as qualified residence interest. They can select either the beach house or the condo to be treated as a qualified second residence each year and can change the selection each year. The mortgage interest from the third residence is treated as nondeductible personal interest.

If they are able, Tom and Katie should pay off the debt on the house whose interest will not be deductible.

The definition of a residence includes:

- Houses.
- Condominiums.
- Mobile homes.
- Boats.
- House trailers.
Other property that, under all facts and circumstances, can be considered a residence.

A residence must contain sleeping space, toilet, and cooking facilities [Temp. Reg. §1.163-10T(p)(3)(ii)].

**Example:** Adam and Eva Trehugger own a vacant lot in the Natchez Trace Wilderness Preserve on which they camp for several weeks each year. The Trehuggers cannot deduct the interest on the loan they used to buy the lot as “home mortgage interest” because the lot is not a residence as that term is defined in §1.163-10T(p)(3)(ii). Therefore the interest is not “qualified residence interest” within the meaning of §163(h)(3).

A taxpayer can treat a home under construction as a qualified residence for up to 24 months, but only if it becomes a qualified residence when it is ready for occupancy. A vacant lot does not qualify as a residence under this rule until construction begins.

**Example:** Kris owns a lot on which she wants to build a vacation home. On April 20, 2006, Kris obtains a mortgage secured by the lot and any property to be constructed on the lot. On August 9, 2006, she begins construction. The residence is ready for occupancy on November 9, 2008. Kris uses it as a residence during 2008 and elects to treat it as her second residence for the period November 9, 2008, through December 31, 2008.

Since a residence under construction is a qualified residence as of the first day that the residence is ready for occupancy (November 9, 2008), Kris may treat it as her second residence for up to 24 months of the period during which it is under construction, commencing on or after the date that construction is begun (August 9, 2006).

If Kris treats the residence under construction as her second residence beginning on August 9, 2006, it would cease to qualify as a qualified residence on August 8, 2008. [Temp. Reg. §1.163-10T(p)(5)].
Interest on debt to buy the lot that is incurred before construction begins would be personal interest. However, that interest could be deductible if a home equity loan is used to acquire the lot. Also, if the taxpayer can demonstrate that, before beginning construction, the lot had been held as an investment, interest incurred before construction begins would qualify as investment interest expense (deductible to the extent of investment income). However, proving investment intent can be difficult if the property is ultimately used for another purpose.

**Acquisition Indebtedness**

Acquisition indebtedness is debt secured by a qualified residence (including a designated second residence) not in excess of $1 million ($500,000 for married filing separately). The loan proceeds must be traceable to expenses of acquiring, constructing, or substantially improving a qualified residence.

Acquisition indebtedness also includes debt used to refinance earlier indebtedness that meets this definition of acquisition indebtedness, but only to the extent of the balance of the original acquisition indebtedness at the time of refinancing.
Example: Gloria gets a $100,000 loan to buy a residential lot on January 15, 2003. The debt is secured by the lot. On January 1, 2004, she begins building a home on the lot. Gloria spends $250,000 of her own money to build the house. Construction is complete on December 31, 2005, and she immediately moves in. On March 15, 2006, she gets a $300,000 loan secured by the residence. The lender on the second loan pays off the existing $100,000 debt, and disburses the remaining $200,000 directly to Gloria. Gloria has no other debt secured by a qualified residence.

The $100,000 debt that was incurred in 2003 was incurred to construct the residence because the proceeds of the debt are directly traceable to construction of the residence (i.e., the purchase of the lot). For the period before construction began (January 15, 2003, through December 31, 2003) Gloria may not treat the debt as acquisition indebtedness because it is not secured by a qualified residence. During the period January, 2004, through December 30, 2005, Gloria may treat the residence under construction as a qualified residence. Accordingly, the debt may qualify as acquisition indebtedness. During the period December 31, 2005, through March 15, 2006, the residence is a qualified residence and the debt will qualify as acquisition indebtedness.

The $300,000 debt is also considered incurred to construct the residence. The first $100,000 is treated as incurred to construct the residence because it was used to refinance debt incurred to construct the residence. The remaining $200,000 is treated as debt incurred to construct the residence because it was incurred within 90 days after the residence was completed, and construction expenditures of at least that amount were incurred between the date 24 months prior to the date the residence was completed and the date the debt was incurred.

The entire $300,000 loan is acquisition indebtedness because it is also secured by a qualified residence. Therefore, all of the interest on that loan is deductible as qualified residence interest.

Mortgage loans obtained on or before October 13, 1987, are grandfathered and not subject to the $1 million/$500,000 limits. As long as the debt was originally secured by the residence and continues to be secured by it, there is no limit on the amount of debt that was
incurred and no restrictions on the use of the debt proceeds. However, these grandfathered loans reduce the $1 million acquisition debt ceiling dollar for dollar for debt incurred after October 13, 1987.

Grandfathered debt that is refinanced is also grandfathered to the extent of the pre-October 13, 1987, debt’s outstanding balance on the refinancing date. However, a refinancing (either of the original debt or a grandfathered refinancing) is grandfathered only through the original due date of the grandfathered debt, with one exception. That exception is if the pre-October 13, 1987, debt was a balloon note. A refinancing of that debt is grandfathered for the shorter of 30 years from the date of the first refinancing or the first refinancing’s original term [§163(h)(3)(D)(iv)(II)].

The total amount of debt which may be treated as debt incurred in acquiring, constructing, or substantially improving a residence may not exceed the cost of the residence (including the cost of any improvements).

The 30-Day Rule

Taxpayers may treat any payment made from any account of the taxpayer, or in cash, within 30 days before or 30 days after debt proceeds are received in cash as if the payment were made from the debt proceeds to the extent thereof (IRS Notice 89-35). This option, if elected, overrides the general tracing rules which might result in expenditures being treated as personal. Otherwise, when a taxpayer receives debt proceeds in cash (i.e., the funds are not deposited in an account), the presumption is that they are used for personal expenditures. No formal election statement is required to use the 30-day rule. However, taxpayers should document their decisions to prevent confusion in later years.

90-Day Rules for Residential Expenditures

A 90-day rule allows taxpayers to treat debt as if it were incurred to acquire a residence to the extent payments are made to acquire it within 90 days before or after the date the debt is incurred (IRS Notice 88-74). This rule overrides the general interest tracing rules and the 30-day rule.
In the case of construction or substantial improvement of a residence, debt incurred prior to the time the construction or improvement is complete may be treated as being incurred to construct or improve the residence to the extent of any expenditures made no more than 24 months prior to the date that the debt is incurred. Debt incurred after the residence or improvement is complete, but no later than 90 days after such completion, may be treated as being incurred for construction or improvement to the extent of any such expenditures made within the period starting 24 months prior to the date of completion and ending on the date the debt is incurred.

For these 90-day rules, debt is incurred when the loan proceeds are actually disbursed to, or for, the benefit of the taxpayer. Alternatively, a taxpayer may treat the loan application date as the date the debt is incurred, provided it is actually disbursed within a reasonable time after loan approval (i.e., generally 30 days).

**Mortgage Insurance Premiums Deductible as Interest**

Premiums paid or accrued after December 31, 2007, and before January 1, 2011, for qualified mortgage insurance in connection with acquisition of qualified residence of the taxpayer are treated as qualified residence interest and thus deductible [2007 Mortgage Relief Act §3(b)]. The deduction is subject to phase-out rules affecting taxpayers with adjusted gross income (AGI) over $100,000 for the tax year.

“Qualified mortgage insurance” means:

- Mortgage insurance provided by the Department of Veterans Affairs (formerly the Veterans Administration) (VA), the Federal Housing Administration (FHA), or the Rural Housing Administration (RHA), and

- Private mortgage insurance [as defined by Sec. 2 of the Homeowners Protection Act of 1998 (12 U.S.C. 4901), as in effect on December 20, 2006].

Except for amounts paid for qualified VA or RHA mortgage insurance, any amounts paid in advance for qualified mortgage insurance that is properly allocable to years after the close of the year paid are treated as paid in those periods to which they are allocated, and are deductible in those years.
Notwithstanding the general rules for the treatment of qualified residence interest, IRS Notice 2008-15 allows individuals to allocate a prepaid mortgage insurance premium ratably over the shorter of:

- The stated term of the mortgage, or
- 84 months, beginning with the month in which the insurance was obtained.

Notice 2008-15 notes that taxpayers may have to contact the issuer of the Form 1098, *Mortgage Interest Statement*, to determine the manner in which the premium amount was reflected in box 4.

The rules regarding the deduction of qualified mortgage insurance premiums don’t apply with respect to any mortgage insurance contract issued before January 1, 2007.

### Home Equity Indebtedness

Home equity indebtedness is debt that is not acquisition debt secured by a qualified residence. Interest on the debt is fully deductible qualified residence interest to the extent it is not more than the lesser of:

- $100,000 ($50,000 for married filing separately), or
- The FMV of the residence less acquisition indebtedness (including pre-October 14, 1987, grandfathered acquisition indebtedness) [§163(h)(3)(C)].

There is no limit on the number of qualified home equity loans a taxpayer may have, so long as they total under the $100,000 or FMV limitation. How the proceeds are used is irrelevant except they may not be used to acquire tax-exempt obligations. The home equity indebtedness category is an exception to the general rule that tracing the use of loan proceeds determines how the interest is treated for tax purposes. However, how the proceeds are used is relevant for alternative minimum tax (AMT) purposes.

If a home equity loan is used solely for qualified educational expenses and the borrower so certifies using Form W-9S, *Request for Student’s or Borrower’s Taxpayer Identification Number and Certification*, the loan is also a qualified education loan under §221 whose interest should be reported to the borrower on Form 1098-E, *Student Loan Interest Statement*. Some or all of the interest can then be deducted on the Form 1040. If less than all the interest is deductible as student
loan interest, the excess can be deducted on Schedule A as home equity interest.

**Secured Debt**

Even though debt may be incurred in acquiring, constructing, or substantially improving a qualified residence, the debt does not qualify as acquisition indebtedness until the debt is secured by the qualified residence. Debt is secured by a qualified residence only if:

- The residence is specific security for payment on the debt,
- In the event of default, the residence could be foreclosed on to satisfy the debt, and
- The security interest is recorded or otherwise perfected under state law [Temp. Reg. §1.163-10T(o)(1)].

A debt is not considered to be secured by a qualified residence if it is secured solely by virtue of a lien upon the general assets of the taxpayer or by a security interest, such as a mechanic’s lien or judgment lien that attaches to the property without the consent of the debtor.

Debt will not fail to be treated as secured solely because, under an applicable State or local homestead law or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted. [Temp. Reg. §1.163-10T(o)(2)].

Qualified residence acquisition debt must be traceable to home acquisition expenditures under the general tracing rules (or the 90-day special exception to the tracing rules), and the debt must be secured by the qualified residence. When the debt is traceable to such expenditures, but the debt is not secured by the residence, the interest is treated as personal interest until the debt becomes secured. Such interest is nondeductible even if the debt proceeds are allocated to the acquisition of the residence under the tracing rules.
**Example:** A married couple takes out a loan to purchase their principal residence. The debt is secured by commercial rental property owned 50% by the couple and 50% by another person; the debt is not secured by the couple’s principal residence.

There is no question that the debt and the related interest expense are allocated to the residence under Reg. §1.163-8T even though the debt is secured by other commercial property. However, that allocation of interest doesn’t determine the deductibility of the interest expense as qualified residence interest under §163(h)(3). Section 163(h)(3)(A) clearly requires acquisition indebtedness to be secured by the residence. That requirement is not contradicted by the interest allocation rules under Reg. §1.163-8T. Therefore, the interest is personal interest under §163(h)(2) and is not deductible.

⇒ **Planning Point:** Many parents loan funds to their children to assist them with the purchase of their first home. Interest paid by the children to their parents is deductible as mortgage interest only if the loan is properly secured by the residence. Otherwise it is nondeductible personal interest.

**Example:** An employee retirement plan allows participants to borrow from their accounts for the purchase or construction of a principal residence. The loans must be secured by recorded deeds of trust and payable at least quarterly on a level-amortized basis. The interest rate is based on the prevailing commercial rate for similar loans at the time a loan is made. Assuming that the residence is the principal residence of the plan participant, the interest is deductible qualified residence interest under §163(h)(3) because the loan is secured by the principal residence and the proceeds will be used to purchase, construct, or improve the participant’s principal residence (PLR 8935051).
Mortgage Interest Not Qualified Residence Interest

Sometimes taxpayers have loans secured by one or more personal residences that are more than the amount that can be treated as qualified residence debt. This could happen if:

- An old mortgage is refinanced and the new loan exceeds the amount of the old loan;
- The taxpayer acquires residential property for more than the $1 million/$500,000 limits; or
- The taxpayer has more than two residences subject to mortgages.

The taxpayer must then trace the use of the proceeds to determine whether the interest is deductible. If the excess debt is traceable to a personal residence, the excess interest is nondeductible personal interest. If the debt is traceable to other expenditures, the deductibility of the interest depends on the various rules for personal, trade or business, passive activity, or investment interest. It is irrelevant that the debt in excess of the ceiling is secured by a qualified residence.

Electing Out of Home Mortgage Interest Treatment

Interest expense on up to $100,000 of home equity debt secured by a qualified residence is fully deductible for regular tax purposes regardless of the actual use of the proceeds. However, sometimes home equity loans are used in ways that make the interest fully deductible. For example, a Schedule C business owner may use a home equity loan to finance his business. In that case it might be better to treat the interest as a trade or business expense which reduces self-employment (SE) tax. Thus, the taxpayer could save the home equity loan interest deduction for another home equity debt or, if the taxpayer does not itemize his personal deductions, take a deduction that would otherwise go unused. It may also change an itemized deduction to one that decreases AGI (affecting various AGI-sensitive items).

Taxpayers can make an irrevocable election to treat debt as not secured by a qualified residence [Temp. Reg. §1.163-10T(o)(5)]. If the election is made, the tracing rules apply to determine the tax treatment of the interest expense.
Example: Maureen paid $40,000 for her home, which is now worth $75,000. She has a first mortgage on the home, the proceeds of which were used to buy the residence, with an average balance of $15,000 in 2006. She also has loan #2 secured by a second mortgage on the property, which she used in her business. The second loan has an average balance of $25,000. In 2006, Maureen gets loan #3, which is also secured by her home and which has an average balance in 2006 of $5,000.

If she does not elect to treat loan #2 as unsecured, the applicable debt limit for loan #3 in 2006 would be zero dollars ($40,000 − $15,000 − $25,000) and none of the interest paid on loan #3 would be qualified residence interest.

If, however, Maureen elects to treat loan #2 as not secured by the residence, the applicable debt limit for loan #3 would be $25,000 ($40,000 − $15,000), and all of the interest paid on loan #3 during the taxable year would be qualified residence interest. Since the proceeds of loan #2 are allocable to her trade or business under §1.163-8T, interest on the loan is deductible as a trade or business expense.

Planning Point: Electing out of home mortgage interest treatment could prevent a taxpayer from claiming a qualified residence interest deduction for any interest related to the debt. The regulations do not specifically say the election can be made for only a part of the debt. Thus, if an election is made for a home equity loan that was used 40% for a Schedule C business activity and 60% for a personal automobile, 60% of the interest is nondeductible personal interest due to the tracing rules. If the taxpayer had separate home equity loans he or she could make the election only for the loan used for business purposes, preserving the deductibility of the other loan interest as home equity loan interest.
Points and Prepaid Interest

Points are amounts paid when real estate is purchased or refinanced. Points are sometimes called loan origination fees, discount fees, or discount points.

Except in the case of certain points on home mortgages (see below), interest which a cash basis taxpayer pays and which is properly allocable to later tax years must be charged to a capital account and treated as paid in the year in which (and to the extent that) the interest represents a charge for the use of borrowed money during each such tax year [§461(g)(1)]. This rule applies to all taxpayers, including individuals, corporations, estates and trusts and covers interest paid for personal, business or investment purposes.

**Example:** Alta is on the cash method. She borrows funds November 1, 2006, and prepays 16 months interest of $1,600. She deducts $200 in 2006, $1,200 in 2007, and $200 in 2008.

Points paid on the purchase of a personal residence are usually fully deductible in the year the house was purchased. However, they must satisfy all of the following to be deductible in full in the year paid:

- The payment of points must be an established business practice in the area the loan is made.
- The points paid must not exceed the number of points generally charged in the area.
- The points must be computed as a percentage of the principal amount of the mortgage.
- The points must be paid with funds other than those obtained from the lender.

If points are paid by the seller of the property, they are treated as if they were paid by the buyer and the buyer can deduct them. However, the buyer must reduce his or her basis in the property by the amount deducted.

Mortgage prepayment penalties (and late payment charges) can be deducted as qualified residence interest if the charge is not for a specific service provided by the mortgage holder.
Points paid on refinancing must be amortized. If the points are amortized, the amount paid as points is divided by the number of years of the mortgage and a portion is deductible each year. If the mortgage is paid off early or refinanced with a different lender, the remaining points are deductible in full.

**Refinancing**

**Investment and Business-Related Mortgages**

A taxpayer may incur debt in order to pay off another debt. Under the tracing rules, to the extent the proceeds of a replacement debt are used to repay any portion of a existing debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated [Reg. §1.163-8T(e)(1)]. Interest expense accruing on a debt is allocated to expenditures in the same manner as the debt is allocated.

**Home Mortgages**

Interest paid on a home mortgage is deductible within limits, depending on whether it is home acquisition debt, home equity debt, or grandfathered debt. Interest on the refinanced mortgage is deductible if it falls into one of these categories.

Home acquisition debt is a mortgage taken out after Oct. 13, 1987, to buy, build, or substantially improve a main or second home, and is secured by that home. Interest on home acquisition debt is deductible, but the total home acquisition debt can’t exceed $1 million ($500,000 if married filing separately).

Home equity debt is any debt secured by a first or second home, other than home acquisition debt, or grandfathered debt. Thus, it includes mortgage loans taken out for reasons other than to buy, build, or substantially improve the home and mortgage debt in excess of the home acquisition debt limit. Interest is deductible on up to $100,000 of home equity debt ($50,000 if married filing separately).
Grandfathered debt is mortgage debt secured by a first or second home that was taken out before Oct. 14, 1987, no matter how the proceeds were used. All of the interest paid on a grandfathered debt is fully deductible.

If the old mortgage being refinanced is home acquisition debt, the new mortgage will also be home acquisition debt, up to the principal balance of the old mortgage just before it was refinanced. The interest on this portion of the new mortgage is deductible. Any debt in excess of this limit won’t be home acquisition debt, but may qualify as home equity debt, subject to the $100,000/$50,000 limit.

If grandfathered (pre-Oct. 14, 1987) debt is being refinanced for an amount that isn’t more than the remaining debt principal, the refinanced debt is still grandfathered debt. If the new debt exceeds the mortgage principal on the old debt, the excess will be treated as home acquisition or home equity debt.

Refinanced grandfathered debt is treated as grandfathered debt only for the period that remained on the old debt that was refinanced. Once that period ends, the debt is treated as home acquisition debt or home equity debt, based on how the debt proceeds are used. An exception allows a longer period of deduction for balloon notes that are refinanced after Oct. 13, 1987.

In general, points paid to refinance a personal residence aren’t fully deductible in the year paid. Instead, they are amortized over the life of the loan.

To figure the deduction for points, divide the total points by the number of payments to be made over the life of the loan. Then, multiply this result by the number of payments made in the tax year.

**Example:** You paid $3,000 in points and have a 30-year mortgage payable in 360 monthly installments. You can deduct $8.33 per month \((3,000 \div 360 = 8.3333)\). For a year in which you make 12 payments, you can deduct a total of $99.96 \((8.33 \times 12)\).
A larger first-year deduction is allowed for points if part of the proceeds of the refinancing are used to improve the home and certain other requirements. In that case, the points associated with the home improvements are fully deductible in the year they were paid.

Example: Veranda refinances her old mortgage (interest rate 10%) that has an outstanding balance of $80,000 with a new 6% loan from a different lender in 2006 for $100,000. She uses the proceeds of the new mortgage loan to pay off the old loan and to pay for a new sun porch costing $20,000. Since 20% of the new loan was incurred to pay for improvements, 20% of the points paid are deducted in the year of the refinancing. The remaining points on the refinancing are amortized over the life of the new loan.

If the mortgage loan is refinanced with the same lender, the remaining balance of capitalized points must be deducted over the term of the new loan, not in the year the first mortgage ends.

If a mortgage is being refinanced for the second time, the portion of the points on the first refinanced mortgage that haven’t yet been deducted may be deductible at the time of the second refinancing.

Example: Assume the same facts as in the prior example, except that in 2007 Veranda repays the second loan with the proceeds of a third loan. The balance of the unamortized points on the second loan are deductible in 2007. Any points that Veranda has to pay on refinancing the third loan are amortized over the life of that mortgage.

If prepaid interest is refunded to the borrower when the loan is paid off before its due date or when the property securing the debt is sold, the refund is presumably treated as a tax-free recovery of amounts charged to capital account when the prepayment was made. If the refund is less than the unamortized balance, the deficiency should be deductible as interest, since the debt is no longer outstanding.
Conversely, any excess of the refund over the unamortized balance should be reported as income under the tax benefit doctrine.

A prepayment penalty paid to terminate an old mortgage is deductible as interest in the year of payment.

Fees paid to obtain a new home mortgage aren’t deductible, nor can they be added to the basis of the personal residence to reduce the gain when it is sold. Examples of such nondeductible fees include credit report fees, loan origination fees, and appraisal fees.

**Reverse Mortgage Loans**

The primary purpose of the reverse mortgage loan is to enable elderly persons with limited income to remain in their homes. In a reverse mortgage, the lender makes payments to the borrower in installments over a period of months or years. Usually the maximum amount of the loan is a percentage of the current appraised value of the residence. The loan is secured by a mortgage on the borrower’s home. The loan agreement may add accrued interest to the outstanding loan balance monthly.

The borrower must repay the loan when the principal amount has been fully paid to the borrower, the home subject to the mortgage is sold, the borrower dies, or the borrower no longer uses the home as his or her principal residence. The amount due at that time includes the total of the installments paid by the lender to date plus the accrued interest.

The interest is deductible by the borrower when actually paid by the borrower to the lender (assuming it falls within one of the categories of deductible interest). Actual or constructive payment does not occur when the interest is added to the outstanding loan balance. Therefore, the interest is not deductible by the borrower at that time (Rev. Rul. 80-248).
Example: Randy enters into a reverse mortgage. The lender will pay Randy $500 per month for the next ten years. The lender records a mortgage on Randy’s home, which has been appraised at $160,000. Interest will accumulate monthly at the applicable federal rate and is added to the principal balance. Randy will owe the entire balance (including interest) at the end of the ten year term. Assuming Randy continues to live in the home for the entire ten year period, Randy can deduct the interest only when it is paid at the end of the period.

Repayment Ordering Rules for Multiple-use Debt

Sometimes a single loan is used for several purposes, such as for a personal residence, new car, rental or other passive activities, investment, or a trade or business. If less than all the loan is repaid, ordering rules determine which category is deemed repaid first.

Repayments are allocated to the categories in the following order:

■ Amounts allocated to personal expenditures.
■ Amounts allocated to investment expenditures and passive activity expenditures (other than passive activity expenditures described in category 3).
■ Amounts allocated to passive activity expenditures in connection with a rental real estate activity with respect to which the taxpayer actively participates [within the meaning of §469(i)].
■ Amounts allocated to former passive activity expenditures.
■ Expenditures for trade or business activities or certain low-income housing projects subject to favorable TRA ’86 transition rules (as described in Act Sec. 502 of TRA ‘86) [Temp. Reg. §1.163-8T(d)].
Example: Sybil borrows $100,000 on July 12, immediately deposits the proceeds in an account, and uses the proceeds as follows:

On August 31 she invests $40,000 in an S corporation in which she does not participate.

On October 5 she uses $20,000 to repair her rental property.

On December 24 she pays $40,000 for a new Earthshaker SUV (for personal use only).

On January 19 of the following year, she repays $90,000 (leaving $10,000 outstanding). The $40,000 allocated to the SUV, the $40,000 allocated to the S corporation passive activity, and $10,000 of the $20,000 allocated to the rental activity are treated as repaid, leaving $10,000 outstanding on her rental.

To the extent a new loan is used to repay another debt, the new loan is allocated to the expenditures to which the repaid debt was allocated using this repayment allocation scheme. The amount of the new loan allocated to any such expenditure equals the amount of repaid debt allocated to such expenditure.

Amounts allocated to two or more expenditures in the same category (e.g., amounts allocated to different personal expenditures) are treated as repaid in the order in which the amounts were allocated (or reallocated) to such expenditures. The taxpayer can treat allocations and reallocations that occur on the same day as occurring in any order.

**Investment Interest**

Interest expense characterized as an investment expense may be limited. Investment interest is deductible only to the extent of net investment income [§163(d)(1)].
**General Definition**

Investment interest expense is interest allocable to debt proceeds used to acquire property that generates the following types of income or gain [§163(d)(3)(A) and (5)(A)]:

- Interest.
- Dividends.
- Annuities.
- Royalties not derived from the ordinary course of a trade or business.
- Income of these types from an otherwise passive activity (portfolio income).
- Gain from the sale or exchange of property producing income of these types.
- Gain from the sale or exchange of property held for investment.
- Oil and gas working interest income treated as nonpassive even though the taxpayer fails to meet the material participation standard.

Investment interest includes interest:

- Allocated to portfolio income, such as interest on a loan taken out to buy stocks paying dividend income.
- Paid on money borrowed to invest in a business if the investor does not materially participate in the business and the business is not treated as a passive activity. However, an allocation must be made to any portfolio income included in the passive activity under the passive loss rules.
- On loan proceeds placed in a bank account prior to disbursing the funds. Interest paid on the borrowed funds is investment interest until the funds are disbursed.

Investment interest does not include interest:

- That is capitalized (e.g., under the uniform capitalization rules).
- Related to tax-exempt income and not deductible under §265(a)(2).
- Paid on business indebtedness.
- On personal loans, such as a personal residence loan.
- Paid on debt used to acquire real estate used in a trade or business.
Net Investment Income

Net investment income is the excess of investment income over investment expenses [§163(d)(4)(A)]. Investment income includes:

- Gross income from property held for investment.
- The excess of any net gain over any net capital gain resulting from the disposition of investment property.
- As much of the taxpayer’s net capital gain from the disposition of investment property and qualified dividends as the taxpayer elects to include.

Investment expenses are the deductions allowed (other than interest) that are directly related to the production of investment income. An expense subject to the 2% AGI limitation on miscellaneous itemized deductions is considered only to the extent a deduction is allowed after application of the 2% limit.

For items 2 and 3 above, only dispositions of property held for investment are considered. Section 1231 gains from the sale of assets used in a trade or business treated as long-term capital gains are not considered. Net gain refers to the net gain from investment assets whether short-term or long-term. Capital loss carryovers must be included when computing net gain.

**Example:** In 2007 Prunella reported long-term capital gains of $65,000. She also reported a long-term capital loss carryover of $80,000. Thus, no gain was included in her taxable income for 2007, and she still had $15,000 in long-term capital losses to carry over to subsequent years.

In 2008, Prunella reported capital gains of $20,000. Of this amount only $5,000 was included in income after subtracting the remaining $15,000 of capital losses carried over from 2007.

Prunella’s loss carryovers, which reduced capital gains in 2007 and 2008, also reduced her investment income to the same extent for purposes of the investment interest expense limitation of §163(d).
Net capital gain means the excess of net long-term capital gain over net short-term capital loss. The intent is to exclude net capital gains (which are taxed at more favorable tax rates) and qualified dividends from investment income.

Property held for investment includes oil and gas working interests that are treated as nonpassive despite the taxpayer’s failure to meet the material participation standard [§163(d)(5)(A)]. Thus, the net income or loss from such working interests (excluding interest expense) is included in computing net investment income.

**Including Capital Gain & Dividends in Investment Income**

Net investment income excludes net capital gains and qualified dividends unless the taxpayer elects to include all or part of them in investment income [§163(d)(4)(B)]. Taxpayers can elect to include any amount of their net capital gain and/or qualified dividends in investment income.

→ **Planning Point:** This allows the taxpayer to treat net capital gain or qualified dividend income as investment income only to the extent necessary to maximize the investment interest expense deduction. The downside of the election is that the amount of net capital gain and/or qualified dividends included in net investment income is ineligible for the favorable rates on net capital gains. Instead, the elected amount is taxed at the ordinary income rates.

Taxpayers should not make the election if they already have enough investment income to deduct all their investment interest. Also, remember that if the investment interest deduction is limited, the disallowed amount generally carries over indefinitely. The election is recommended if the taxpayers do not expect to have enough investment income (other than qualified dividends and net capital gains) to offset their investment expense for several years. Also, the election is more beneficial to taxpayers whose ordinary income is taxed at lower rates.
To make the election, the taxpayer enters the amount of capital gain or qualified dividend income he elects to include in investment income on Form 4952, *Investment Interest Expense Deduction*. The capital gain tax worksheet reduces net capital gains subject to the favorable rates (which includes qualified dividends) by the amounts included in investment income.

**Passive Activities and Investment Interest**

Passive activities are not treated as held for investment [§469(e)(1)(A)]. Thus, net investment income does not include any income or expenses from passive activities [§163(d)(4)(D)].

A passive activity is one of the following:
- Any rental activity (except those of certain real estate professionals).
- A business activity, including an S corporation or partnership, in which the taxpayer does not materially participate.

Certain activities appear to be rental activities but meet specific exceptions provided in Temp. Reg. §1.469-1T(e)(3)(ii) whereby certain activities are not categorized as rental, even though gross income is received for the use of the property. Examples include motel rentals averaging less than seven days, rentals incidental to one’s primary business, and hotel rentals averaging 30 days or less where significant personal services are provided. Also, nonmaterially participating working interests in oil and gas properties are not treated as passive unless the working interest is held in an activity that limits the taxpayer’s liability.

Interest expense to acquire a passive activity is a passive loss item, not investment interest expense. However, if debt is used to acquire an interest in a passive activity that also generates portfolio income, the portion of the interest expense from debt allocable to portfolio income assets is treated as investment interest expense rather than as a passive item.

Under a net lease arrangement the tenant pays most or all of the expenses. The owner’s only obligation is usually to pay the interest and taxes on the property. But, because a net lease is a rental subject to the passive loss rules, it is not considered investment property for

**Disallowed Investment Interest Expense**

Investment interest that is disallowed as a deduction because it exceeds net investment income is carried forward indefinitely and treated as investment interest in the carryforward year [§163(d)(2)].

**ALTERNATIVE MINIMUM TAX**

Individual taxpayers are subject to two tax systems: regular income tax and alternative minimum tax (AMT). The taxpayer is liable for the larger of the taxes computed under each system. Investment interest and qualified residential interest are deductible for both regular tax and AMT. However, the amount of investment and qualified residential interest deductible for AMT is not always the same as for regular tax.

**Note:** AMT applies to interest deductions only if the taxpayer itemized deductions. If the taxpayer took the Standard Deduction, there is no interest adjustment for AMT.

**Residential Interest Expense**

The regular tax deduction for residential interest is treated differently for AMT in three ways.

First, for AMT, only “qualified housing interest” is deductible residential interest [§56(b)(1)(C)(i)]. “Qualified housing interest” is interest incurred on debt used to purchase, construct, or substantially improve the principal residence or one other residence. Refinanced debt is included in this definition to the extent the debt was not increased by the refinancing. Home equity loan interest is not deductible residential interest for AMT [§56(e)(1)]. Thus, interest from home equity loans used for personal purposes generally is not deductible for AMT. However, the interest may be deductible for AMT under the tracing
rules. For example, if debt proceeds are used to purchase a taxable investment, the interest is investment interest.

Second, for regular tax, the taxpayer’s “qualified residence” can be a boat or motor home. For AMT, the taxpayer can deduct the interest for the principal residence of the taxpayer at the time interest is paid or accrued, and property that is the taxpayer’s “second home” within the meaning of §163(h)(4)(A)(i)(II). “Second home” includes a house, apartment, condominium, or mobile home used by the taxpayer for personal purposes for the greater of 14 days or 10% of the days the home is rented at fair market rates.

**Note:** The AMT definition does not include boats or motor homes.

Third, for regular tax, debt secured by a qualified residence incurred before October 13, 1987, is acquisition debt. This grandfather rule does not apply for AMT. Only debt secured by a qualified residence and incurred before July 1, 1982, is acquisition debt for AMT [§56(e)(3)]. Taxpayers get an interest deduction for regular tax even if the debt was not used to acquire, construct, or substantially improve a qualified residence if the debt was incurred before October 13, 1987. But if the loan is secured by a home but the proceeds were not used to purchase, construct or improve a qualified residence, the interest is not deductible as qualified housing interest for AMT unless the debt was incurred before July 1, 1982.

Interest paid on a home mortgage that has been refinanced more than one time is deductible as qualified housing interest for purposes of AMT to the extent the interest on the mortgage that was refinanced is qualified housing interest and the amount of the mortgage indebtedness is not increased. Additional funds obtained through the refinancing must be used to acquire, construct, or substantially improve the taxpayer’s principal or qualified residence. Otherwise, the interest on the additional funds will not be deductible for AMT (Rev. Rul. 2005-11).

Any interest on a portion of home equity loans not used for home improvements should be added back on Line 4 of Form 6251, *Alternative Minimum Tax*, when computing AMT income.
**Example:** Jim and Donna deduct $12,000 of home mortgage interest on their 2009 Schedule A. Of this $12,000, $10,000 is from the original mortgage used to acquire the home in 2007. The remaining $2,000 is from a home equity loan. The home equity loan was taken out in 2008 for $22,000 and was used to add a bathroom and deck to the home. For AMT purposes, no adjustment is needed because the home equity loan was used to improve the home.

Assume the same facts except that the home equity loan was used to purchase a new family car. Jim and Donna would have to add back the $2,000 interest from the home equity loan because the proceeds were not used to improve the residence. The $2,000 is allowed for regular tax purposes, assuming it meets the regular home mortgage interest rules of §163(h)(3)(C).

**Investment Interest Expense**

Investment interest expense is deductible for both regular tax and AMT to the extent of net investment income; any excess is carried forward. However, investment income and investment interest can be different for regular tax and AMT purposes.

For regular tax purposes, investment interest is allowed up to the amount of investment income generated for the tax year. For AMT, net investment income is recomputed after accounting for all AMT adjustments and tax preference items. Investment interest is modified for AMT purposes to include interest and deductions related to tax-exempt “specified private-activity bonds” [§57(a)(5)(A)]. The term “specified private activity bond” means any private activity bond as defined in §141 issued after August 7, 1986, the interest from which is tax exempt under §103 [but not including any qualified §501(c)(3) bond as defined in §145 such as hospital bonds]. Therefore, any interest from these bonds is includible in income and interest expense incurred in connection with these bonds is deductible for AMT purposes.

In addition, all adjustments contained in §§56, 57, and 58 apply when arriving at net investment income per §163(d) for AMT purposes.
**Example:** Don has Investment Income of $25,000 reported on the return. He has also claimed investment interest expense of $9,000 on Schedule A. He earned interest of $5,000 from a private activity bond. In connection with this bond, he has investment interest expense of $1,000. Excluding all other AMT adjustments, if his taxable income before personal exemptions is $115,000, his alternative minimum taxable income (AMTI) will be $119,000 ($115,000 + $5,000 − $1,000).

Thus, in certain situations when the taxpayer has investment interest expense that would otherwise be limited and tax-exempt interest from private-activity bonds, the increased investment interest expense and the private-activity bond interest income will net to zero for AMT.

AMT investment interest expense is also increased by interest on home equity indebtedness attributable to property held for investment (e.g., a home equity loan from which proceeds were used to purchase stock).

If the taxpayer’s AMT investment interest deduction differs from the regular tax amount, two Forms 4952 are included in the return to show the recomputed amount. One Form 4952 is labeled “Alternative Minimum Tax.” The taxpayer should also maintain two investment interest carryforward schedules—one for regular tax and one for AMT.

**Planning Tip:** A taxpayer who is subject to AMT may have to add back to income the interest paid on unimproved land held for investment. In order not to lose the deduction the taxpayer can elect to capitalize the carrying charges of the unimproved land that is held for investment under §266. By making the election, the basis is increased by the carrying charges and the investment interest deduction is not necessarily lost forever.
DEPRECIATION

Depreciation is defined as the loss in the value of property over the time the property is used. The cost of certain property used in business or for the production of income is recovered by taking a depreciation deduction. Unlike other ordinary and necessary business expenses currently deductible by under §162 (e.g. travel, rent, compensation, etc.), fixed assets are depreciated over a prescribed number of years.

Depreciable Property

To be eligible for a depreciation deduction, the property must meet all of the following basic requirements:

- The property must be used in a trade or business or held for the production of income.
- The property must have a determinable useful life longer than one year.
- The property must be something that is subject to wear and tear, to decay or decline from natural causes, to exhaustion, or to obsolescence [Reg. §1.167(a)-2].

Certain property may meet the aforementioned requirements but is specifically identified as nondepreciable property. Assets not eligible for depreciation include the following:

- Personal property placed in service and disposed of within the same tax year.
- Land, including the cost of clearing, grading, planting, and landscaping (if distinguishable from land preparation costs).
- Inventory (including improved or unimproved lots and buildings held for sale to customers in the ordinary course of business).
- Demolition costs of buildings.
- Property rented or leased (i.e. taxpayer does not own it).

Note: Equipment used by a taxpayer to build his or her own business improvement is depreciable, but the allowable depreciation is capitalized into the basis of the improvements.
Placed in Service

A taxpayer begins to depreciate property when it is placed in service for use in a trade or business or for the production of income. Property is considered placed in service when it is ready and available for a specific use. Qualifying property is considered placed in service even if the property is not being used.

Example: On February 4, Barbara Seville purchased a duplex she intended to rent to tenants. She spent two months making repairs and improvements to the house and advertised it as available for rent on April 19. This is the date the rental property was placed in service because it was when the property became ready and available for use. Barbara can claim depreciation on the property beginning in April, regardless of when she actually begins renting the duplex.

Stop depreciating property when it is retired from service (or when you have fully recovered the cost of the property, whichever comes first). Retirement happens when an asset is permanently withdrawn from use in a trade or business or for the production of income due to any of the following events:

- Sale or exchange of the property.
- Conversion of the property to personal use.
- Abandonment.
- Transfer of property to a supplies or scrap account.
- Destruction.

Reporting the disposition of assets is discussed later in the text.

MACRS

The Modified Accelerated Cost Recovery System (MACRS) is used to recover the basis of most business and investment property placed in service after 1986. Prior to this, the Accelerated Cost Recovery System (ACRS) was used; however, this text does not cover ACRS due to the increased inapplicability of ACRS today. IRS Publication 534,
Depreciating Property Placed in Service Before 1987, covers ACRS depreciation.

Within MACRS, there are two depreciation systems — the General Depreciation System (GDS) and the Alternative Depreciation System (ADS). Most taxpayers use GDS unless they elect ADS or are required to use ADS. ADS provides for a different method and longer depreciable lives for assets.

**General Depreciation System (GDS)**

**Asset Class**

Once the basis and placed in service date of an asset are identified, determine the class life of the asset. Under GDS, there are nine property classifications. Some of those applicable to real estate are as follows:

- **Five-year property.**
  - Any qualified Liberty Zone leasehold improvement property.
- **Ten-year property.**
  - Any single-purpose agricultural or horticultural structure (e.g. barn or greenhouse).
  - Any tree or vine-bearing fruit or nuts.
- **15-year property.**
  - Certain land improvements (e.g. landscaping, fences, shrubbery, roads, and bridges).
  - Initial clearing and grading land improvements for gas utility property.
  - Any qualified leasehold improvement property placed in service before January 1, 2006.
  - Billboards.
- **20-year property.**
  - Farm buildings (other than single-purpose agricultural or horticultural structures).
  - Initial clearing and grading land improvements for electric utility transmission and distribution plants.
- **Residential rental property.** This is any residential building structure (e.g. apartment buildings, duplexes, single family homes), if 80% or more of its gross rental income for the tax year is from its dwelling unit(s). It does not include a unit in a hotel, motel, or
other establishment where more than half the units are used on a transient basis. If the taxpayer personally occupies any part of the structure, include in gross income the fair rental value of the portion occupied. This property is depreciated straight-line over 27½ years.

Commercial real property. This is real property that is neither residential nor has a class life of less than 27½ years. It includes property such as an office building, a hotel, a warehouse, or a store. This property is depreciated straight-line over 39 years.

Depreciation Methods

Under GDS, there are three depreciation methods — 200% declining balance, 150% declining balance, and straight-line.

200% Declining Balance

This method is used to depreciate nonfarm 3-year, 5-year, 7-year, and 10-year property. A switch is made to the straight-line method in the first tax year that the straight-line method produces a larger deduction. The depreciation tables account for this change. A half-year or mid-quarter convention (discussed later) applies.

150% Declining Balance

The 150% declining balance method is used to depreciate 15 and 20-year property; 3, 5, 7, 10, 15, and 20-year farm property; and 3, 5, 7, and 10-year property where the taxpayer elects this method (as opposed to using the default 200% declining balance method). As is true with the 200% declining method, a switch is made to the straight-line method in the first tax year that the straight-line method produces a larger deduction.

The election to use this method is irrevocable. To elect the 150% declining balance, no statement need be attached to the return. The election is made simply by entering “150 DB” in column (f) of Section B of Part III of Form 4562, Depreciation and Amortization. This election is not made on an asset by asset basis; it applies to all assets placed in service within a property class. Hence, if elected to apply to a
five-year asset, the 150% declining balance method must be used on all five-year assets. A half-year or mid-quarter convention (discussed later) applies.

Note: If the 150% declining balance method is elected, there is no AMT adjustment for any property included under the election. AMT depreciation is discussed later.

Generally, this election must be made by the due date of the tax return (including extensions) for the year the asset is placed in service. However, if the election was omitted from the originally filed return, the taxpayer can amend the return to make the election so long as the amended return is filed within six months of the original due date of the return (excluding extensions). Write “FILED PURSUANT TO SECTION 301.9100-2” on top of the election statement.

**Straight-Line Method**

Residential rental and commercial real property must be depreciated using the straight-line method over the GDS recovery period. Residential rental property is depreciated straight-line over 27½ years while commercial real property is depreciated straight-line over 39 years. A mid-month convention (discussed later) applies to these assets.

**Conventions**

In determining the depreciation deduction for MACRS property, averaging conventions establish when the recovery period for assets begins and ends. One of three conventions applies to every asset placed in service in a trade or business:

- Mid-month convention.
- Half-year convention.
- Mid-quarter convention.

The following discussion applies to a twelve-month tax year. In short-years, special rules apply. Short-years are discussed later in the text.
**Note:** For property subject to either the half-year or mid-quarter conventions, no depreciation deduction is allowed if the property is placed in service and taken out of service in the same year [Reg. §1.168(d)-1(b)(3)].

**Mid-month Convention**

This convention is used for commercial real property, residential rental property, and railroad grading and tunnel bores. The recovery period begins or ends on the midpoint of the month the asset is placed in service. Effectively, taxpayers are allowed a half-month of depreciation in the initial month the asset is placed in service and in the final month of the recovery period.

**Example:** On September 2, 2005, Jodie, a calendar-year taxpayer, purchased and placed in service a rental home that cost $187,000. Because residential rental property is subject to the mid-month convention, the asset is deemed placed in service on September 15, 2005. Jodie can deduct $1,984 for depreciation on this asset. The manual calculation is as follows:

\[
27.5 \text{ years} \times 12 \text{ months} = 330 \text{ months} \\
$187,000 / 330 \text{ months} = $567 \text{ depreciation per month} \\
$567 / 2 = $284 \text{ half month of depreciation (Sept.)} \\
$567 \times 3 \text{ full months (Oct., Nov., & Dec.)} = $1,700 \\
$284 + $1,700 = $1,984
\]

Another easier way to calculate the depreciation is to use Table A-6 in Appendix A of IRS Pub. 946. Since the asset is placed in service in the ninth month of the year, multiply the asset’s basis times 1.061%, which equals $1,984 (rounding taken into consideration).

**Code Section 179 Expensing Election**

A taxpayer may elect to write off the entire cost of qualifying assets in the year it’s placed in service as opposed to depreciating the asset
over a number of years. Property must meet the following requirements to qualify for §179:
- It must be eligible property.
- It must be acquired for business use.
- It must have been acquired by purchase.
- It must NOT be excepted property.

Generally, except for single-purpose agricultural (livestock) or horticultural structures, land and buildings are not eligible for the §179 expense deduction. A single-purpose agricultural or horticultural structure is any building or enclosure specifically designed, constructed, and used for both the following purposes:
- To house, raise, and feed a particular type of livestock and its produce.
- To house the equipment, including any replacements, needed to house, raise, or feed the livestock.

A single-purpose horticultural structure is either of the following:
- A greenhouse specifically designed, constructed, and used for the commercial production of plants.
- A structure specifically designed, constructed, and used for the commercial production of mushrooms.

Eligible property must be acquired for use in your trade or business to qualify for the §179 deduction. Property acquired only for the production of income such as investment property, rental property, and property that produces royalties does not qualify.

The §179 deduction is not available for the following types of property:
- Certain property that is leased to others.
- Certain property used predominantly to furnish lodging or in connection with the furnishing of lodging.
- Air conditioning or heating units.

**Short-Year Depreciation**

Short-year depreciation applies when a business places assets into service in any year that is less than 12 months long. Short tax years generally occur in a business’ initial tax year, final tax year, or in a year the business entity changes its tax year.
The IRS depreciation tables cannot be used to compute depreciation for items subject to short-year depreciation, even in the subsequent years when tax years are 12 months long. To calculate the short-year depreciation, first compute the MACRS depreciation deduction for a full tax year. Then multiply the result by a fraction; the number of months the asset is deemed placed in service during the year (depends on the applicable convention) over 12. The manual calculation of the depreciation of these items continues throughout the lives of the assets until they are either disposed of or fully depreciated.

The calculations required apply to all assets placed in service during the short-year. Shareholder asset contributions to a corporation via a §351 transfer, where the shareholder and the corporation have the same tax year, do not require special calculations except for the proration for the year (i.e. the time the shareholder held the property vs. the time the business entity held the property). New assets placed in service after the incorporation date require short-year calculations if the corporation year does not consist of 12 full months.

**Fiscal Year**

Depreciation for fiscal year taxpayers is treated the same as for calendar year filers if the business begins on the first day of the month and the first year is 12 months.

If the business begins on any day other than the first of the month or exists for less than 12 full months, the short-year depreciation rules apply to all assets placed in service during that short year.

If a fiscal year C corporation changes to an S corporation, the C corporation cannot file a short-year C corporation return. The S corporation has the short-year return, causing it to be subject to the short-year depreciation rules.

**Computing AMT Depreciation**

Depreciation must also be computed for AMT purposes. To the extent regular depreciation exceeds AMT depreciation, the taxpayer has a positive adjustment to enter in computing the AMT. If AMT depreciation exceeds regular depreciation, there is a negative adjustment to enter.
For property placed in service after December 31, 1998, an AMT adjustment must be computed for §1250 property depreciated using a method other than straight-line.

**Depreciation and Like-Kind Exchanges**

In 2007, the IRS released final regulations explaining how to depreciate property acquired in like-kind exchanges. The regulations adopt a modified form of the “split basis” concept. The guidance may be beneficial, but because of its complexity, taxpayers can elect not to apply them.

**Note:** The election is made by the due date (including extensions) of the return for the year of replacement by typing, or legibly printing, at the top of Form 4562 “ELECTION MADE UNDER REG. §1.168(i)-6(i).” A separate election is required for each like-kind exchange to which the taxpayer does not want the regulations to apply.

New MACRS property acquired in a like-kind exchange for old MACRS property is depreciated in the same manner as the exchanged property for the portion of the taxpayer’s basis in the acquired property that didn’t exceed the taxpayer’s adjusted basis in the exchanged or involuntarily converted property. In simple terms, the acquired MACRS property is depreciated over the remaining recovery period of the exchanged MACRS property, using the same depreciation method and convention as that of the exchanged or converted MACRS property.

However, any excess basis in the acquired MACRS property over the adjusted basis in the exchanged or converted MACRS property is treated as newly purchased MACRS property. This is a simple concept. Unfortunately, the new regulations complicated the depreciation rules exponentially.

The regulations contain a new set of terms that form the basis for these rules. It is necessary to understand these terms in order to accurately apply the rules of the regulations.
**Exchange Basis**: The taxpayer’s depreciable basis in the replacement property determined after calculating year-of-disposition depreciation for the relinquished property. The exchange basis usually equals the adjusted basis of the relinquished property after subtracting year-of-disposition depreciation [Reg. §1.168(i)-6(b)(7) and (9)].

**Excess Basis**: The taxpayer’s additional depreciable basis (if any) in the replacement property over and above the amount of exchange basis. The excess basis usually equals the amount of additional consideration paid to acquire the replacement property. The excess basis amount is reduced by the amount of replacement property basis expensed under §179 (if any) [Reg. §1.168(i)-6(b)(8) and (10)].

**Depreciation of Excess Basis**

The depreciation of excess basis is pretty straightforward under the rules provided in the regulations. Under these rules, any excess basis in the replacement property is treated as property that is placed in service in the year of replacement. This means that the depreciation allowances for the depreciable excess basis are determined by using the applicable recovery period, depreciation method, and convention prescribed under the MACRS rules for the replacement property at the time of replacement.

**Depreciation of Exchange Basis**

The regulations provide not-so-straightforward rules for determining the depreciable exchange basis of MACRS replacement property involved in a like-kind exchange.

If both the recovery period and the depreciation method under the MACRS rules for the replacement property are the same as the recovery period and the depreciation method under the MACRS rules for the relinquished property, the depreciation allowances for the replacement property, beginning in the year of replacement, are determined by using the same recovery period and depreciation method that was used for the relinquished property. Thus, the replacement property is depreciated over the remaining recovery period and by using the depreciation method of the relinquished property.
If the recovery period and/or the depreciation method under the MACRS rules for the replacement property are different than the recovery period and/or the depreciation method under the MACRS rules for the relinquished property, the depreciation allowances for the replacement property beginning in the year of replacement is determined as follows:

- If the recovery period for the replacement property is longer than the recovery period for the relinquished property, then the depreciable exchange basis of the replacement property is depreciated over the recovery period of the replacement property that would remain if the replacement property had been placed in service when the relinquished property had been placed in service.

**Example:** Mike placed in service a residential rental property in 1998 with a recovery period of 27.5 years. In 2008, Mike completes a like-kind exchange under §1031 and replaces the residential rental property with nonresidential real property. Since nonresidential real property has a recovery period of 39 years (a longer recovery period), Mike will depreciate the property using the remaining years of the longer 39-year recovery period as if it had been placed in service in 1998.

- If the recovery period for the replacement property is shorter than the recovery period for the relinquished property, then the depreciable exchange basis of the replacement property is depreciated over the remaining recovery period of the relinquished property.
Example: Mike placed in service a nonresidential real property in 1998 with a recovery period of 39 years. In 2008, Mike completes a like-kind exchange under §1031 and replaces the nonresidential real property with residential rental property. Since the residential rental property has a shorter recovery period of 27.5 years, Mike will depreciate the replacement property over the remaining years of the longer 39-year recovery period.

This would be an instance where it would be to the taxpayer’s benefit to elect not to apply these new rules because the remaining years of depreciation for the relinquished 39-year property is longer than the recovery period of the new 27.5-year replacement property.

If that was not enough, there is one more thing to consider — convention. The applicable convention for the exchange basis is deemed to be the mid-month convention for replacement property that is nonresidential real property, residential rental property, or any railroad grading or tunnel bore. Thus, if the relinquished property was depreciated using the mid-month convention, then the replacement property is deemed to have been placed in service in the same month as the relinquished property and must continue to be depreciated using the mid-month convention.

If nonresidential real property, residential rental property, or any railroad grading or tunnel bore is received as a result of an exchange of property that was depreciated using the mid-quarter convention, the replacement property is deemed to have been placed in service in the month that includes the mid-point of the quarter that the relinquished property was placed in service and must be depreciated using the mid-month convention.

If nonresidential real property, residential rental property, or any railroad grading or tunnel bore is received as a result of an exchange or an involuntary conversion of property that was depreciated using the half-year convention, the replacement property is deemed to have been placed in service in the month that includes the mid-point of the placed-in-service year and must be depreciated using the mid-month convention (for example, for a calendar-year taxpayer with a full 12-month taxable year, the mid-point is July 1).
Missed Depreciation

Sometimes owners are unaware that property can be depreciated, use the wrong recovery period, or claim depreciation for nondepreciable assets (such as land). If either too much or not enough depreciation was claimed, the IRS has procedures to correct the errors.

→ **Caution!** Basis is generally reduced by the depreciation “allowed or allowable” whether or not the taxpayer actually claimed the deduction. Since the reduced basis increases taxable gain on sale of the property, taxpayers should follow proper procedures to deduct missed depreciation or they will pay more tax as a result of the oversight.

If the taxpayer later determines that the depreciation method or life is not consistent with tax law, the taxpayer should correct the error by the due date of the tax return for the second year of the asset’s life. If the correction is not made by the filing deadline of the second year, the taxpayer must use the method and life chosen when the asset was placed in service until either the IRS changes the method or life under examination of a return or the taxpayer files Form 3115, *Application for Change of Accounting Method*, requesting permission from the IRS for the change.

**Requesting a Change of Accounting**

Rev. Proc. 2002-9 provides for automatic approval of an accounting method change to recoup allowable depreciation that was not claimed or that was under-claimed on prior returns (both open and closed years). A request for change made under this revenue procedure is considered approved by the Commissioner unless the taxpayer receives written notice that the method of accounting appears to be improper. If the taxpayer is denied automatic consent, he or she can apply for a change under the normal rules. When Rev. Proc. 2002-9 is applicable to a change in depreciation, no user fee is required for the change.
Rev. Proc. 2008-52 applies to taxpayers who are changing to a permissible method of accounting for depreciation for an item of property that meets all of these basic requirements:

- The property must be held by the taxpayer as of the beginning of the year of change.
- The property’s depreciation is understated because the taxpayer failed to claim any depreciation or claimed less than was allowed.
- The property must be depreciable under §56(a)(1) (AMT depreciation), §56(g)(4)(A) (ACE depreciation), §§167 and 168 (ACRS and MACRS), §197 (amortization), §1400I (commercial revitalization deduction), or §1400L (New York Liberty Zone property).

This revenue procedure does not apply to property whose use has changed but is still owned by the taxpayer, and property which §263A requires the taxpayer to capitalize costs.

To make a change under Rev. Proc. 2008-52, the taxpayer attaches Form 3115 to a timely-filed, original return (including extensions) for the year of the change. The taxpayer must file a copy of Form 3115 with the IRS National Office no earlier than the first day of the year of change, and no later than when Form 3115 is filed with the federal income tax return. The taxpayer should mail a copy of Form 3115 to:

Internal Revenue Service  
Attn: CC:PA:LPD:DRU (Automatic Rulings Branch)  
PO Box 7604  
Benjamin Franklin Station  
Washington, DC 20044

§481 (a) Adjustments

The required adjustment for changing from an impermissible method to a permissible method is called a §481(a) adjustment. The adjustment is usually taken into account over a four-year period, beginning in the year of change. However, a negative adjustment (in the taxpayer’s favor) is allowed to be taken all in the year of change. The adjustment is the difference between the depreciation taken in prior years and the allowable depreciation for those years. The §481(a) adjustment requires the taxpayer to adjust the basis of the property to which the adjustment applies.
Most changes in depreciation or amortization are considered accounting method changes, but only changes from an impermissible method to a permissible method require a §481(a) adjustment. In general, an adjustment to the useful life of an asset where depreciation is determined under Code §167 is not considered a change in accounting.

The regulations give examples of depreciation changes that are considered an accounting change and those that are not:

- **Waiver of the two-year rule of Rev. Rul. 90-38 for certain changes in accounting.** This change allows a taxpayer who has used an impermissible method of depreciation for only one tax year to either file an amended return or to file Form 3115 and include the change amount in the §481(a) adjustment.

- **Method change procedure for disposed of depreciable or amortizable property.** This change allows a taxpayer to file Form 3115 prior to the expiration of the statute of limitation for assessment of the return in the year the property was disposed of, provided the taxpayer files an amended return for the year of change to include adjustments that the change would cause to taxable income.

Under Chief Counsel Notice 2004-007 a taxpayer may take the position that a change in computing depreciation is not a change in accounting method, and he or she can file amended returns to change the accounting for depreciation or amortization.

If the taxpayer files amended returns for a change in depreciation or amortization, no §481(a) adjustment is required or permitted (Chief Counsel Notice 2004-024).

If the taxpayer is only making a depreciation or amortization change to one asset, the taxpayer may not file amended returns for some tax years and a Form 3115 for other tax years. However, if a taxpayer is making changes to two or more assets, the taxpayer may file amended returns for some assets and file a Form 3115 for different assets.
Example: In May of 2006, James bought residential rental property for $200,000 (exclusive of land) that was 27½-year MACRS property. He never claimed depreciation on the property. When preparing his 2008 tax return his tax preparer found missed depreciation.

James will want to claim his missed depreciation by filing Form 3115. Since he owned the property on January 1, 2008 and used it in his rental activity, he is eligible to claim the missed depreciation. His §481(a) adjustment is ($11,818), which will be taken entirely in the year of change since it is an adjustment in the taxpayer’s favor. The “§481(a) adjustment” will be shown as an “other expense” on his 2008 Schedule E.

Note: If James had sold this property in 2008 but had not discovered the missed depreciation until 2009, Rev. Proc. 2004-11 allows James to claim the missed depreciation in 2008 by attaching Form 3115 to his amended return for 2008 and sending a copy of the Form 3115 to the national office no later than when he files his amended return for the year of change. Part 1 of Form 3115 would reflect “9” as the change number in this situation.

Improvements

Depreciation of additions or improvements to real property is determined in the same manner as the depreciation deduction for the underlying real property would be determined if the underlying real property were placed in service at the same time as the addition or improvement [§168(i)(6)(A)]. The addition or improvement is depreciated as a separate item of property.
Example: A calendar year taxpayer buys and places in service a residential apartment complex in 2000 and office building in 2005. In 2008, taxpayer makes improvements to both properties. The 2008 improvements are 27.5-year class property for the apartment complex, and 39-year class property for the office building, for purposes of MACRS depreciation.

The applicable MACRS depreciation period for additions or improvements to real property begins on the later of:

1. The date on which such addition or improvement is placed in service; or
2. The date on which the property with respect to which such addition or improvement was made is placed in service [§168(i)(6)(B)].

The mid-month convention also applies to improvements.

Leasehold Improvements

MACRS treats improvements made by either landlords (lessors) or tenants (lessees) as recoverable over the cost recovery period applicable to the leasehold improvements—not over the period of the lease. This rule applies even if improvements made by the landlord to the tenant’s specifications are not suitable for the next tenant. The one who pays for the improvements is treated as the owner-taxpayer for purposes of deducting depreciation for improvements and buildings erected on leased premises [§168(i)(8)(A)].

If a lease ends before the end of the MACRS recovery period of a tenant’s improvement, and the tenant doesn’t retain the improvement, the tenant has either gain or loss for the remaining unrecovered basis of the property. The remaining basis of unamortized leasehold improvements, left behind when the lease terminates, is deductible as a loss. A gain would arise where, for example, the tenant is paid an amount to terminate the lease and the amount exceeds the basis of the leasehold improvements (and lease acquisition costs, if any).
**Example:** Jiffy Shopper Inc. leases a building for its new store. The term of the lease is five years. Jiffy tears out a brick wall on the front of the building and installs large windows in its place. The windows may be depreciated by Jiffy as 39-year MACRS property. If Jiffy does not renew the lease at the end of its five-year term, it may then deduct the remaining basis of the windows.

Where a leasehold improvement is made by the landlord for a tenant, and is irrevocably disposed of or abandoned by the landlord at the termination of the lease by the tenant, the improvement is treated as disposed of by the landlord at the time of the disposition or abandonment, for purposes of determining gain or loss. Therefore, the landlord may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the landlord at the termination of the lease [§168(i)(8)(B)].

Thus, the landlord can deduct any unrecovered basis he has in an improvement, except to the extent that he receives consideration that is allocable to the improvement. In the case of abandoned improvements, consideration might consist of payments for termination of the lease.

Leasehold improvements made by a tenant (and not required by the landlord in lieu of rent), are not income to the landlord. If the tenant moves out, abandoning the leasehold improvements, no income is recognized by the landlord. The landlord ends up owning a zero-basis asset.
Rental Property

Rental Income

Property owners must include in gross income all amounts received as rent. Rental income is any payment received for the use or occupancy of the property. In addition to normal amounts received as rent, there are other amounts that may be rental income.

Advance rent is any amount received before the period it covers. Advance rent is included in income in the year received regardless of the period covered or whether the cash or accrual method of accounting is used.

Example: Chiana signs a 10-year lease to rent her property. In the first year, she receives $5,000 for the first year’s rent and $5,000 as rent for the last year of the lease. Chiana must include $10,000 in her income in the first year.

Security deposits are not included in income when received if they must be returned to the tenant at the end of the lease. But if part or all of the security deposit is kept during any year because the tenant does not live up to the terms of the lease, the landlord includes the amount kept in income for that year. If an amount called a security deposit is to be used as a final payment of rent, it is advance rent and should be included in income when received.

Lease cancellation payments a tenant makes to cancel a lease are rent and included in income in the year received, regardless of the method of accounting used.

Expenses paid by a tenant that are normally the landlord’s expenses are rental income to the landlord. The landlord can deduct the expenses if they are deductible as rental expenses.
**Example:** Bill Frawley’s tenant pays the water and sewer bill for Bill’s rental property and deducts it from the normal rent payment. Under the terms of the lease, Bill’s tenant does not have to pay this bill. Bill includes the utility bill paid by the tenant and any amount received as a rent payment in his rental income. Bill can deduct the utility payment made by his tenant as a rental expense.

**Example:** While Bill is out of town, the furnace in his rental property stops working. His tenant pays for the necessary repairs and deducts the repair bill from the rent payment. Bill includes the repair bill paid by the tenant and any amount received as a rent payment in his rental income. He can deduct the repair payment made by his tenant as a rental expense.

Property or services paid as rent, instead of cash, is included as rental income to the extent of the FMV of the property or services received. If the services are provided at an agreed-upon or specified price, that price is the FMV unless there is evidence to the contrary.

**Example:** Bill has a tenant who is a house painter. He offers to paint Bill’s rental property, in lieu of paying a month’s rent. Bill must include in rental income the amount the tenant would have paid for one months’ rent. Bill can deduct that same amount as a rental expense for the painting.

A **lease with an option to purchase** gives a tenant the right to buy the property being rented, if the option is exercised. Payments received under the agreement are generally rental income, if the option has not been exercised. Once the option is exercised, payments received for the period after the date of sale are considered part of the selling price. A payment is rent if it is made for the use or possession of business property to which the taxpayer doesn’t have title or in which he has no equity. That being said, it is often difficult to tell whether an arrangement is a lease or a sale.
Rev. Rul. 55-540 addressed whether a transaction is a sale or a true lease for federal income tax purposes. The ruling states that, in the absence of compelling persuasive factors to the contrary, a transaction should be treated as a purchase and sale rather than as a lease or rental agreement if one or more of the following conditions are present:

- Portions of the periodic payments are made specifically applicable to an equity interest to be acquired by the lessee.
- The lessee will acquire title upon the payment of a stated amount of “rentals” which, under the contract, he is required to make.
- The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to purchase title to the property.
- The agreed “rental” payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property.
- The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made.

Rev. Rul. 55-540 also says there is a presumption that a transaction is a sale and not a lease if the total of the rental payments, and any option price payable, approximates the price at which the equipment could have been bought at the time of entering into the agreement.

**Rental Expenses**

Ordinary and necessary rental expenses for managing, conserving, or maintaining rental property while it is vacant are deductible from the time it is made available for rent. If the property is placed in service, in the sense that it is ready and available for rent, depreciation can begin.
Repairs Versus Improvements

The cost of improvements is recovered through depreciation taken over the life of the asset. Unlike improvements, repairs are currently deductible. It is therefore important to recognize the difference between the two. The following is a list of items that are generally considered improvements and not repairs:

- Access roads
- Additions
- Attic
- Bathroom
- Bedroom
- Built-in appliances
- Central air conditioning
- Central humidifier
- Central vacuum
- Deck
- Retaining wall
- Driveway
- Duct work
- Fence
- Filtration system
- Flooring
- Furnace
- Garage
- Hard-surfacing roads
- Heating & air conditioning
- Heating system
- Insulation
- Interior improvements
- Kitchen modernization
- Landscaping
- Lawn & grounds
- Miscellaneous
- New roof
- Patio
- Pipes, duct work
- Plumbing
- Porch
- Replace gravel with cement driveway
- Satellite dish
- Security system
- Septic system
- Soft water system
- Sprinkler system
- Storm windows, doors
- Swimming pool
- Walkway
- Walls, floor
- Wall-to-wall carpeting
- Water heater
- Wiring upgrades

A repair keeps property in good operating condition. It does not materially add to the value of the property or substantially prolong its life. Repainting inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs. Work done that does not add to the value or extend the life of the property, but rather keeps the property in good condition, is considered a repair, not an improvement.

If repairs are made as part of an extensive remodeling or restoration of the property, the whole job is an improvement. An improvement adds to the value of property, prolongs its useful life, or adapts it to new uses.
Examples of deductible costs incurred for repairs and maintenance include such items as:

- Recrowning and resurfacing roads with the same materials as are already in the road without lengthening or widening it.
- Constructing logging roads.
- Patching asphalt driveways.
- Resurfacing a parking lot to restore its original condition after construction.
- Slurry-sealing a parking lot.
- Reinforcing sagging floors.
- Piecemeal repairs to floors.
- Repairing a flat roof to maintain it in proper condition.
- Replacing corrugated roofing sheets blown away.
- Replacing deteriorated roof decking.
- Painting.
- Replastering due to water damage.

**Other Expenses**

In addition to depreciation and repairs, the following expenses are deductible from rental income.

- Advertising.
- Cleaning and maintenance.
- Utilities.
- Insurance.
- Real estate taxes.
- Interest and points (see earlier discussion).
- Commissions.
- Tax return preparation fees.
- Travel expenses.
- Rent for equipment used for rental purposes.
- Local transportation expenses.

If insurance premiums are for more than one year in advance, each year the part of the premium payment that applies to that year can be deducted. The total premium cannot be deducted in the year paid.
Tax assessments that are charges for local benefits that increase the value of property, such as installation of streets, sidewalks, or water and sewer systems, are nondepreciable capital expenditures which are added to the basis of the property. Tax assessments for maintaining, repairing, or paying interest charges for the benefits are currently deductible.

Ordinary and necessary travel expenses are deductible if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain rental property. The expenses must be allocated between rental and nonrental activities. The cost of traveling away from home to make improvements to the property is added to basis and recovered by taking depreciation. To deduct travel expenses, records should be kept that show:

- The costs of each separate expense for travel, lodging, and meals.
- The dates of departure and arrival.
- Destination.
- Business purpose.

Ordinary and necessary local transportation expenses to collect rental income or to manage, conserve, or maintain rental property is deductible using one of two methods: actual expenses or the standard mileage rate. For 2009, the standard mileage rate is 55 cents per mile for all business miles driven.

To deduct car expenses under either method, you must keep an account book, diary, log, expense statement, or trip sheet showing (1) the miles driven or the actual expense, (2) the time and place of automobile use, (3) the business purpose, and (4) the business relationship of the taxpayer to the persons using the automobile. In addition, individual taxpayers must complete Form 4562, Part V, and attach it to the tax return.

The part of the tax return preparation fee paid to prepare Schedule E (Form 1040), Part I, can be deducted as a rental expense.

**Example:** Aeryn has a rental property. On her 2009 Schedule E she can deduct fees paid in 2009 to prepare Part I of her 2008 Schedule E. She can also deduct, as a rental expense, any expense (other than federal taxes and penalties) she paid to resolve a tax underpayment related to her rental activities.
Special rules apply to rentals of condominium units or cooperative apartments.

**Condominium**

A condominium is a single unit in a multi-unit building, which also owns a share of the common elements of the structure, such as land, lobbies, elevators, and service areas. Condominium owners may pay dues or assessments to a special corporation that is organized to take care of the common elements.

If a condominium is rented to others, the owner can deduct depreciation, repairs, upkeep, dues, interest and taxes, and assessments for the care of the common parts of the structure. The owner cannot deduct special assessments paid to a condominium management corporation for improvements. But the owner can recover his or her share of the cost of any improvement by taking depreciation.

**Cooperative**

Cooperative apartment owners who rent to others can usually deduct, as a rental expense, maintenance fees paid to the cooperative housing corporation. However, they cannot deduct a payment earmarked for a capital asset or improvement, or otherwise charged to the corporation’s capital account.
Example: Dudley pays assessments to his cooperative for paving the community parking lot, installing a new roof, and paying the principal of the corporation’s mortgage. Dudley cannot deduct these payments and must add them to the basis of his stock in the corporation. However, Dudley’s basis increase cannot be more than the amount by which his payments to the corporation exceeded his share of the corporation’s mortgage interest and real estate taxes.

His share of interest and taxes is the amount the corporation elects to allocate to him, if the allocation reasonably reflects those expenses for his apartment. Otherwise, Dudley figures his share as follows:

1. He divides the number of his shares of stock by the total number of shares outstanding, including any shares held by the corporation.

2. He multiplies the corporation’s deductible interest by the number figured in (1). This is Dudley’s share of the interest.

3. He multiplies the corporation’s deductible taxes by the number figured in (1). This is his share of the taxes.

In addition to the maintenance fees paid to the cooperative housing corporation, cooperative owners can deduct their direct payments for repairs, upkeep, and other rental expenses, including interest paid on a loan used to buy stock in the corporation.

Tenant-stockholders in a cooperative housing corporation who rent their cooperative apartment to others, can deduct depreciation for their stock in the corporation.

The depreciation deduction is calculated as follows:

1. Figure the depreciation for all the depreciable real property owned by the corporation. If the cooperative stock was bought after its first offering, figure the depreciable basis of this property as follows.
   a. Multiply the stockholder’s cost per share by the total number of outstanding shares.
   b. Add to the amount figured in (a) any mortgage debt on the property on the date the stock was bought.
c. Subtract from the amount figured in (b) any mortgage debt that is not for the depreciable real property, such as the part for the land.

2. Subtract from the amount figured in (1) any depreciation for space owned by the corporation that can be rented but cannot be lived in by tenant-stockholders.

3. Divide the number of the stockholder’s shares of stock by the total number of shares outstanding, including any shares held by the corporation.

4. Multiply the result of (2) by the percentage figured in (3). This is the depreciation on the stock.

The depreciation deduction for the year cannot be more than the part of the stockholder’s adjusted basis in the stock of the corporation that is allocable to the stockholder’s rental property.

**Not Rented for Profit**

If property is not rented with the intention of making a profit, rental expenses are deducted only up to the amount of rental income. The excess expenses cannot be carried forward to later years. This is sometimes referred to as the “hobby loss” rule.

Individuals report not-for-profit rental income on Form 1040, Line 21. Mortgage interest (if the property is used as a primary or second home), real estate taxes, and casualty losses are deductible on the appropriate lines of Schedule A (Form 1040) if the taxpayer itemizes deductions. Other rental expenses are deductible as miscellaneous itemized deductions on Line 22 of Schedule A (Form 1040). These expenses are subject to the 2%-of-AGI limit.

If rental income is more than rental expenses for at least three years out of a period of five consecutive years, the taxpayer is presumed to be renting the property to make a profit. Taxpayers can elect to postpone determining whether an activity is engaged in for profit until after the close of the fourth year following the first tax year in which the activity is conducted [§183(e)]. This election allows the taxpayer to presume that the activity is engaged in for profit in advance of actual results during the five-year period.

The benefit of the election is that it may preclude the IRS from disallowing losses in the early years of the rental activity. In practice,
the election is rarely used until the IRS notifies the taxpayer that it is disallowing deductions related to the activity.

The election must be made within three years after the due date (without extensions) of the return for the year in which the taxpayer first engages in the activity or, if earlier, within 60 days of receiving written notice of the IRS’s intent to disallow deductions from the activity.

If the election is made, the statute of limitations for assessing a deficiency with respect to the activity during any year in the test period is automatically extended for two years after the due date (without extensions) of the return for the last tax year in the presumption period [§183(e)(4)].

While making the election may allow a taxpayer additional time to establish the existence of a trade or business activity, it raises a red flag to the IRS to a possible hobby loss issue.

**Property Changed to Rental Use**

If a personal residence or other property (or a part of it) is converted to rental use at any time other than the beginning of the tax year, the total yearly expenses, such as taxes and insurance, are allocated between rental use and personal use.

For depreciation purposes, the property is treated as being placed in service on the conversion date. Depreciation or insurance cannot be deducted for the part of the year the property was held for personal use. However, the home mortgage interest and real estate tax expenses for the part of the year the property was held for personal use is an itemized deduction on Schedule A (Form 1040).

**Example:** Galadriel’s tax year is the calendar year. She moved out of her home in May and started renting it out on June 1. She can deduct as rental expenses 7/12 of her yearly expenses, such as taxes and insurance. Starting with June, she can deduct as rental expenses the amounts she pays for items generally billed monthly, such as utilities. When figuring depreciation, she treats the property as placed in service on June 1.
Renting Part of Property

If only a portion of a property is rented, certain expenses must be divided between the rental portion and the part of the property used for personal purposes, as if they were two separate pieces of property.

The rental expenses, such as home mortgage interest and real estate taxes, are deducted on Schedule E (Form 1040). Part of other expenses that normally are nondeductible personal expenses, such as electricity, or painting the outside of the house, can also be deducted. Expenses for the part of the property used for personal purposes are deductible, to the extent allowed by the law code, only on Schedule A (Form 1040). No part of the cost of the first phone line is deductible even if the tenants have unlimited use of it.

Expenses that belong only to the rental part of property do not have to be divided. Examples include painting a rented room, or premiums paid for liability insurance for renting a room in your home. The entire cost of such items is a rental expense. If a second phone line is installed strictly for a tenant’s use, all of the cost of the second line is deductible as a rental expense. Depreciation is deductible on the part of the property, as well as on the furniture and equipment, used for rental purposes.

Expenses for both rental and personal use must be divided between rental and personal use. Any reasonable method can be used for dividing the expense. It may be reasonable to divide the cost of some items (for example, water) based on the number of people using them, or on the number of rooms in the home, or according to square footage.

Example: Frodo rents a room in his house. The room is 12 × 15 feet, or 180 square feet. His entire house has 1,800 square feet of floor space. He can deduct as a rental expense 10% of any expense that must be divided between rental use and personal use. If Frodo’s heating bill for the year for the entire house was $600, $60 ($600 × 10%) is a rental expense. The balance, $540, is a personal expense that he cannot deduct.
Personal Use and Vacation Home Rules

Personal residences may have both rental and personal use. Generally, rental income and expenses are reported on Schedule E of an individual owner’s tax return. However, if the residence is rented less than 15 days per calendar year, none of the rent is taxable, and the expenses other than real estate taxes and personal residence interest are ignored.

If a personal residence is rented for part of the year, it is treated as a qualified residence only if the taxpayer uses it for personal purposes more than the greater of [§163(h)(4)(A)(i)(II) and §280A(d)(1)]:

- 14 days; or
- 10% of the days the unit was rented at a fair market rental rate.

If a second residence is not rented or held for rent during the year, it is a qualified residence even if the taxpayer has no days of personal use during the year [§163(h)(4)(A)(iii)].

A home that is not a personal residence because there were too many rental days and not enough personal-use days is treated as rental property, and all expenses (including interest) must be allocated between the rental use and personal use. Income and expenses allocated to rental use are deductible, subject to the at-risk and passive activity limits (discussed later), and the hobby loss rules (see above). Expenses allocated to personal use are treated as personal. Therefore, the personal-use portion of mortgage interest is nondeductible because the property does not qualify as a residence.

→ Planning Point: Taxpayers should closely monitor personal and rental use of vacation homes to avoid the potentially unfavorable characterization as a rental property.

Renting to Family Members

For determining whether property is a vacation home or rental property with personal use, use by brothers, sisters, spouses, ancestors, or lineal descendents is treated as use by the taxpayer, even if the family member pays rent. However, a family member’s use is not attributed to the owner if the family member pays a fair rental
price and uses the dwelling as the family member’s principal residence [§280A(d)(3)].

**Example:** Bob rents a house from his mother, Lorraine. Bob has no ownership interest in the property, uses it as his principal residence, and pays his mother a fair market rental. Therefore, Bob’s use of the house is not considered personal use by Lorraine. The house is considered a rental property, so any rental loss incurred is deductible by Lorraine, subject to the hobby loss, at-risk, and passive activity loss rules. The vacation home rules do not apply.

If Bob paid less than a fair market rent, Lorraine would be considered to use the house for personal purposes. The house would be considered Lorraine’s vacation home, and the rental expenses would be subject to the vacation home limitations.

➔ **Caution!** If renting a house to a family member at less than FMV causes it to be considered personal use property, any loss on its disposition is a nondeductible personal loss. Also, if no rent is charged, depreciation and maintenance expenses are not deductible.

**Timeshare**

Although rental income is nontaxable if a residence is rented fewer than 15 days per calendar year, it is unlikely this exclusion will help timeshare owners because under Prop. Reg. §1.280A-3(f)(4) there must be less than 15 rental days per year for all of the timeshare unit’s owners. As a result, total rental days of a timeshare unit will almost surely be more than 14 days. Even if there are less than 15 total rental days a timeshare owner must have personal use of over 14 days or 10% of the rental days for the timeshare to qualify as a personal residence and for the rent to be tax-free. In other words, the rent is nontaxable only when:
- The total rental days for all owners are less than 15, and
- The property is a personal residence based on the individual timeshare owner’s use (i.e. personal use is the greater of 14 days, or 10% of the rental days).

Otherwise, timeshare expense deductions depend on how the owners use the unit.

**Timeshare Not Rented**

Timeshare fees often cover a number of types of expenses, including real estate taxes, utilities, and management charges. Typically a detailed breakdown is given to the timeshare owner annually. Property taxes for timeshares used personally and not rented out (or held out for rent), are deductible on Schedule A. Utilities and association membership charges are nondeductible personal expenses.

If the timeshare is mortgaged, the interest is deductible on Schedule A as qualified residence interest. A timeshare is considered a personal residence for mortgage interest deduction purposes in years that it is not rented [§163(h)(4)(A)(iii)]. Thus the timeshare does not have to meet the §280A(d)(1) personal residence definition (personal use over greater of 14 days or 10% of rental days). However, the $1,000,000/$500,000 limit, “principal residence and one other residence”, and other requirements (discussed under “Mortgage Interest” above) must be satisfied to deduct it as qualified residence interest.

**Rental of Timeshare**

When the 14-day/10% test is applied to the unit and the personal days of all the unit’s owners during the year are counted, the personal use will usually be enough to cause all of its owners to be subject to the vacation home rules that limit deductions and require allocations of expenses. If so, the timeshare owners must in theory allocate expenses between personal and rental use based on the use by all the owners during the year. Thus, the personal and rental percentages will be the same for all owners. If this information is unobtainable, the next best solution is to make an allocation based on the owner’s actual personal and rental use percentages.
Example: Brett owns a timeshare he can use two weeks per year. In 2008, he rents it one week and uses it for a vacation the other week. Brett’s timeshare weeks cost a total of $32,000, financed by a $25,000 mortgage loan. Brett’s interest expense is $1,750 and his annual maintenance fee is $800 ($300 of which is for property taxes). In addition, Brett pays $125 for advertising to rent it out. The rental income is $1,050. Brett learns that the unit is rented approximately half the year and used by the other owners for the other half.

Brett reports $1,050 of rental income on Schedule E. He deducts up to that amount of allocable rental expenses (using 50% as the allocation percentage) on Schedule E. Allocable rental expenses before depreciation total $1,400 ($875 mortgage interest, $150 property taxes, $250 maintenance fees, and $125 advertising), so Brett can offset the rental income with $1,050 allocable rental expenses. The $350 of remaining allocable expenses in excess of the rental income is carried forward to the next year.

On Schedule A, Brett deducts $150, the other half of the property taxes. The other $875 of mortgage interest is nondeductible (his personal use did not exceed the greater of 14 days or 10% of his rental days) unless Brett takes the position that it is investment interest.

To treat interest paid on a timeshare as investment interest, a taxpayer has to prove the intent to hold it for potential appreciation in value. If there is any personal use, this is hard to prove.

Incidental Rentals and Other Recharacterization Rules

Except for those in which real estate professionals materially participate, rental activities are passive by definition. However, if the rental of property is merely incidental to the primary goal of holding the property for investment purposes, then interest paid is considered investment interest rather than as a passive activity expense. The rental is treated as incidental to holding property for investment if and only if:
The principal purpose for holding the property is to realize gain from appreciation; and

The gross rental income for the year is less than 2% of the lesser of the property’s:

- (a) Unadjusted basis; or
- (b) FMV [Temp. Reg. §1.469-1T(e)(3)(vi)(B)].

**Example:** Dillon owns 1,000 acres of unimproved land with a FMV of $350,000 and an unadjusted basis of $210,000. He holds the land in hopes of realizing gain from appreciation. In order to defray the cost of holding the land, Dillon leases the land to a rancher, who uses the land to graze cattle and pays rent of $4,000 per year. Thus, the gross rental income from the land is less than two percent of the lesser of the FMV and the unadjusted basis of the land (.02 × $210,000 = $4,200). The rental of the land is not a “rental activity” because the rental is treated as incidental to an activity of holding the property for investment.

Reg. §1.469-1(e)(3) and Temp. Reg. §1.469-1T(e)(3) list five additional situations where providing property for use by another is not considered a rental activity for the passive activity loss rules. Instead, such activities are generally either investment or trade or business activities. See “Passive Activities and Investment Interest” above.

**Lease Acquisition Costs**

When rental property is purchased, it may already be rented to tenants, making it more desirable from the lessor’s point of view. However, for purposes of depreciation, no part of the cost of acquiring property subject to a lease is allocable to that lease. The entire cost is taken into account in determining the depreciation deduction of the property (if any) subject to the lease [§167(c)(2)].
**Example:** Frieda buys an office building that has been leased to several successful businesses on a long-term basis. The portion of the purchase price attributable to the favorable attributes of the leases is not a separate depreciable account. Instead, it remains a part of the basis of the building (and land) in determining depreciation.

**Example:** Ace Developers, LLC, buys four buildings on the same block in Houston, Texas. Each building is purchased subject to outstanding leases, the average unexpired term of which is 45 months. Ace also purchases all of the outstanding leasehold interests from the tenants, paying a total of $405,000 to cancel all the leases. Ace then demolishes the existing buildings and erects a new building on the site.

What Ace Developers really acquired for its $405,000 was not land, nor an existing lease for its own use. Rather, Ace acquired the use of land that it already owned for the unchallenged purpose of erecting a new building. The $405,000 is most closely related to the construction of the new building and must therefore be added to taxpayer’s basis in that new building. Accordingly, the costs of canceling the existing leases must be amortized over the useful life of the new building.

Favorable attributes of leases include leases negotiated at a higher rental than could currently be obtained or an anchor tenant’s long-term lease which enhances the rental value of other space in the property and, in turn, the value of the building as a whole. From the tenant’s perspective, payments made by a lessee to get a business lease are not currently deductible but must be amortized over the unexpired term of the lease, if the lease is not renewable.

If the lease is renewable any renewal period must be taken into account in determining the amortization period, if less than 75% of the lease cost is attributable to the portion of the lease (exclusive of the renewal period) remaining when the lease is acquired. This rule applies whether the tenant is on the cash or accrual basis and even though he has an option to buy the property [Reg. §1.162-11(a) and §178(a)].
This rule also applies to payments made to acquire the lessee’s rights under an existing lease, lump-sum bonuses or premiums paid to the lessor when a lease is made, or legal fees and other costs incurred by a lessee in arranging a lease.

**Tenant Inducements**

The landlord’s cash payments made directly to the tenant as an inducement to enter into a lease generally must be capitalized as a lease acquisition cost and amortized over the term of the lease, regardless of the landlord’s accounting method.

Renewal periods are not taken into account, unless renewal of the lease is economically-compelled, i.e. there is a reasonable degree of certainty that the tenant could be expected to exercise its right of renewal. The tenant’s use of the cash does not change this result. For example, the prospective landlord may pay for property that will be owned by the tenant, such as tenant improvements, furniture, or equipment, or may fund a portion or all of the tenant’s existing obligations.

Payments made directly by the prospective lessor to the tenant’s obligees (for instance, furniture vendors or the tenant’s existing landlord) generally will be treated as cash payments.

**Example:** Wally’s office building has excess vacant office space and the local market has more space than it has tenants. Accordingly, Wally offers prospective tenants lease inducement packages which include cash “signing bonuses”, compensation for a tenant’s unexpired existing lease term, allowances for tenant improvements, and free or substantially reduced rent.
<table>
<thead>
<tr>
<th>Inducement</th>
<th>Treatment by Landlord</th>
<th>Treatment by Tenant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash bonus or payments to tenant’s creditors (for example, paying moving expenses).</td>
<td>Amortize over term of lease.</td>
<td>Current income.</td>
</tr>
<tr>
<td>Free rent or rent holiday.</td>
<td>No rental income unless constant rent accrual.</td>
<td>No rent deduction unless constant rent accrual.</td>
</tr>
<tr>
<td>Deferred payment lease.</td>
<td>Income to extent of present value of deferred rents, and imputed interest [treated as portfolio interest under Temp. Reg. §1.469-2T(c)(3)].</td>
<td>Deduction for present value of deferred rents and imputed interest if lease payments exceed $250,000 or tenant is an accrual-method taxpayer.</td>
</tr>
<tr>
<td>Assignment of old lease from tenant to new landlord.</td>
<td>Unclear: either deduct rent &amp; expenses of assigned lease in excess of income earned, or amortized over the term of the new lease.</td>
<td>No income, deduction of remaining basis in leasehold improvements in the old space.</td>
</tr>
<tr>
<td>Sublet old lease to new landlord.</td>
<td>Rent expense for payments to old landlord for remaining term of the lease, deductible as the rent accrues.</td>
<td>Rental income equal to new landlord-sublessor's payments, continue to amortize basis in tenant improvements but subject to passive loss limitations.</td>
</tr>
<tr>
<td>Compensation for tenant’s old lease.</td>
<td>Rent reduction or amortization over term of new lease.</td>
<td>Current income.</td>
</tr>
</tbody>
</table>

The tenant must recognize income currently for the full amount of the landlord’s cash lease inducement payment or its equivalent. Accordingly, if the landlord’s funds are used to pay for tenant improvements, furniture, or equipment that the lessee will own, phantom income is likely to result. The tenant’s basis in the property generally is the income recognized, and can be depreciated over the property’s MACRS life under §168(i)(8).

If a tenant makes payments to a landlord to cancel a lease, the payments must be deducted by the tenant in the year of payment rather than capitalized if they are paid to secure relief from an unprofitable contract. Also, a lump-sum amount paid as damages by a tenant to a landlord for cancellation of the lease is deductible as a business expense when paid or incurred (Rev. Rul. 69-511). On the other hand, a tenant’s lease termination payment cannot be deducted in the tax year paid where it is made as part of an overall plan to
acquire another site and relocate there. The payment has to be capitalized as part of the cost of acquiring the new site (PLR 9607016).

**Rental Loss Limitations**

Depreciation and other deductions can often exceed the income from rental properties. Before the loss can be deducted, one must consider the at-risk, passive activity, and vacation home rules, among others.

At-Risk Loss Limitations

Losses are first limited to the at-risk rules. Losses that do not satisfy the at-risk rules are suspended until the next year.

- If the taxpayer increases his/her at-risk amount in the subsequent year, the losses are released to that extent. If the taxpayer’s at-risk amount does not increase, the losses continue to be suspended and are carried over to the next year.

- If the taxpayer disposes of the activity prior to increasing his or her at-risk amount, the “at-risk suspended” losses are lost and never deductible. Form 6198, *At-Risk Limitations*, is used to report the suspended at-risk losses.

Losses from passive activities that pass the at-risk limit are then subject to the passive activity limitation rules.

- If the taxpayer has passive income, or is eligible for the $25,000 window mentioned later, the losses are allowed to be deducted currently. If the taxpayer does not have passive income and is not eligible for the $25,000 window, then the losses are suspended until the next year.

- If the taxpayer disposes of the activity prior to having passive income, the “passive suspended” losses are allowed as described later in the Dispositions discussion.

The §465 at-risk rules limit a taxpayer’s deductible losses to the amount the taxpayer could actually lose from an activity. These rules operate to prevent the taxpayer from deducting losses in excess of amounts for which he or she has an economic risk. The at-risk rules apply to activities that are part of a trade or business or that are entered into for the production of income. Individuals, partners in a
partnership, and shareholders of an S Corporation are all covered by the at-risk rules. The at-risk loss limitation is applied before all other provisions for loss deductions.

At-risk amounts change each year depending on the income from the activity, the losses incurred, and additional contributions made to the activity.

Taxpayers are generally considered to be at-risk in an activity to the extent of the cash and adjusted basis of property contributed, as well as for amounts borrowed for use in the activity.

- The taxpayer’s at-risk amount is increased by the amount of personal funds contributed to the activity.
- The amount at-risk is increased by an amount equal to the taxpayer’s share of all items of income received or accrued from the activity during the taxable year minus the taxpayer’s share of allowable deductions that are allocable to the activity.
- The amount at-risk is increased by the taxpayer’s share of tax-exempt income of the activity.
- The taxpayer’s at-risk amount is decreased by the amount of money withdrawn from the activity by, or on behalf of, the taxpayer.
- The at-risk amount is decreased by the amount of loss from the activity allowed as a deduction. This includes expenses relating to the production of tax-exempt income that are not deductible.

Certain borrowed amounts are used in the computation of the at-risk amount but only to the extent the taxpayer is liable for repayment of the debt.

- To the extent a taxpayer is personally obligated to repay a liability (recourse liability), the taxpayer’s amount at-risk in the activity is increased by the amount of any liability that is:
  - Incurred in the conduct of the activity; or
  - For use in the activity.
- If the taxpayer obtains a nonrecourse loan for use in an activity and pledges property not used in the activity as security, the taxpayer’s at-risk amount is increased by the FMV of the property pledged.
Example: John and Jerry are partners in a partnership. They went to the bank to borrow money to purchase assets for the partnership. The bank agrees on the condition that each partner be personally liable for the repayment of the loan. This is a recourse loan.

- A taxpayer is not considered at-risk for amounts borrowed if the amounts are borrowed from a person having an interest in the activity or from a person who is related to a person with such interest in the activity unless one of the following exists.
  - The interest in the activity is that of a creditor.
  - The interest in the activity is that of a shareholder.
- Related parties are those identified in §267(b) or §707(b)(1). In applying §267(b) or §707(b)(1), “10%” is substituted for “50%.”
- Nonrecourse liabilities are debts that the taxpayer is not personally liable to repay. Since the taxpayer is not held liable for repayment, this type of debt is not used in the computation of at-risk.

Example: Mike borrowed $30,000 from his uncle to purchase a rental unit. Mike’s uncle is not in the business of loaning money. The rental property is collateral for the loan and if Mike defaults on repayment, his uncle has no option other than to recover the loan through the sale of the property. This is a nonrecourse loan and Mike is not at-risk for this amount.

- Qualified nonrecourse financing increases the at-risk amount even though no one is personally liable for repayment, provided it is:
  - Borrowed by the taxpayer in connection with an activity of holding real property;
  - Secured by the real property used in the activity;
  - Unable to be converted into an ownership interest in the real property; or
  - Borrowed from a qualified person. A qualified person is:
    - Any federal, state or local government; or
• Any person who is actively and regularly engaged in the business of lending money and who is not:
  ○ Related to the taxpayer, unless the terms of the loan are commercially reasonable and they are the same terms available to other unrelated persons,
  ○ The person from whom the taxpayer bought the property, or
  ○ The person who receives a fee with respect to the taxpayer’s investment in the property.

**Example:** ABC Partnership was formed to rent residential rental property. In 2008, Allen, Brian, and Carl went to the bank to borrow the funds needed to purchase an apartment building. The note was secured by the real property. Although the partners are not personally liable for repayment of the note, it is treated as qualified nonrecourse financing and increases their at-risk limitation.

Assume the bank acquired the apartment building on a foreclosure from an earlier year. Now the lender is also the seller. The note is not treated as qualified nonrecourse financing, therefore, it does not increase the partners’ at-risk basis because the bank is no longer a qualified person as defined in §465(b)(6)(D).

Amounts borrowed from a person with an interest in the profits of the activity are not considered at-risk even if the note is a recourse liability.
Example: John and Ray formed a partnership and began a retail sales business. They purchased $3,000 of inventory with their own funds and an additional $12,000 of inventory was financed through the seller of the inventory. John and Ray are each liable for repayment of this note. Under the terms of the note, the seller/lender received 6% annual interest plus 5% of the net profit from the activity. Their at-risk amount is only $3,000 because the lender has an interest in the net profits.

If John and Ray paid the lender a percentage of the gross profits instead, they would be considered at-risk for $15,000 ($3,000 + $12,000). This way the lender would not have any interest in the profits or capital of the partnership (Reg. §1.465-8).

Passive Activity Loss Limitations

The passive loss rules came into effect with the Tax Reform Act of 1986 by the creation of Internal Revenue Code §469. This section limits the amount of passive losses a taxpayer can deduct on a current year’s tax return.

A taxpayer is allowed to deduct passive losses only to the extent of the taxpayer’s passive income.

There are two exceptions to this general rule:

- Active participation rental real estate activities; or
- The sale of the passive activity.

The passive activity limitations apply to individuals, trusts, estates, personal service corporations, and to certain closely held corporations.

The passive loss limitations do not apply to S corporations and partnerships directly. However, the losses are passed through to the individual shareholders and partners, where the limitations apply.

Spouses filing a joint return are generally deemed to be one shareholder for the following:

- The computation of the passive activity loss.
- The allocation of the disallowed loss and passive activity credit among activities and the identification of disallowed passive activity deductions and credits from passive activities.
If the deductions and credits would result in a different income tax liability by reporting the items separately for each spouse compared to reporting them jointly, the spouses must account separately for their own deductions and credits.

The rules for self-employment tax are different from the passive rules. A taxpayer can be liable for self-employment tax if a taxpayer operates a trade or business even if the taxpayer does not materially participate. Yet if the taxpayer does not materially participate in the activity, the gain or loss from the activity will be passive. There is no correlation between self-employment tax and the passive rules. Limited partners are not subject to self-employment tax.

**Passive Activity Defined**

A passive activity is any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate. A passive activity also includes a rental activity.

Taxpayers may elect to treat one or more trade or business activities or rental activities as a single activity if those activities form an appropriate economic unit for measuring gain or loss. The determination is made by looking at all of the facts and circumstances regarding the activities.

The following factors are taken into consideration:

- The similarities and differences in the types of trades or businesses.
- The extent of common control.
- The extent of common ownership.
- The geographical locations.
- The interdependence between or among activities, which may include the extent to which the activities:
  - Involve the purchase or sale of goods between or among themselves.
  - Involve products or services that are generally provided together.
  - Have the same customers.
  - Have the same employees.
  - Use a single set of books and records to account for the activities.
Once the activities have been grouped in appropriate economic units, they may not be regrouped unless the original grouping was clearly inappropriate or there is a material change in the facts and circumstances.

The facts and circumstances apply to grouping activities after May 10, 1992. The Regulations were modified and finalized for grouping after October 4, 1994.

**Trade or Business Activity**

A trade or business activity includes activities that:

- Involve the conduct of a trade or business within the meaning of the general business expenses provision of §162 (allowance for deducting ordinary and necessary expenses paid or incurred during the year in carrying on a trade or business).
- Are conducted in anticipation of the start of a trade or business.
- Involves research or experimental expenses that are deductible as such.

A trade or business activity does not include:

- A rental activity; or
- The rental of property that is incidental to an activity of holding property for investment.

**Rental Activity**

A rental activity is a passive activity even if the material participation rules are satisfied, except for taxpayers in the real property trade or business, which is discussed later. Each activity is treated as a separate activity, unless the taxpayer elects to treat all interests in rental real estate as one activity.

A rental activity is one where:

- Tangible property held in connection with the activity is used by, or held for use by, customers.
- Gross income from the conduct of the activity represents amounts paid for the use of tangible property.

An activity is not a rental activity if it meets any of the following:
- The average period of customer use is seven days or less.
- The average period of customer use is 30 days or less and significant personal services are provided with the rental.
- Extraordinary personal services are provided in connection with customer use.
- The rental is incidental to a nonrental activity. The rental is incidental if the gross rental income from the property is less than 2% of the smaller of its adjusted basis or FMV.
- The rental property is made available during defined business hours for nonexclusive use by various customers.
- The property is provided for use in a nonrental activity of the taxpayer’s partnership, S corporation, or joint venture.

A taxpayer’s rental real estate activity is not a passive activity if the taxpayer materially participates in the activity and performs qualifying services in real property trades or business (real estate professional). (This provision is effective for tax years beginning after December 31, 1993.) [§469(c)(7)]

**Material Participation**

A trade or business activity is not a passive activity for the purpose of the passive activity limitations if the taxpayer materially participates in the activity.

A taxpayer materially participates in an activity for the tax year if he or she meets any one of the following tests [§469(h)]:

- The taxpayer participates in the activity for more than 500 hours during the year.
- The taxpayer’s participation in the activity for the tax year constitutes substantially all of the participation in the activity of all individuals, including individuals who are not owners of interests in the activity for the year.
- The taxpayer participates in the activity for more than 100 hours during the tax year and his or her participation in the activity for the year is not less than any other individual’s participation, including those who do not own an interest in the activity.
- The activity is a significant participation activity for the tax year and the individual’s aggregate participation in all significant participation activities during the year exceeds 500 hours.
The taxpayer materially participated in the activity for any of five tax years, whether or not consecutive, during the immediately preceding 10 tax years.

The activity is a personal service activity and the taxpayer materially participated in the activity for any three preceding tax years, whether or not consecutive.

Based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during the year.

**Significant Participation Activity**

An activity is a significant participation activity only if:

- The activity is a trade or business activity in which the taxpayer participates for more than 100 hours during the tax year.
- The activity would be one in which the taxpayer does not materially participate for the tax year if material participation were determined without reference to the significant participation standard.

**Publicly Traded Partnerships [§469 (k)]**

An interest in a publicly traded partnership is always a passive activity and is never combined with other passive activities.

It is treated as if it is the only passive activity that the taxpayer owns. The taxpayer will complete a separate Form 8582, *Passive Activity Loss Limitations*, and related worksheets for each publicly traded partnership interest he or she owns.

Only gains from that particular publicly traded partnership interest can offset losses from that particular publicly traded partnership interest. Of course, when the publicly traded partnership interest is disposed of, any remaining suspended passive losses are deductible as nonpassive.

**Passive Activity Income and Deductions**

Passive activity income includes all income from passive activities and generally includes gain from the disposition of an interest in a passive activity.
Passive activity income does not include:

- Income from an activity that is not a passive activity.
- Gain from the disposition of substantially appreciated property that had been used in a nonpassive activity.
- Portfolio income, which includes interest, annuities, dividends, royalties and gains and losses from the disposition of property that produces these sources of income.
- Personal service income, which includes wages, salaries, commissions, self-employment income, deferred compensation, taxable social security and other retirement benefits, and payments from partnerships to partners for personal services (guaranteed payments).
- Income from positive §481 adjustments allocated to activities other than passive activities.
- Income or gain from investments or working capital.
- Income from an oil or gas property if the taxpayer treated any loss from a working interest in the property for any tax year beginning after 1986 as a nonpassive loss.
- Any income from intangible property if the taxpayer’s personal efforts significantly contributed to the creation of the property.
- Gain from the disposition of an interest in an activity or an interest in property used in an activity that qualifies for the exception regarding an interest in a partnership or S corporation, property used in more than one activity, property formerly used in a nonpassive activity, property held for sale to customers, or income from property held primarily as an investment by dealers.
- Any other income that must be treated as nonpassive income.
- Income from any interest in a publicly traded partnership.
- State, local, and foreign income tax refunds.
- Income from the reimbursement of a prior year casualty or theft loss that is included in gross income and the loss deduction was not from a passive activity deduction.
- Alaska Permanent Fund Dividends.
- Cancellation of debt income if at the time the debt is discharged the income is not allocated to passive activity expenditures.

Passive activity deductions include all deductions from activities that are passive activities for the tax year and all deductions from passive activities that were disallowed under the passive loss rules in prior years and carried forward to the tax year. They include losses from dispositions of property used in a passive activity at the time of the
disposition and losses from the disposition of less than the entire interest in the passive activity.

Passive activity deductions do not include:

- Expenses that are clearly and directly allocable to portfolio income.
- Interest expenses other than interest properly allocable to passive activities.
- Losses from dispositions of property that produce portfolio income or property held for investment.
- State, local, and foreign taxes.
- Miscellaneous itemized deductions that may be disallowed because of the 2%-of-adjusted-gross-income limit.
- Charitable contributions.
- Net operating loss deductions.
- Percentage depletion carryovers for oil and gas wells.
- Capital loss carryovers.
- Deductions and losses that would have been allowed for tax years beginning before 1987 but for basis or at-risk limits.
- Net negative §481 adjustments allocated to activities other than passive activities.
- Casualty and theft losses unless losses similar in cause and severity recur regularly in the activity.
- The deduction for one-half of self-employment tax.

The excess of deductions over income creates a loss from the activity subject to the passive loss limitation rules. Losses from an activity are carried to Form 8582 to determine the extent to which a passive loss is used to offset other passive activity income. This form and worksheets allocate the allowable loss to the various loss activities.

**Active Participation Rental Real Estate Window**

A taxpayer qualifies for active participation in rental real estate if he or she participates in a significant and bona fide manner, by performing actions such as making management decisions or arranging for others to provide services such as repairs. However, if a taxpayer hires another party to make these decisions and perform most of the management functions, such as finding tenants, negotiating leases, the taxpayer will not normally be considered to be actively participating.
An individual may deduct up to $25,000 of net passive activity loss from all rental real estate activities in which the taxpayer actively participates. This deduction is allowed against nonpassive income \[\text{§469(i)}\].

This deduction is only available to natural individuals, qualifying estates, and qualified revocable trusts that made the election to be treated as part of the decedent’s estate. Irrevocable trusts are not eligible for the window.

The taxpayer must own 10% or more by value of all interests in the activity in order to use this $25,000 window. For this determination, the participation of a spouse is taken into account.

- The active participation is not as restrictive as the material participation rules. It may be satisfied without a regular, continuous, and substantial involvement in the operations of the activity.
- A limited partner or taxpayer holding an interest treated as a limited partnership interest cannot be an active participant in a rental real estate activity.

The $25,000 special window is treated as a business loss. Therefore a taxpayer could have a net operating loss as a result of the rental operations.

The $25,000 window is reduced by 50% of the amount by which the taxpayer’s modified adjusted gross income (MAGI) for the tax year exceeds $100,000. The benefit is completely eliminated when MAGI is $150,000 or more.

MAGI includes the taxpayer’s adjusted gross income determined without regard to:

- Any amount includible in gross income under \(\text{§86}\) (taxable social security benefits).
- The amounts excludable from gross income under \(\text{§135}\) (exclusion of U.S. savings bonds interest used for higher education) and \(\text{§137}\) (Adoption Assistance).
- The amounts allowable as a deduction under \(\text{§219}\) (traditional IRA) and \(\text{§221}\) (student loan interest).
- Any passive activity loss or any loss allowable due to \(\text{§469(c)(7)}\) (special rule for taxpayers in a real property trade or business).
The $25,000 is reduced to $12,500 and the phase-out begins at $50,000 for married individuals filing a separate return who lived apart the entire year. The window is completely phased-out when MAGI is $75,000. The window is not available to married taxpayers filing separate returns who have lived together at any time during the year.

**Calculation**

The calculation for this window is made on Form 8582, *Passive Activity Loss Limitations*, in the Part II, Special Allowance for Rental Real Estate with Active Participation.

If a taxpayer actively participated during the tax year in which any part of the loss arose, the carryover loss to future years retains its character and qualifies for the $25,000 window in that year.

**Example:** Siren, a single taxpayer, actively participates in her residential rental activity. She has no other passive activities. During 2007, the activity generates a $35,000 loss from its operations. Siren’s AGI is $85,000 which means she is allowed to deduct $25,000 of the rental losses in the current year and carries the remaining $10,000 forward to 2008.

During 2008, Siren’s rental activity has a break-even year, with no gain or loss. Further, Siren did not actively participate in the rental activity during the year. Her AGI for 2008 is $73,000. Since she was actively involved in the rental activity during 2007, the year the carryover loss was created, she can deduct the $10,000 carryover amount as an active participation rental real estate activity qualifying for the window.

**Reporting Passive Activity Interest**

Passive activity interest expense is first carried to Form 8582, and then to the applicable schedule (i.e., Schedule C, E, or F). It should not be reported as an itemized deduction on Schedule A (IRS Notice 88-37).
**Former Passive Losses**

Activities can change character during their existence. A taxpayer may materially participate in one year (nonpassive) and not materially participate in another year (passive).

A loss from an activity in the year it is a passive activity keeps its characteristic of being passive for the entire time that the loss is carried over. If the taxpayer is no longer passive in the activity, the carryover losses are considered “former passive activity losses.”

These “former passive activity losses” are deductible in the earlier of the year that the taxpayer:
- Has any passive income from the activity.
- Is allowed the losses through the $25,000 window, if applicable.
- Disposes of the activity.

Under certain circumstances the loss may be allowed against the income of the activity that is no longer passive. The taxpayer must be able to show that such income is from the same activity in which the taxpayer previously did not materially participate. (Committee Reports from TRA’86)

**Real Estate Professionals**

The general rule is that a rental activity is a passive activity even if the taxpayer materially participated in that activity. There is an exception to that rule, however, if the individual materially participated as a real estate professional.

The taxpayer qualified as a real estate professional for the year if both of the following requirements are met.
- More than half of the personal services performed in all trades or businesses during the tax year were performed in real property trades or businesses in which the taxpayer materially participated.
- The taxpayer performed more than 750 hours of services during the tax year in real property trades or businesses in which he or she materially participated.

Personal services performed as an employee in real property trades or businesses do not count unless the taxpayer was a 5% owner of the employer. An individual was a 5% owner if he or she owned (or are
considered to have owned) more than 5% of the employer’s outstanding stock, outstanding voting stock, or capital or profits interest.

For this purpose, each interest in a rental real estate activity is a separate activity, unless the choice is made to treat all interests in rental real estate activities as one activity.

To make this election, attach a statement to the original tax return that declares the individual is a qualifying taxpayer for the year and making the election under §469(c)(7)(A). The election applies for the year made and all later years in which the individual is a real estate professional. The election is revoked if the facts and circumstances materially change.

If married filing jointly, either spouse must meet both of the above conditions, without taking into account services performed by the other spouse. However, one can count his or her spouse’s participation in an activity in determining materially participation.

If qualified as a real estate professional, report income or losses from rental real estate activities with material participation as nonpassive income or losses, and complete Line 43 of Schedule E (Form 1040). If the taxpayer also has an unallowed loss from these activities from an earlier year when not qualified, see Former Passive Activities, earlier.

A real property trade or business is a trade or business that does any of the following with real property.

- Develops or redevelops it.
- Constructs or reconstructs it.
- Acquires it.
- Converts it.
- Rents or leases it.
- Operates or manages it.
- Brokers it.

A closely held corporation can qualify as a real estate professional if more than 50% of the gross receipts for its tax year came from real property trades or businesses in which it materially participated.
**Gifts**

If property is disposed of by gift, the suspended losses are not deductible. Instead, the basis in the property transferred is increased by the amount of the loss that was not allowed as a deduction.

**Divorce**

If passive activity property is transferred to a spouse incident to divorce, the disposition by gift rules will apply. The suspended loss is added to the basis of the property upon transfer.

**Nontaxable Transactions**

Property disposed of in a nontaxable transaction such as a like-kind exchange, a §351 transfer, or a transfer to a partnership under §721 does not release suspended passive losses. Generally the property received in the transaction must be disposed of in a taxable transaction to release the losses. To the extent of any gain recognized on the nontaxable transaction, suspended passive losses are deductible.

**Death**

If the disposition is due to death, unused losses are allowed as a deduction against the decedent’s income for the year. The losses are allowed to the extent they exceed the amount by which the transferee’s basis in the passive activity has been increased under the rules for determining basis of property acquired from a decedent.

**Example:** Ted had suspended passive activity losses of $25,000 from rental property on the date of his death. Ted’s adjusted basis in the property just prior to his date of death was $50,000 and the property’s FMV was $60,000. Ted’s final return will include $15,000 of the suspended passive loss. This is the amount in excess of the estate’s basis in the property over Ted’s basis in the property [$25,000 – ($60,000 - $50,000)].
Example: Kaylee sold her entire interest in a limited partnership. Upon the sale, Kaylee realized a gain of $3,000. During her period of ownership, Kaylee had accumulated $6,000 of suspended passive losses from this activity. For 2008, Kaylee also had $1,000 income from another passive activity. The $6,000 suspended loss first offsets the $3,000 gain realized on the sale, then offsets the $1,000 income from the other passive activity. The remaining $2,000 can then be used to offset nonpassive income.

Self-Rental

Renting to one’s closely held corporation is a way to draw money out of the business other than as wages which are subject to payroll tax withholding, or corporate distributions which are taxable as dividends to shareholders to the extent of earnings and profits and are not deductible by the corporation.

The self-rented property regulations are important because they prohibit using net rental income to offset other passive losses if the property is rented for use in a trade or business in which the taxpayer materially participates (other than certain development activities) unless the rental agreement is a written, binding contract entered into before February 19, 1988 [Regs. §§1.469-2(f)(6) and 1.469-11(c)(1)(ii)]. These rules apply only if the rental generates net income. A loss from the rental remains a passive loss.

Example: Johann Gutenberg materially participates and is sole shareholder in his printing business, which is an S corporation. He buys a building and rents it to the S corporation. The S corporation will operate printing presses in the building. Because Luther is renting the building to a trade or business in which he owns an interest and materially participates, he must recharacterize the net rental income from the property as nonpassive. Thus, his net passive rental income is zero and cannot be used to offset any passive losses he may have.
Aggregating a self-rental activity with other rental activities that generate passive losses as a single economic unit does not avoid recharacterization. The self-rental activity must be removed from the passive loss calculation before any grouping is considered. However, the recharacterization rules only prevent taxpayers from using income from self-rented property to absorb losses from other passive activities. It does not prevent taxpayers from offsetting income and losses from such property against each other, regardless of when generated.

**Example:** Simon and River Tamm owned and materially participated in two S corporations, B and J. Each corporation rented commercial real estate from them. B paid $120,000 of rent per year in 2007 and 2008 for real property BB. Consequently, Simon and River had net rental income from property BB of $102,646 in 2007 and $102,045 in 2008. J never paid its agreed-upon rent of $60,000 in 2007 or 2008 for real property JJ, so taxpayers had a net rental loss of $41,706 in 2007 and $40,169 in 2008 from property JJ.

Simon and River elected to treat the two rental activities as a single activity and offset the net rental income from BB with the net rental loss from JJ. Under the self-rental rule, net rental income from property used in a trade or business in which the taxpayer materially participates is treated as nonpassive income; but losses from such a rental activity remain passive.

Consequently, grouping the two rental activities does not allow the income and losses to be netted before applying the self-rental rule. The net rental income from BB is recharacterized as nonpassive before it can be netted with any losses. After the recharacterization, there is no passive income to offset the passive losses from JJ. Accordingly, the passive loss was disallowed.

If rents are too high, they may be reclassified as dividends or compensation. If rents are too low, or not paid at all, those who rent to their closely held corporation may be in constructive receipt of rental income.
**Example:** Louis and Rita Hooper rented commercial real estate to their wholly-owned corporation, of which Louis was the president and chief financial officer and Rita was the vice president and secretary. The Hoopers and the corporation were all cash basis taxpayers. Louis and Rita decided in a board of directors meeting in June 1989 that the corporation would no longer pay rent to them after May 31, 1989. They remained the owners of the rental property, which the corporation continued to use, until August 1989 when they contributed the real estate to the corporation.

Because petitioners exercised absolute control of the corporation, they also had the power to receive rental income from the corporation. Thus, despite petitioners’ decision not to be paid rental income for those three months, petitioners were entitled to this income and continued to have the right to receive such income until they contributed the property to the corporation. The corporation had sufficient funds to pay the rent. As a result, they constructively received taxable rental income for June, July, and August 1989 and made a constructive contribution of capital to the corporation for this amount (Louis G. Hooper, et ux., TC Memo 1995-108).

Leases between related parties are looked at closely by IRS examiners during audits and reviewed for proper application of the recharacterization rules. They should be documented by written agreements and, hopefully, evidence that the rent is reasonable when compared to local rates.

Section 162(a)(3) does not allow an individual to deduct rent paid to himself. A taxpayer cannot deduct on Schedules C or F rent paid for the use of property he or she owns and report the rental income on Schedule E, in order to reduce self-employment taxes.
Example: Larson E., a self-employed attorney, has an office in a building he jointly owns with his wife. He pays rent to himself and his spouse, claiming a Schedule C business deduction, and reports the rental income on Schedule E of their joint return.

Since the property is jointly owned each spouse is entitled to half of the rental income. Thus, a Schedule C business deduction (and an equal amount of Schedule E rental income) is allowed for the half of the rent paid to the spouse. No deduction is allowed for the half allocable to Larson since he had an equity interest in the building.

Depreciation and other property expenses related to the portion of the office space used by Larson are reported half on Larson’s Schedule C and half on his wife’s Schedule E. Depreciation and other property expenses related to office space used by other tenants are reported 100% on Schedule E [Cox v. Comm., 80 AFTR 2d 97-5718 (121 F3d 390), 8/05/1997].

For passive loss purposes, rent paid to a spouse in the above example is recharacterized as nonpassive income under the self-rented property rules. Any participation by an individual’s spouse in an activity is attributed to such individual [Reg. §1.469-5T(f)(3)]. Thus, the nonpassive income generated on the lessor/spouse’s Schedule E cannot be offset with passive losses.

In order for a rental arrangement between spouses to be recognized for federal tax purposes, their actions with respect to sharing the economic burden of, and claiming deductions for, expenses related to the property must be consistent with the assertion that they are conducting separate rental activities.

- The arrangement should be properly documented with a written lease.
- The property should be properly titled in the name of the spouse.
- Any debt should be in the name of the same spouse that owns the property.
- The lease terms should be entered into as if it were an arms-length rental.
- A Form 1099-MISC is issued for the rent.
- A separate rental checking account should be established.
Any rental income received by the spouse should not immediately flow back to the payor’s sole proprietorship.

**Casualty Losses**

Three requirements must be met for a taxpayer to have a casualty:
- Taxpayer must have suffered a loss to property;
- The loss must directly related to a casualty (or theft); and
- There is proof of the amount of the loss from the casualty.

A taxpayer can be an individual, partnership, corporation, estate, or trust. Most of this text refers to the taxpayer as an individual but the general rules apply to the other entities.

A casualty or theft loss is reported on the Form 4684, *Casualties and Thefts*. The form has two pages depending on the type of property. For personal use property use page one of the Form 4684 to report casualties and thefts, while business and income producing property is reported on page 2.

Each separate casualty or theft loss gets reported on a new Form 4684. If the taxpayer suffers five different casualty losses the return will have five separate Forms 4684 attached.

S corporations and partnerships do not claim a casualty or theft loss at the entity level. The loss is a separate pass through item reported on a Schedule K-1 to the partner or shareholder. There is a section later that discusses how to handle this situation.

**Who Reports the Loss**

Only the owner of the property is allowed to claim a loss from a casualty.
<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spouses</td>
<td>If they file a joint return, it doesn’t matter which spouse owned the property. If property is owned separately only the spouse who owns the property can deduct the loss on a separate return [Kraus, Gilbert (1951) PH TCM 51327]. Property owned jointly on separate returns must be split regardless if one spouse pays for all the repairs (Rev. Rul. 75-347). In community property states, the loss is allowed only to the extent of the spouse’s community interest.</td>
</tr>
<tr>
<td>Parents and Children</td>
<td>The loss can only be deducted by the legal owner of the property. Where a car was titled in the child’s name, the parent cannot claim a loss even if the child is the parent’s dependent [Oman, Frank, (1971) TC Memo 1971-183 and Draper, Thomas, (1950) 15 TC 135].</td>
</tr>
<tr>
<td>Buyer and Seller</td>
<td>Ownership is determined under state law and provisions of the contract [Randall, Walter, (1978) TC Memo 1978-222].</td>
</tr>
<tr>
<td>Shareholder and Corporation</td>
<td>Ownership is determined at the time of the casualty. A shareholder is not entitled to loss on property owned by the corporation [Huffstutler, J. Terry, (1953) PH TCM ¶54000].</td>
</tr>
<tr>
<td>Life Estate and Remainderman</td>
<td>The courts have taken different positions. In one case the entire loss was allocated to the life estate owner [Bliss, Katharine v. Com., (1958, CA2) 1 AFTR 2d 1985]. In a different case the loss was allocated between the life estate and remainderman [Steinert, Lena, (1959) 33 TC 447, acq].</td>
</tr>
<tr>
<td>Tenant and Landlord</td>
<td>In this situation the courts and IRS seem to contradict. The courts have denied any loss to a tenant because of either no basis or lack of ownership [Miller, Robert, (1975) TC Memo 1975-110 and Bonney, Theodore v. Com., (1957, CA2) 52 AFTR 74]. In the case where a tenant had return the property in the same condition as before the casualty the IRS allowed the loss to the tenant (Rev. Rul. 73-41).</td>
</tr>
<tr>
<td>Members of Homeowner’s Association</td>
<td>IRS website “In summary, if the common elements are owned by the homeowners association, the members are not entitled to any casualty loss deduction for damage to the common elements and, therefore, the members may not deduct a special assessment to replace uninsured property (common elements) damaged by Hurricane Katrina. However, if the common elements are owned by the members of the homeowners association as tenants in common, the members may be entitled to a casualty loss deduction.” The taxpayer was allowed to use the assessments along with other repairs paid as the amount of the casualty loss when it was their property specifically damaged by an earthquake [Robin E. Schmidt v. Commissioner, TC Summary Opinion 2002-23].</td>
</tr>
</tbody>
</table>
By definition a casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

- A sudden event is one that is swift. Losses to property due to progressive deterioration is not deductible as a casualty loss. This is because the damage results from a steadily operating cause or a normal process, rather than from a sudden event.
- An unexpected event is one that is ordinarily unanticipated and unintended.
- An unusual event is one that is not a day-to-day occurrence and that is not typical of the activity in which the taxpayer engages [§165(c)(3)].

**Example:** Taxpayer had a home in the vicinity of another home where a celebrity was tried for a double murder case. The reason for the loss was due to the sudden inundation of media and onlookers to the neighborhood after 1994 double murders.

The court said no. O.J. Simpson’s neighbors were denied a casualty loss deduction for alleged devaluation of their residence due to inundation of media and onlookers to the neighborhood after the 1994 double murders. Devaluation due to ongoing public attention didn’t result in a §165 casualty: while murders and initial influx of onlookers were sudden and unexpected exertion of force, force wasn’t exerted on and didn’t damage the taxpayers’ property. Also, the taxpayers didn’t show physical damage to property; and the situation reflected a temporary fluctuation since public attention had decreased significantly and neighbors continued to invest substantially in upgrading their homes (Gerald Chamales, et ux. v. Commissioner, TC Memo 2000-33).

Following is a chart showing the outcome of various casualties.
<table>
<thead>
<tr>
<th>Event</th>
<th>Casualty Allowed</th>
<th>Cite</th>
</tr>
</thead>
<tbody>
<tr>
<td>An earth slide is a casualty even though it could be foreseen.</td>
<td>Yes</td>
<td>Heyn, Harry, (1966) 46 TC 302, acq 1967-2 CB 2.</td>
</tr>
<tr>
<td>Damage to roof due to squirrels.</td>
<td>No</td>
<td>IRS Letter Ruling 8133097.</td>
</tr>
<tr>
<td>Damage done to home because of nearby quarry.</td>
<td>Yes</td>
<td>Durden, Ray, (1944) 3 TC 1, acq.</td>
</tr>
<tr>
<td>Defective design or workmanship that could lead to collapse or casualty.</td>
<td>No</td>
<td>IRS Letter Ruling 7815027.</td>
</tr>
<tr>
<td>Most natural disasters such as earthquakes, hurricanes, tornadoes, lightning, and volcanic eruptions.</td>
<td>Yes</td>
<td>IRS Publications 17 and 225.</td>
</tr>
<tr>
<td>Taxpayer’s negligence that caused fire in home.</td>
<td>No</td>
<td>Blackman, Biltmore, (1987) 88 TC 677.</td>
</tr>
</tbody>
</table>
Proof of Loss

To deduct a casualty or theft loss, there must be documentation to establish the amount of the loss.

For a casualty loss, a taxpayer should have the following documentation:

- The type of casualty (car accident, fire, storm, etc.) and when the casualty occurred.
- Proof that the loss was a direct result from the casualty.
- That the taxpayer was the owner of the property or, if it was leased property, that the taxpayer was contractually liable to the owner for the damage.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.
- Supporting documentation for the type and basis of the property damaged by the casualty.

=> Tax Tip: The costs of photographs and appraisals used as evidence of the value and condition of property damaged as a result of a casualty are not a part of the loss. They are expenses in determining a tax liability and deductible as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income limit on Schedule A (Form 1040).

Computing the Loss

The following steps compute the amount of loss.
1. Determine the adjusted basis in the property before the casualty or theft.
2. Determine the decrease in FMV (see discussion below) of the property as a result of the casualty or theft.
3. Subtract any insurance or other reimbursement received or expect to receive from the smaller of the amounts determined in (1) and (2).
**Note:** If the reimbursement is more than the adjusted basis in the property, there is a gain due to a casualty. This is true even if the decrease in the FMV of the property is smaller than the adjusted basis. Gain on casualties is discussed later.

Special rule for business or income-producing property: If business or income-producing property, such as rental property, is completely destroyed, the decrease in FMV is not considered [Reg. §1.165-7(b)(1)(ii)]. The loss is figured as follows: adjusted basis in the property MINUS any insurance or other reimbursement received or expect to receive.

Reporting multiple property damage in a single casualty:

<table>
<thead>
<tr>
<th>Type of property</th>
<th>Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal use — real property.</td>
<td>The entire property (including any improvements, such as buildings, trees, and shrubs) is treated as one item [Reg. §1.165-7(b)(2)].</td>
</tr>
<tr>
<td>Business or income property — real property.</td>
<td>The loss is computed separately for each type of property. Losses to building and trees are accounted for separately [Reg. §1.165-7(b)(2)].</td>
</tr>
</tbody>
</table>

**Decrease in FMV**

FMV is the price a willing buyer will pay a seller under no obligation sell or buy and both know all the relevant facts. The decrease in FMV can be determined in one of two ways, either by an appraisal or the cost of the clean up and repairs [Reg. §1.165-7(a)].

**Note:** Personal use real property treats building and landscaping as one property. The taxpayer must use either the appraisal method or the repairs method to value the decline in the FMV. A taxpayer cannot use the appraisal method for the building and repair method for the landscaping.
An appraisal to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterwards should be made by a competent appraiser. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property.

Several factors are important in evaluating the accuracy of an appraisal, including the following:

- The appraiser’s familiarity with the property before and after the casualty or theft.
- The appraiser’s knowledge of sales of comparable property in the area.
- The appraiser’s knowledge of conditions in the area of the casualty.
- The appraiser’s method of appraisal.

A taxpayer may be able to use an appraisal that was used to get a federal loan (or a federal loan guarantee) as the result of a Presidentially declared disaster to establish the amount of the disaster loss.

➤ **Caution!** When dealing with landscaping damage on personal use property, the IRS won’t accept damage to landscaping as decline in FMV unless an appraisal is done on the entire property.

“One method of determining the decrease in FMV is to compare an appraisal of the entire residential property, including trees and other landscaping, before the damage caused by the casualty to an appraisal of the entire residential property after the damage caused by the casualty, including damage to trees and other landscaping. Valuation of the damage to a tree by an arborist does not determine the decrease in FMV of the entire property (www.irs.gov).”

Using property tax bills as measure of the reduction in FMV can be used to show the percentage decline in FMV of the property. This method is generally not accepted as an appraisal by the IRS to determine FMV before and after.
“Valuation of property based upon percentage of decline in local assessment value before and after the fire was approved. Taxpayer used the percentage reduction in the local assessment to determine loss in value of property caused by fire for which he was reimbursed by insurance. The local assessment value was also used to allocate basis between land and building (Virgil R. Williams, TC Memo 1960-19).”

If the taxpayer could establish the FMV of the property before the casualty with a qualified appraisal, then if the local assessments were to decrease by certain percentage, i.e. 30%, after the casualty the court has accepted that method to establish FMV after the casualty.

**Cost of cleaning up or making repairs**

The cost of repairs to the property damaged is acceptable as evidence of the loss of value if the taxpayer shows that:

- The repairs are necessary to restore the property to its condition immediately before the casualty;
- The amount spent for such repairs is not excessive;
- The repairs do not cost more than the damage suffered; and
- The value of the property after the repairs does not, as a result of the repairs, exceed the value of the property immediately before the casualty.

The courts have not allowed taxpayers to use estimated repair costs or the cost of any work the taxpayer did themselves [Oliver, Jane, (1997) TC Memo 1997-84 and Wheeler, Elvin, (1984) TC Memo 1984-425].

The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in FMV in the entire property. The taxpayer can measure the loss by what was spent on the following:

- Removing destroyed or damaged trees and shrubs, minus any salvage received.
- Pruning and other measures taken to preserve damaged trees and shrubs.
- Replanting necessary to restore the property to its approximate value before the casualty.
Items Not To Consider

The following are not considered part of the decrease in FMV.

- The cost of protecting the property against a casualty or theft is not part of a casualty or theft loss. For example, the cost to board up a house against a storm.
- The incidental expenses due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of the casualty or theft loss.
- The cost of replacing stolen or destroyed property is not part of a casualty or theft loss.
- Do not consider sentimental value when determining decrease in FMV.
- A decrease in the value of the property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not to be taken into consideration.

Insurance and Other Reimbursements

If the taxpayer has insurance that covers the casualty or theft loss the amount of expected insurance proceeds must reduce the loss regardless if a claim was filed [§165(h)(4)(E)].

<table>
<thead>
<tr>
<th>Type of Reimbursement</th>
<th>How to Handle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance proceeds.</td>
<td>If the proceeds relate to the property damaged, the loss must be reduced. Insurance proceeds for personal living expenses such as temporary housing do not reduce the loss.</td>
</tr>
<tr>
<td>Cash gifts.</td>
<td>If the taxpayer has unrestricted use of the money, it does not reduce the loss regardless of how the money is spent.</td>
</tr>
<tr>
<td>Disaster relief funds.</td>
<td>Unless the funds are restricted to be used only for repair of the damaged property, the money does not reduce the loss.</td>
</tr>
<tr>
<td>Lawsuit settlement.</td>
<td>If related to the damaged property, it would reduce the amount of the loss.</td>
</tr>
<tr>
<td>Federal loan canceled.</td>
<td>If part of the federal disaster loan was canceled under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, it is considered to be reimbursement for the loss. The cancellation reduces the casualty loss deduction.</td>
</tr>
</tbody>
</table>
Reimbursement Received After Deducting Loss

The amount of expected reimbursement must reduce the amount of the casualty loss. This table explains the adjustments to be made.

<table>
<thead>
<tr>
<th>Amount of Reimbursement</th>
<th>When to Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than expected.</td>
<td>When there is no reasonable expectation of any more reimbursements, include the difference between what was expected and the actually amount received as a loss on the current year’s tax return.</td>
</tr>
<tr>
<td>More than expected.</td>
<td>The extra reimbursement could be taxable income in the year received to the extent the original casualty loss reduced taxes for the earlier year. Do not amend the earlier year’s return.</td>
</tr>
<tr>
<td>Same as expected.</td>
<td>Do not have to do anything with the reimbursement.</td>
</tr>
</tbody>
</table>

Deduction Limits

Once the amount of the casualty or theft loss has been calculated, the final step is to determine how much of the loss can be deducted.

Note: Special rules relate to a taxpayer reporting casualty losses due to Presidentially-declared disasters. See the section on Disaster Area Losses for more information.

The loss is reduced first by $100 and then by 10% of the taxpayer’s adjusted gross income. This rule does not apply to business or income producing property reported on Page 2 of Form 4684. However, a loss on employee property is subject to the 2% rule because the loss is reported as a miscellaneous itemized deduction.

When a casualty involves both real and personal properties, apply a single $100 reduction to the total loss and then the 10% rule to figure the casualty loss deduction.
Definitions

**Single event.** Generally, events closely related in origin cause a single casualty. For example, if a storm damages a taxpayer’s residence and his automobile parked in his driveway, any loss sustained results from a single casualty. Similarly, if a hurricane causes high waves, all wind and flood damage to a taxpayer’s property caused by the hurricane and the waves results from a single casualty [Reg. §1.165-7(b)(4)(ii)]. If the same hurricane causes damage to two different pieces of property not located in the same area, it has been interpreted as a single event [Phelps, Winston, (1979) TC Memo 1979-413].

**More than one event.** If the taxpayer has more than one casualty or theft loss during the tax year, each event must be reduced by the $100.

**More than one person.** If two or more individuals (other than a husband and wife filing a joint return) have losses from the same casualty or theft, the $100 rule applies separately to each individual.

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**Example:** A fire damaged Sally’s house and also damaged the personal property of her house guest. She must reduce her loss by $100. Her house guest must reduce his loss by $100.

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**Married taxpayers.** If husband and wife file a joint return, they are treated as one individual in applying the 10% rule. It does not matter if the spouses own the property jointly or separately. If they file separate returns, the 10% rule applies to each return on which a loss is claimed [Reg. §1.165-7(b)(4)(iii)].

**More than one owner.** If two or more individuals (other than a husband and wife filing a joint return) have a loss on property jointly owned, the $100 rule applies separately to each owner [Reg. § 1.165-7(b)(4)(iii)].

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**Example:** If two sisters live together in a home they own jointly and they have a casualty loss on the home, the $100 rule applies separately to each sister.
Examples of How These Rules are Applied

More than one loss in the year.

If taxpayer has more than one casualty or theft loss during the tax year, reduce each loss by any reimbursement and by $100. Then reduce the total of all the losses by 10% of adjusted gross income.

Example: In March, Chris had a car accident that totally destroyed her car. She did not have collision insurance on her car, so she did not receive any insurance reimbursement. Her loss on the car was $1,200.

In November, a fire damaged her basement and totally destroyed the furniture, washer, dryer, and other items she had stored there. Her loss on the basement items after reimbursement was $1,700. Her adjusted gross income for the year that the accident and fire occurred is $25,000. The following computation shows how to calculate her casualty loss deduction for the year.

<table>
<thead>
<tr>
<th></th>
<th>Car</th>
<th>Basement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss</td>
<td>$1,200</td>
<td>$1,700</td>
</tr>
<tr>
<td>Subtract $100 per incident</td>
<td>-200</td>
<td>-100</td>
</tr>
<tr>
<td>Loss after $100 rule</td>
<td>$1,100</td>
<td>$1,600</td>
</tr>
<tr>
<td>Total loss</td>
<td></td>
<td>$2,700</td>
</tr>
<tr>
<td>Subtract 10% of $25,000 AGI</td>
<td></td>
<td>-2,500</td>
</tr>
<tr>
<td>Total casualty loss deduction</td>
<td></td>
<td>$200</td>
</tr>
</tbody>
</table>

The two events are reported on two separate Forms 4684.

Property used partly for business and partly for personal purposes.

When property is used partly for personal purposes and partly for business or income-producing purposes, the casualty or theft loss deduction is figured separately for the personal-use portion and for the business or income-producing portion [Reg. §1.165-7(b)(4)(iv)]. The reason for figuring each loss separately is because the losses attributed to these two uses are figured in two different ways. When figuring each loss, allocate the total cost or basis, the FMV before and
after the casualty or theft loss, and the insurance or other reimbursement between the business and personal use of the property. The $100 rule and the 10% rule apply only to the casualty or theft loss on the personal-use portion of the property.

**Example:** Janet uses half of a duplex for rental and lives in the other half. The cost of the duplex was $400,000. Janet made no further improvements or additions to it. A flood in March damaged the entire duplex. The FMV of the duplex was $380,000 immediately before the flood and $320,000 afterwards. Her insurance company reimbursed her $40,000 for the flood damage. Depreciation on the rental part of the duplex before the flood totaled $24,000. Her adjusted gross income for the year the flood occurred is $125,000. She has a deductible business casualty loss of $10,000. She does not have a deductible personal casualty loss because of the 10% rule. The loss is figured as follows.

<table>
<thead>
<tr>
<th></th>
<th>Rental Part</th>
<th>Personal Part</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Cost (total $400,000)</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>2. Subtract depreciation</td>
<td>(24,000)</td>
<td>0</td>
</tr>
<tr>
<td>3. Adjusted basis</td>
<td>176,000</td>
<td>200,000</td>
</tr>
<tr>
<td>4. FMV before flood (total $380,000)</td>
<td>190,000</td>
<td>190,000</td>
</tr>
<tr>
<td>5. FMV after flood (total $320,000)</td>
<td>(160,000)</td>
<td>(160,000)</td>
</tr>
<tr>
<td>6. Decrease in FMV (line 4 - line 5)</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>7. Loss (smaller of line 3 or line 6)</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>8. Subtract insurance</td>
<td>(20,000)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>9. Loss after reimbursement</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>10. Subtract $100 on personal-use property</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>11. Loss after $100 rule</td>
<td>10,000</td>
<td>9,900</td>
</tr>
<tr>
<td>12. Subtract 10% of $125,000 AGI on personal-use property</td>
<td>0</td>
<td>(12,500)</td>
</tr>
</tbody>
</table>

**Deductible rental loss** | 10,000 |
**Deductible personal loss** | 0 |

**Note:** A casualty loss is not considered a deduction under the passive loss rules (Notice 90-21). The loss in this example is allowed in full even though a rental activity is a passive activity.
# Gains on Casualties

If the taxpayer receives an insurance payment or other reimbursement that is more than the adjusted basis in the destroyed, damaged, or stolen property, the taxpayer has a gain from the casualty or theft. The gain is figured as follows:

- Amounts received minus adjusted basis in the property at the time of the casualty or theft equals the gain from casualty.
- Even if the decrease in FMV of the property is smaller than the adjusted basis of the property, use the adjusted basis to figure the gain.
- The amount received includes any money plus the value of any property received minus any expenses the taxpayer has in obtaining reimbursement. It also includes any reimbursement used to pay off a mortgage or other lien on the damaged, destroyed, or stolen property.
- If the taxpayer has both casualty or theft gains as well as losses to personal-use property, a comparison of the total gains to the total losses must be done. Do this after reducing each loss by any reimbursements and by $100 but before reducing the losses by 10% of the adjusted gross income.

Casualty or theft gains do not include gains the taxpayer elects to postpone. See the section on Postponement of Gain, later.

The following chart shows how to report gains or losses from personal-use property.

<table>
<thead>
<tr>
<th>Description</th>
<th>How to Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Losses more than gains.</td>
<td>If the losses are more than recognized gains, subtract the gains from the losses and reduce the result by 10% of the adjusted gross income [§165(h)(4)(A)]. The result, if any, is the deductible loss from personal-use property.</td>
</tr>
<tr>
<td>Gains more than losses.</td>
<td>If the recognized gains are more than losses, subtract losses from the gains [§165(h)(2)(B)]. The difference is treated as a capital gain and must be reported on Schedule D (Form 1040). The 10% rule does not apply to the gains.</td>
</tr>
<tr>
<td>Main residence.</td>
<td>If the gain from the casualty relates to the taxpayer’s principal residence the taxpayer may elect to apply the §121 exclusion or §1033 to postpone the gain by purchasing a replacement home.</td>
</tr>
</tbody>
</table>
Postponement of Casualty Gain

A taxpayer generally reports gain as income in the year the reimbursement is received. Under §1033, the taxpayer can elect to postpone the gain into replacement property if the property is similar or related-use property and acquired within the replacement period. This is an election by the taxpayer. However, if qualified replacement property is acquired, the postponement of gain is mandatory.

The simplest way to postpone the entire gain is to spend the entire amount of insurance proceeds on replacing or repairing the damaged property. If the cost of the replacement property/repairs is less than the reimbursement, the taxpayer must include the gain in income up to the amount of the unspent reimbursement.

Example: In 1970, Patrick bought an ocean-front cottage for personal use at a cost of $18,000. He made no further improvements or additions to it. When a storm destroyed the cottage this January, the cottage was worth $250,000. He received $146,000 from the insurance company in March. Patrick has a gain of $128,000 ($146,000 - $18,000).

He spent $144,000 to rebuild the cottage. Since this is less than the insurance proceeds received, he must include $2,000 ($146,000 - $144,000) in his income. Even though Patrick’s FMV decreased by $250,000, he will still have a gain.

To qualify to postpone the gain the taxpayer must meet three criteria:

- The property cannot be purchased from a related person in certain situations.
- The replacement property must be similar or related use-property.
- The property must be acquired within the replacement period.

Buying Replacement Property from a Related Person

A taxpayer cannot postpone reporting a gain from a casualty or theft if the taxpayer buys the replacement property from a related person.
(discussed later). This rule applies to the following taxpayers [§1033(i)(2)]:

- C corporations.
- Partnerships in which more than 50% of the capital or profits interest is owned by C corporations.
- All others (including individuals, partnerships, other than those in (2), and S corporations) if the total realized gain for the tax year on all destroyed or stolen properties on which there are realized gains is more than $100,000.

For casualties and thefts described in (3) above, gains cannot be offset by any losses when determining whether the total gain is more than $100,000. If the property is owned by a partnership, the $100,000 limit applies to the partnership and each partner. If the property is owned by an S corporation, the $100,000 limit applies to the S corporation and each shareholder.

The related party rule also does not apply if the related person acquired the property from an unrelated person within the period of time allowed for replacing the destroyed or stolen property. A related party is defined under §267(b) or §707(b)(1).

The code defines the replacement property as property similar or related in service or use to the property damaged or stolen. The taxpayer is not required to use the actual reimbursement to purchase the replacement property just that the replacement property is of equal or greater FMV then the reimbursement [Reg. §1.1033(a)-2(c)].

<table>
<thead>
<tr>
<th>If the taxpayer is an</th>
<th>Similar or related in service or use means:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner-user.</td>
<td>Replacement property must function in the same way as the property it replaces.</td>
</tr>
</tbody>
</table>
| Owner-investor.      | Replacement property must have a similar relationship of services or uses to the taxpayer as the property it replaces. Some factors for determining a similar relationship are the following:
  - Whether the properties are of similar service to the taxpayer.
  - The nature of the business risks connected with the properties.
  - What the properties demand of the taxpayer in the way of management, service, and relations to the tenants. |
If the destroyed business or income-producing property was located in a **Presidentially declared disaster area**, any tangible replacement property acquired for use in any business is treated as similar or related in service or use to the destroyed property [§1033(h)(2)].

The replacement property can also be in the form of acquiring a controlling interest in a corporation that owns property similar or related in service or use to the damaged, destroyed, or stolen property. A controlling interest means ownership of at least 80% of the combined voting power of all classes of voting stock and at least 80% of the total number of shares of all other classes of stock. There will also be basis adjustments to the corporation’s assets. Check §1033(b)(3) for instructions on how these adjustments are applied.

**Basis of Replacement Property**

The general rule is that the basis of the replacement property is reduced by the amount of postponed gain. The gain is only deferred until the subsequent sale of the replacement property. The formula to compute the new basis is:

Original adjusted basis
minus any proceeds/reimbursements
plus any money spent (including any proceeds/reimbursements and/or new loans).

**Example:** A fire destroyed a rental home. The insurance company reimbursed the owner $67,000 for the property, which had an adjusted basis of $62,000. This caused the owner to have a gain of $5,000 from the casualty. He constructed another rental home for $110,000 within the replacement period to postpone the gain. The new basis would be $105,000 ($62,000 cost - $67,000 insurance proceeds + $110,000 money spent to replace).
**Replacement Period**
To postpone reporting gain, the taxpayer must acquire replacement property within a specified period of time. This is the replacement period.

<table>
<thead>
<tr>
<th>The replacement period begins:</th>
<th>The replacement period ends:</th>
</tr>
</thead>
<tbody>
<tr>
<td>On the date the property was damaged, destroyed, or stolen [§1033(a)(2)(B)].</td>
<td>Two years after the close of the first tax year in which any part of the gain is realized [§1033(a)(2)(B)(i)].</td>
</tr>
</tbody>
</table>

**Example:** In what year does the replacement period end?

David owned a vacation home with a cost basis of $100,000. It was destroyed by a storm in July of 2004. The insurance company agreed to pay him $150,000 to rebuild the home. Here is a schedule of the insurance proceeds:

- In 2004 a payment of $25,000;
- In 2005 a payment of $75,000;
- In 2006 the final payment of $50,000.

Did the replacement period end in 2006, 2007, or 2008?

The replacement period ends in 2008 because that was two years after the close of the year in which a gain would have been realized. The payments prior to 2006 were less than his basis in the property so no gain would have been realized [Conlorez Corp, (1968) 51 TC 467, acq; Stewart & Co, R.A., (1971) 57 TC 122; Engelstein, David Est, (1977) TC Memo 1977-219; Rentz, Marion, (1977) TC Memo 1977-13].
Note: It is important to track partial payments because as soon as one of the payments exceeds the cost basis, the replacement property must be acquired within two years. It doesn’t matter if not all the payments have been received within those two years. If this is the situation, an extension of the replacement period can be requested as discussed later.

The chart below shows two special situations that are exceptions to the general rule.

<table>
<thead>
<tr>
<th>Situation</th>
<th>The replacement period ends:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Main home in Presidentially declared disaster area.</td>
<td>4 years after the close of the first tax year in which any part of the gain is realized.</td>
</tr>
<tr>
<td>Property in the Hurricane Katrina disaster area. (This 5-year replacement period applies only if substantially all of the use of the replacement property is in the Hurricane Katrina disaster area).</td>
<td>5 years after the close of the first tax year in which any part of the gain is realized.</td>
</tr>
</tbody>
</table>

What the does the term acquire mean: The regulations use the term “purchase” to define the term “acquire” [Reg. §1.1033(a)-2(c)]. If the taxpayer purchases the property in a bona fide purchase, where title passes, and later has the property repossessed it will qualify as purchase [Ruud, Bert, (1969) TC Memo 1969-252]. Property acquired via gift or inheritance does not qualify.

While there is not any guidance, it appears that replacement property could be acquired before the casualty as long as it was held at the time the reimbursement was received [§1033(a)(2)(A)(i)]. The property would still need to meet the similar or related uses test to qualify. It would be advisable to request a private letter ruling if your client has this situation, given the lack of guidance.

However, an advance payment made to a contractor to repair damaged property is not considered acquiring replacement property unless the work is finished before the replacement period ends (Rev. Rul. 56-543).
Extension of the Replacement Period

A taxpayer can request an extension of the replacement period if he applies to the district director of the Internal Revenue Service for the taxpayer’s area [Reg. §1.1033(a)-2(c)(3)]. The regulations use the term “district director” which no longer exists. Unfortunately, there are no other update procedures for making this request. It is recommended that the request be made following the procedures under Notice 2003-19 for other types of elections.

The request will be approved where there is reasonable cause for not making the replacement within the regular deadline. The high market value or scarcity of replacement property is not sufficient grounds for granting an extension. If the replacement property is being constructed and the taxpayer clearly shows that the construction cannot be completed within the replacement period, the taxpayer may be granted an extension of the period (IRS Publication 547).

The request should be filed at the end of the replacement period or within a reasonable time after the end of the replacement period. Ordinarily, requests for extensions are not made or granted until near the end of the replacement period or the extended replacement period. If approved extensions are usually limited to a period of not more than one year.

Electing to Postpone a Gain

The election to postpone the gain under §1033 is made in the year that taxpayer would have realized gain. If a partnership or a corporation owns the stolen or destroyed property, only the partnership or corporation can choose to postpone reporting the gain.

The IRS prescribed method is to file a statement with the return making the election. However, the fact that gain was not reported on the tax return would be considered a deemed election to postpone the gain [Reg. §1.1033(a)-2(c)(2)].
This statement must include the following information:

- The date and details of the casualty or theft.
- The insurance or other reimbursement received from the casualty or theft.
- A computation of the gain.

In addition to the required information above, the statement must include the following information depending on when the replacement property will be acquired.

<table>
<thead>
<tr>
<th>Date replacement property acquired</th>
<th>Additional information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before return filed</td>
<td>Detailed information about:</td>
</tr>
<tr>
<td></td>
<td>■ The replacement property.</td>
</tr>
<tr>
<td></td>
<td>■ The postponed gain.</td>
</tr>
<tr>
<td></td>
<td>■ The basis adjustment that reflects the postponed gain.</td>
</tr>
<tr>
<td></td>
<td>■ Any gain being reported as income.</td>
</tr>
<tr>
<td>After return filed</td>
<td>A statement that it is the taxpayer’s intent to defer the gain under §1033 must be attached to the return.</td>
</tr>
<tr>
<td></td>
<td>A second statement must be attached to the return in the year the taxpayer acquires the replacement property. This statement should contain detailed information on:</td>
</tr>
<tr>
<td></td>
<td>■ The replacement property.</td>
</tr>
<tr>
<td></td>
<td>■ The postponed gain.</td>
</tr>
<tr>
<td></td>
<td>■ The basis adjustment that reflects the postponed gain.</td>
</tr>
<tr>
<td></td>
<td>■ Any gain being reported as income.</td>
</tr>
<tr>
<td></td>
<td>If the taxpayer acquires part of the replacement property in one year and part in another year, the taxpayer must make a statement for each year. The statement should contain detailed information on the replacement property bought in that year.</td>
</tr>
</tbody>
</table>

Once qualified replacement property has been designated by the taxpayer as replacement property, in a statement attached to the tax return, it cannot later be substituted for other qualified replacement property. This is true even if the substituted property is acquired within the replacement period. However, if the taxpayer discovers that the original replacement property was not qualified replacement
property, the taxpayer can (within the replacement period) substitute the new qualified replacement property (Rev. Rul. 83-39).

**Note:** If the election is made to postpone the gain and the taxpayer either fails to acquire replacement property or does not spend the entire reimbursement, an amended return must be done to report the gain and pay any additional tax due. A taxpayer who fails to make the election and reports the gain can, within the statute of limitations, amend the return (if all the requirements are met under §1033) to request a refund of the taxes paid on the deferred gain.

If a taxpayer dies after having a gain but before buying replacement property, the gain must be reported for the year in which the decedent realized the gain. The executor of the estate or the person succeeding to the funds from the casualty or theft cannot postpone reporting the gain by buying replacement property.

**Reporting From a Pass Through Entity**

An S corporation or partnership does not report a casualty or theft gain or loss at the entity level. The gain or loss is passed through to the shareholders or partners via the K-1. If there was a gain (loss) from a casualty or theft to property not used in a trade or business or for income-producing purposes by either a partnership or corporation, notify the shareholder or partner. The corporation or partnership should not complete Form 4684 for this type of casualty or theft. Instead, each shareholder or partner will complete his or her own Form 4684.

Partnerships (other than electing large partnerships) and S corporations that have a casualty or theft involving property for which the section 179 expense deduction was previously claimed and passed through to the partners or shareholders must not use Form 4684 to report the transaction. Instead, see the Instructions for Form 4797 for details on how to report. Partners and S corporation shareholders who receive a Schedule K-1 reporting such a transaction
should review the Instructions for Form 4797 for details on how to figure the amount to enter on Form 4684, Line 20.

**Disaster Area Losses**

A Presidentially declared disaster is a disaster that occurred in an area declared by the President to be eligible for federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. A list of the areas warranting assistance under the Act is available at the Federal Emergency Management Agency (FEMA) web site at [www.fema.gov](http://www.fema.gov).

If a taxpayer has a casualty loss in the current year from a disaster that occurred in a Presidentially declared disaster area, the taxpayer can choose to deduct that loss on the current year tax return or on an amended return for the tax year immediately preceding the tax year in which the disaster happened [§165(i)].

**Example:** Donna is a calendar year taxpayer. A flood damaged her home in 2008. The flood damaged or destroyed a considerable amount of property in her town. The President declared the area that includes her town a federal disaster area as a result of the flood. She can choose to amend her 2007 return to deduct the flood loss on her home or claim the loss on her 2008 tax return.

The choice to take the casualty loss for the disaster in the preceding year must be made by the later of the following dates:

- The due date (without extensions) for filing the income tax return for the tax year in which the disaster actually occurred.
- The due date (with extensions) for filing the return for the preceding tax year.

**Example:** A calendar year taxpayer has until April 15, 2010 to amend the 2008 tax return to claim a casualty loss that occurs during 2009.
Regardless of whether the taxpayer elects to deduct the loss on the current year return or on an amended return a statement should be attached stating which year the loss will be taken. The statement should specify the date or dates of the disaster and the city, town, county, and state where the damaged or destroyed property was located at the time of the disaster.

This election can only be revoked within 90 days of making the election. Any refunds made must be returned to the IRS [Reg. §1.165-11(e)].

To claim the loss in a prior year, an amended return must be filed if that year has already been filed. The loss will be figured under the normal rules for reporting a casualty loss regardless if claimed in the current year or on an amended return.


In general, the *National Disaster Relief Act* provides the following tax benefits:

- Allows all taxpayers, not just those who itemize, to claim the casualty loss deduction regardless of the taxpayer’s adjusted gross income level.

- Increases the amount by which all individual taxpayers must reduce their personal casualty losses from each casualty from $100 to $500 for taxable years beginning after December 31, 2008. The reduction amount returns to $100 for taxable years beginning after December 31, 2009.

- Removes the requirement that the net casualty loss deduction be allowed only if the casualty loss exceeds 10 percent of the taxpayer’s adjusted gross income.

- Provides a five-year net operating loss (NOL) carryback for qualified natural disaster losses.

- Waives certain mortgage revenue bond requirements for affected taxpayers and allows the bond proceeds to be used for rebuilding.

For business taxpayers, the Act also:

- Allows an affected business taxpayer to deduct certain qualified disaster cleanup expenses.

- Allows an affected business taxpayer to deduct 50% of the cost of qualifying property in addition to the regular depreciation allowance that is normally available.
Increases the limits that an affected business taxpayer can expense for qualifying §179 property.

**Note:** The following changes to the law do not apply to the casualty losses in the Midwestern disaster areas declared during the period beginning on May 20, 2008, and ending on July 31, 2008.

The *National Disaster Relief Act* allows taxpayers to deduct qualified disaster expenses in the tax year paid or incurred. Qualified disaster expenses consist of expenditures paid or incurred in connection with a trade or business or with business-related property that otherwise must be capitalized:

- For the abatement or control of hazardous substances that were released on account of a federally declared disaster.
- Debris removal or demolition of structures on real property damaged or destroyed by a federally declared disaster.
- For the repair of business-related property damaged by a federally declared disaster.

Normally, a net operating loss (NOL) is carried back two years and carried forward 20 years. The *National Disaster Relief Act* allows taxpayers to carry back a qualified disaster loss five years. A qualified disaster loss is the lesser of the taxpayer’s net operating loss for the taxable year or the sum of the following:

- The taxpayer’s losses allowable under §165 for the taxable year attributable to a federally declared disaster occurring before January 1, 2010, and occurring in a disaster area; and
- The taxpayer’s deduction for the taxable year for qualified disaster expenses allowable under §198A(a) or the amount that would have been allowable if the taxpayer deducted qualified disaster expenses.

A qualified disaster loss is treated as a net operating loss that is separate from the taxpayer’s regular NOL.

The Act also includes a provision that allows taxpayers to disregard the five-year carryback rule for their qualified disaster loss. In addition, an exception is provided to the general rule that a taxpayer may use an
The alternative minimum tax (AMT) net operating loss deduction to offset only 90% of the taxpayer’s alternative minimum taxable income. The 90% limit does not apply to the portion of the AMT net operating loss deduction attributable to a qualified disaster loss.

The National Disaster Relief Act provides a special 50% depreciation allowance for purchases of qualified disaster assistance property. It allows taxpayers to deduct 50% of the cost of qualified disaster assistance property in addition to the regular depreciation allowance that is normally available.

This new special “bonus depreciation” allowance applies to most types of tangible personal property and computer software acquired on or after the date on which the federally declared disaster occurs, and placed in service on or before December 31 of the third year following the date on which the federally declared disaster occurs. The new bonus depreciation allowance applies to most nonresidential real property and residential rental property.

In addition, 80% or more of the use of the property must be in the disaster area and in the active conduct of a trade or business by the taxpayer in that disaster area. Also, the property owner must rehabilitate property damaged or replace property destroyed, or condemned, as a result of the federally declared disaster. It must be similar in nature to and located in the same county as the property being rehabilitated or replaced.

The following table explains the tax consequences of various grants received by taxpayers in a disaster area.
<table>
<thead>
<tr>
<th>Grant</th>
<th>Tax Consequences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relief grants under Robert T. Stafford Disaster Relief and Emergency Assistance Act</td>
<td>Do not include these grants in income if the grant payments are made to help the taxpayer meet necessary expenses or serious needs for medical, dental, housing, personal property, transportation, or funeral expenses. Do not deduct casualty losses or medical expenses to the extent they are specifically reimbursed by these disaster relief grants. Unemployment assistance payments under the Act are taxable unemployment compensation.</td>
</tr>
<tr>
<td>State disaster relief grants for businesses</td>
<td>A grant that a business receives under a state program to reimburse businesses for losses incurred for damage or destruction of property because of a disaster is not excludable from income under the general welfare exclusion, as a gift, as a qualified disaster relief payment, or as a contribution to capital. However, the business can choose to postpone reporting gain realized from the grant under §1033 discussed earlier.</td>
</tr>
<tr>
<td>Qualified disaster relief payments</td>
<td>Qualified disaster relief payments are not included in the income of individuals to the extent any expenses compensated by these payments are not otherwise compensated for by insurance or other reimbursement. Qualified disaster relief payments include payments received (regardless of the source) for the following expenses. Reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a Presidentially-declared disaster. Reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence due to a Presidentially declared disaster. (A personal residence can be a rented residence or one the taxpayer owns.) Reasonable and necessary expenses incurred for the repair or replacement of the contents of a personal residence due to a Presidentially declared disaster. Qualified disaster relief payments also include amounts paid to those affected by the disaster by a federal, state, or local government in connection with a Presidentially declared disaster. Qualified disaster relief payments do not include: Payments for expenses otherwise paid for by insurance or other reimbursements, or Income replacement payments, such as payments of lost wages, lost business income, or unemployment compensation.</td>
</tr>
<tr>
<td>Grant</td>
<td>Tax Consequences</td>
</tr>
<tr>
<td>-------------------------------------------</td>
<td>------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Qualified disaster mitigation payments</td>
<td>Qualified disaster mitigation payments made under the <em>Robert T. Stafford Disaster Relief and Emergency Assistance Act</em> or the <em>National Flood Insurance Act</em> (as in effect on April 15, 2005) are not included in income. These are payments a property owner receives to reduce the risk of future damage to the property. The taxpayer cannot increase the basis in the property, or take a deduction or credit, for expenditures made with respect to those payments.</td>
</tr>
<tr>
<td>Sale of property under hazard mitigation program</td>
<td>These payments are treated as a sale of the property which cannot be excluded unless it relates to the principal residence and §121 (home sale exclusion) applies. The taxpayer can elect to postpone reporting the gain under §1033 (as discussed earlier), the sale or transfer of property to the federal government, a state or local government, or an Indian tribal government under a hazard mitigation program.</td>
</tr>
</tbody>
</table>

**TAX CREDITS**

The rehabilitation, low income housing, and disabled access credits are included with other credits that comprise the investment credit, which in turn is one of the credits comprising the "general business credit" (GBC). The GBC is limited to the taxpayer’s “net regular tax” [regular tax less the credits allowed by §§21–30D (nonrefundable personal credits, foreign tax credit, nonconventional source fuel credit, credit for qualified electric vehicles, and Puerto Rico economic activity credit)], plus AMT, less the larger of:

- The tentative minimum tax (from Form 6251, *Alternative Minimum Tax—Individuals*).  
- 25% of the net regular tax in excess of $25,000 (or $12,500 for married persons filing separate returns).

The at-risk rules apply and may limit the amount of rehabilitation, low income housing, and disabled access credits that can be claimed.

The passive activity rules may also apply. An equivalent of a $25,000 deduction (phased out for AGI in excess of $200,000 for the rehabilitation credit) is available without regard to participation for rental real estate. Individuals use Form 8582-CR to calculate the
allowable rehabilitation, low income housing, and disabled access credits for a passive activity.

Credits subject to the passive activity rules are allowed only to the extent of the regular tax liability attributable to all passive activities, with the disallowed amount carried forward to future tax years. However, unlike suspended passive losses, unused passive credits cannot be claimed in the year the activity is disposed of. However, taxpayers can elect to increase their basis in the passive activity by the amount of unused passive activity rehabilitation, low income housing, and disabled access credits when determining gain or loss on disposition.

**Rehabilitation Credit**

A rehabilitation investment credit (RIC) is allowed for “qualified rehabilitation expenditures” incurred to rehabilitate and modernize “qualified rehabilitated buildings”, and to rehabilitate “certified historic structures” (§47).

The RIC can be claimed for expenses incurred to rehabilitate older buildings used for nonresidential purposes, or certified historic structures (CHSs) used for residential or nonresidential purposes [§50(b)(2)]. In addition, the property must be subject to depreciation (i.e., be income-producing) [§47(c)(1)(A)(iv)]. Therefore, a personal residence does not qualify for the credit.

The RIC applies to investment in a “qualified rehabilitated building” (QRB) attributable to “qualified rehabilitation expenditures” (QRE) [§47(c)]. A building that is not a CHS must be placed in service before 1936 to qualify.

The credit is generally claimed in the year the QRB is placed in service (after rehabilitation is completed).

The RIC is computed by applying a percentage to the portion of the taxpayer’s basis in a QRB attributable to the QRE. The percentage for property placed in service after 1986 is:

- 10% (13% for structures in the Gulf Opportunity Zone for expenditures after August 27, 2005, and before January 1, 2009) of QRE for a QRB other than a CHS; or
■ 20% (26% for structures in the Gulf Opportunity Zone for expenditures after August 27, 2005, and before January 1, 2009) of QRE for a QRB that is a CHS.

The owner’s basis in the building is reduced by the RIC (even if the full amount cannot be claimed in the current year).

As part of the investment credit, the RIC is claimed on Form 3468, Investment Credit. A statement should be attached to the return indicating:
■ The beginning and ending dates of the 24-month or 60-month measuring period,
■ The adjusted basis of the building at the beginning of the measuring period, and
■ QRE incurred during the measuring period.

To be eligible for the rehabilitation credit, the taxpayer must incur specified minimum rehabilitation expenditures within a selected 24-month period. For rehabilitations completed in phases, a 60-month period is substituted for the 24-month period, in the above rule. However, this completion-in-phases rule is available only if the rehabilitation can reasonably be expected to be completed in phases that are set forth in architectural plans and specifications that are completed before the rehabilitation begins.

In addition, if the RIC is being claimed on a CHS, a copy of the National Park Service (NPS) certification of completed work must be attached to the return, and the NPS number must be entered on Form 3468. If the credit is passed through from a partnership or S corporation, the identification number of the pass-through entity should be listed on Form 3468.

Partners and S shareholders use information in the “Credits” section of the Schedule K-1 to prepare their own Form 3468. The pass-through entity should list RICs separately on an attached statement if from two or more rental real estate activities. Partners and S shareholders should list the name, address, and identification number of the pass-through entity on their Form 3468.

Rehabilitation credits from rental real estate activities may offset an amount of tax attributable to up to $25,000 of income without any requirement of active participation by the taxpayer. However, the ability to use the rehabilitation credit against this special allowance is subject to phase-out when modified AGI exceeds $200,000.
If there is a general business credit (GBC) in addition to the RIC, or a carryback or carryforward of the GBC, or if the RIC is from a passive activity, the RIC is carried to Form 3800, General Business Credit, then from Form 3800 to Form 8582-CR, Passive Activity Credit Limitations.

The carryback period for unused GBC is one year and the carryforward period is 20 years. The full amount of any RIC remaining unused at the end of the carryover period can be deducted in the following year [§196(a)].

The RIC is subject to a five-year recapture rule. The RIC is recaptured if the building is disposed of, a partner or S shareholder disposes of a substantial part of his interest, or there is a reduction in the amount at risk. The amount recaptured is reduced 20% for each year the building is held, so the RIC is no longer subject to recapture once the building has been held for five years. Recapture of the RIC is reported on Form 4255, Recapture of Investment Credit. Partners and S shareholders use the “Recapture of Credits” section of the Schedule K-1 to prepare Form 4255.

Effective for qualified expenses taken into account after December 31, 2007, the American Housing Rescue and Foreclosure Prevention Act of 2008 allows the rehabilitation tax credit to be used to offset the AMT.

Low Income Housing Credit

The low-income housing credit (LIHC) is authorized by §42. It can be claimed by owners of new or substantially rehabilitated residential property for a 10-year period, in connection with units or buildings that are part of a low-income housing project. To qualify for the credit, the housing project must have a certain percentage of residential units that are both rent restricted and occupied by tenants whose income is a certain percentage lower than the median gross income of the geographical area. The credit is designed to compensate the owner of the project for the reduced rents charged to the low-income tenants.

The owner’s basis in the property for depreciation purposes is not affected by the LIHC claimed.

The allocation of tax credits to housing projects is a competitive process. State allocation agencies must evaluate each application for allocation of tax credits to determine the best use of the available tax credits and ensure that the amount of tax credits allocated does not
exceed what is necessary for the financial feasibility of the project. Once allocated by the state allocation authority, the credit flows annually over a 10-year period beginning with the tax year the project is placed in service.

The credit is determined based on the percentage of the building dedicated to low-income tenants and the cost basis of the new, existing, or rehabilitated building. IRC §42(a) provides that the credit for a property is the “applicable percentage” multiplied by the “qualified basis of each qualified low-income building.”

The applicable percentage is a percentage that yields a present value over the 10-year credit period equal to:

- 30% of the qualified basis of the building for acquisitions of existing buildings, for Federally subsidized new construction or rehabilitation, and for which financing involves tax-exempt bonds or below-market rate Federal loans, or
- 70% of the qualified basis of the building for newly constructed buildings and for rehabilitations that are not Federally subsidized.

Under §42(c)(1), qualified basis is the applicable fraction multiplied by the eligible basis.

The applicable fraction is the lesser of the ratio of:

- Low-income units to residential units (unit fraction) or
- The low-income units’ floor space to total residential rental unit floor space (floor space fraction). For most LIHTC projects, the applicable fraction is 100% since the entire project is dedicated to qualified low-income tenants.

Eligible basis under §42(d) for a new building generally is development costs less the costs of the land. Eligible basis is reduced, however, by Federal grants [§42(d)(5)(A)]. Loans from the Community Development Block Grant (CDBG) program and HOME Investment Partnerships Program (HOME) are not treated as Federal subsidies, however. Furthermore, a recipient of a Federal grant such as a local government could make those funds available to a developer as a market-rate loan so that the funds would be treated as neither a Federal subsidy nor grant (PLR 8813024).

For an existing building, eligible basis is the sum of acquisition costs and improvements if the building was not placed in service or substantially improved during the preceding 10 years (unless it qualifies for a waiver). Furthermore, tax credits are available for the
acquisition of an existing building only if credits for rehabilitation are also allocated to that building.

A qualified low-income housing project must also meet two minimum set-aside requirements in §42(g), for income and gross rent, and continue to satisfy them over the subsequent 15 years (the “compliance period”).

To meet the income test, the project owner must irrevocably elect one of two income levels and comply with it by the end of the first year of the credit period:

- The 20-50 test. At least 20% of the units are occupied by individuals whose income is 50% or less of the area’s median gross income, adjusted for family size.
- The 40-60 test. At least 40% of the units are occupied by individuals whose income is 60% or less of the area’s median gross income, adjusted for family size.

To meet the gross rents test, rents must not exceed 30% of the area’s median gross income, adjusted for family size, determined using 1.5 persons per bedroom. Federal, state, or local agency rental assistance is not rent paid by the tenant, but utility allowances are included.

Annual certifications of compliance are required under §42(1), and state agencies must make site visits to review documentation of income verifications and to monitor tenant eligibility.

De minimis increases in a tenant’s income are permitted, but if the tenant’s income is greater than 140% of the maximum qualifying income the next available unit must be rented to a qualified low-income tenant. Vacant units may continue to be treated as occupied by qualifying tenants if reasonable attempts are made to rent the unit to qualifying individuals and no other units of comparable or smaller size are rented to nonqualifying tenants.

An additional 15-year extended-use period is required, under §42(h)(6), subsequent to the initial 15-year compliance period. Tax credits are not available during this period. Therefore, to ensure compliance, the project owner is required to enter into an “extended low-income housing commitment.” This commitment must be in effect as of the end of the year in which the tax credits are taken. The extended low-income housing commitment establishes a minimum applicable fraction for the extended-use period, is binding on all successors of the taxpayer, and is recorded as a restrictive covenant.
At the end of the 15-year compliance period, the taxpayer may submit a request to the housing credit agency to find a person to acquire the project. The agency has one year to find a suitable buyer who will tender a qualified contract and maintain the project throughout the extended-use period. If not, the extended-use period is terminated. A qualified contract provides for a purchase price equal to the outstanding debt secured by the property, adjusted for investor equity and capital contributions.

Under §42(j), the penalty for noncompliance is recapture of the accelerated portion of the credit plus interest for all years the credit was taken. A tax credit project is in noncompliance when the qualified basis decreases from the previous year or, for example, the number of qualified low-income units decrease or there is a change in ownership. The accelerated portion of the tax credit (credit taken over 10 years but the project must comply over a 15-year period) is one-third of the credit previously claimed during the first 11 years, decreasing to one-fifteenth in year 15. A change in ownership is generally a recapture event unless the seller posts a bond with the Treasury assuring continued compliance.

Form 8586, *Low-Income Housing Credit*, is filed to claim the LIHC each year during the 10-year credit period. In addition, Form 8609, *Low-Income Housing Credit Allocation Certification*, and Schedule A of Form 8609 are both filed each year during the 15-year compliance period.

Low-income housing credits from rental real estate activities may, like rehabilitation credits, offset an amount of tax attributable to up to $25,000 of income without any requirement of active participation by the taxpayer. However, for the low-income housing credit, the $25,000 special allowance is not subject to any AGI phase-out for property held directly if it is placed in service after 1989 or, for property held indirectly through a pass-through entity such as a partnership or S corporation, if the interest was acquired after 1989.

Part I of Form 8609 is used to obtain the credit allocation from the state agency and is completed by the agency. Part II and Schedule A of Form 8609 are completed by the owner to certify the information necessary to claim the LIHC. Since the state agency fills out Part I only once, the completed Form 8609 should be photocopied by the owner and a copy filed annually.

If there is a GBC in addition to the LIHC, or a carryback or carryforward of the GBC, or if the LIHC is from a passive activity, the LIHC is carried to Form 3800, *General Business Credit*, then from Form
Investors claiming the LIHC through a pass-through entity (partnership or S corporation) need not file Form 8609 or Schedule A of Form 8609, which is attached to the entity’s return. The investor’s LIHC is carried from the “Credits” section of Schedule K-1 to Form 8586 and from there to Form 1040, or to Form 3800, per the above rules.

Recapture of the LIHC is reported on Form 8611, *Recapture of the Low-Income Housing Credit*. If recapture is through a pass-through entity, the recapture amount is carried from the “Recapture of Credits” section of the Schedule K-1 to Form 8611.

The *American Housing Rescue and Foreclosure Prevention Act of 2008* now allows the low-income housing credit to be used to offset AMT tax liability. The provision is effective for buildings placed in service after December 31, 2007.

**Disabled Access Credit**

Eligible businesses that make themselves accessible to persons with disabilities can claim a §44 nonrefundable disabled access credit. If this credit is used, the taxpayer must reduce the amount deducted or capitalized by the amount of the credit.

The credit applies only to “eligible small businesses” for “eligible access expenditures” paid or incurred in connection with a facility placed in service before November 6, 1990.

To qualify as an eligible small business, a business must have either:

- Gross receipts (reduced by returns and allowances) for the prior year of $1 million or less, or
- Employed 30 or fewer full-time employees during the prior year. An employee is considered full-time if employed at least 30 hours per week for 20 or more weeks.

Eligible access expenditures must be reasonable and necessary and incurred to remove barriers that prevent access or use of a building by disabled individuals, or to provide various equipment and devices to make auditory and visual materials more available to impaired individuals to comply with the *Americans with Disabilities Act* [§44(c)].
The credit is equal to 50% of the eligible access expenditures for the year that exceed $250, but do not more than $10,250. Thus, the maximum credit is $5,000 in any one year. The limitation of the credit to expenditures of $10,250 is applied at both the partnership and the partner level. The same is true for S corporations and shareholders.

The carryback period for an unused disabled access credit is one year and the carryforward period is 20 years.

If this credit is claimed, no deduction, credit, or increase in basis is allowed under any other provision of the Code for the amount of the credit allowed.

**Reforestation Costs**

Reforestation costs are generally capital expenditures. However, property owners can elect to deduct up to $10,000 ($5,000 if married filing separately; $0 for a trust) of qualifying reforestation costs paid or incurred after October 22, 2004, for each qualified timber property.

The remaining costs are amortized over an 84-month period, beginning on the first day of the first month of the second half of the tax year the costs are incurred (July 1 for a calendar year taxpayer), regardless of the month the costs are actually incurred. Owners can claim amortization deductions for no more than six months of the first and last (eighth) tax years of the period.

Qualifying reforestation costs are the direct costs of planting or seeding for forestation or reforestation. Reforestation costs are the direct costs of planting or seeding for forestation or reforestation. Qualifying costs include only those costs that must be capitalized and included in the adjusted basis of the property. They include costs for:

- Site preparation.
- Seeds or seedlings.
- Labor.
- Tools.
- Depreciation on equipment used in planting and seeding.

Qualifying costs do not include costs for which the government reimburses the owner under a cost-sharing program, unless the reimbursement is included in income.
Qualified timber property is property that contains trees in significant commercial quantities. It can be a woodlot or other site the taxpayer owns or leases. The property qualifies only if it meets all the following requirements:

- It is located in the United States.
- It is held for the growing and cutting of timber the owner will either use in, or sell for use in, the commercial production of timber products.
- It consists of at least one acre planted with tree seedlings in the manner normally used in forestation or reforestation.

Qualified timber property does not include property on which shelter belts or ornamental trees, such as Christmas trees, have been planted.

To elect to amortize qualifying reforestation costs, the taxpayer completes Part VI of Form 4562 and attaches a statement that contains the following information:

- A description of the costs and the dates you incurred them.
- A description of the type of timber being grown and the purpose for which it is grown.

A separate statement is attached for each property for which reforestation costs are to be amortized.

The election to deduct qualifying reforestation costs is made by claiming the deduction on a timely filed income tax return (including extensions) for the tax year the expenses were paid or incurred. However, if a return was timely filed without making the election, the election can still be made by filing an amended return within six months of the due date of the return (excluding extensions). The taxpayer must clearly indicate the election on the amended return and write “Filed pursuant to §301.9100-2.” The election applies when computing taxable income for the current tax year and all subsequent years.

This deduction may have to be recaptured as ordinary income under §1245 when the owner sells or otherwise disposes of the property that would have received an addition to basis if the election had not been made.

IRS approval is required to revoke the election to amortize qualifying reforestation costs. An application to revoke the election must include the taxpayer’s name, address, the years for which the election was in effect, and the reason for revoking it. The taxpayer, or a duly
authorized representative, must sign the application and file it at least 90 days before the due date (without extensions) for filing the income tax return for the first tax year for which the election is to end. The application is sent to:

Internal Revenue Service
Associate Chief Counsel
Passthroughs and Special Industries
CC:PSI 1111
Constitution Ave., N.W., IR-5300
Washington, DC 20224

Home Mortgage Interest Credit (§25)

The mortgage interest credit is intended to help lower-income individuals afford home ownership. Qualifying taxpayers claim the credit each year for part of the home mortgage interest paid if they obtain a Mortgage Credit Certificate (MCC).

An MCC can only be used for new or existing single-family homes including single family detached homes, condominiums, duplexes, townhouses, or manufactured houses. Triples and four-plexes do not qualify as eligible structures.

MCCs can be used with conventional, fixed-rate or adjustable rate loans; FHA and VA loans; and privately insured loans. MCCs are not available with tax-exempt bond backed loans such as the Mortgage Revenue Bond program that can carry a below-market fixed interest rate.

A first-time homebuyer may use the tax credit provided by the MCC as long as he/she lives in the home as his/her principal residence.

To be eligible for the credit, the taxpayer must get an MCC from his or her state or local government. Generally, an MCC is issued only in connection with a new mortgage for the purchase of a primary residence. The MCC shows the certificate credit rate to be used to figure the credit. It also shows the certified indebtedness amount. Only the interest on that amount qualifies for the credit. A taxpayer must contact the appropriate government agency, or state or local housing finance agency about getting an MCC before getting a mortgage and buying a home.
If deductions are itemized on Schedule A (Form 1040), the home mortgage interest deduction is reduced by the amount of the mortgage interest credit shown on Form 8396, *Mortgage Interest Credit*, line 3, even if part of that amount is to be carried forward to the following tax year.

**Example:** Felicity bought a home this year. Her mortgage loan is $125,000. The certified indebtedness amount on her MCC is $100,000. She paid $7,500 interest this year. Emily figures the interest to enter on Form 8396, Line 1, as follows:

\[
\frac{100,000}{125,000} = 80\% \times .80
\]

\[
7,500 \times .80 = 6,000
\]

Emily enters $6,000 on Form 8396, Line 1. In each later year, she will figure her credit using only 80% of the interest she pays for that year. The fraction will not change as long as you are entitled to take the mortgage interest credit.

Two limits may apply to the credit:
- A limit based on the credit rate, and
- A limit based on the individual’s tax.

If the certificate credit rate is higher than 20%, the credit cannot be more than $2,000.

The credit, after applying the limit based on the credit rate, generally cannot be more than the regular tax liability on Form 1040, plus any AMT on Form 1040, minus certain other credits. Form 8396 is used to figure this limit.

If two or more persons, other than a married couple filing a joint return, hold an interest in the home to which the MCC relates, the credit must be divided based on the interest held by each person.
Example: Gus Gunderson and his brother, Olaf, were issued an MCC. They used it to get a mortgage on their main home. Gus has a 60% ownership interest, and Olaf has 40%. Gus paid $5,400 mortgage interest this year and Olaf paid $3,600. The MCC shows a credit rate of 25% and a certified indebtedness amount of $130,000. The mortgage on their home is $120,000. The credit is limited to $2,000 because the credit rate is more than 20%.

Gus figures his credit by multiplying the $5,400 mortgage interest he paid this year by the certificate credit rate (25%) for a total of $1,350. His credit is limited to $1,200 ($2,000 × 60%).

Olaf figures the credit by multiplying the $3,600 mortgage interest he paid this year by the certificate credit rate (25%) for a total of $900. His credit is limited to $800 ($2,000 × 40%).

If the allowable credit is reduced because of the tax based limit, the unused portion of the credit can be carried forward to the next three years or until used, whichever comes first.

Example: Manuela received an MCC from State X. This year, her regular tax liability is $1,100, she owes no AMT, and her mortgage interest credit is $1,700. She claims no other credits. Her unused mortgage interest credit for this year is $600 ($1,700 − $1,100). She can carry forward this amount to the next three years or until used, whichever comes first.

If $2,000 limit applies because the certificate credit rate is more than 20%, the taxpayer cannot carry forward any amount more than $2,000 (or his or her share of the $2,000 if the credit must be divided).
Example: In the earlier example for dividing the credit, Gus and Olaf used the entire $2,000 credit. The excess $150 for Gus ($1,350 − $1,200) and $100 for Olaf ($900 − $800) cannot be carried forward to future years, despite the respective tax liabilities for Gus and Olaf.

If the original mortgage loan for which an MCC is given is refinanced, a new MCC must be obtained to be able to claim the credit on the new loan, and the amount of credit to be claimed on Form 8396, Line 1, on the new loan may change.

If an MCC is reissued and the amount of the new mortgage is smaller than or equal to the certified indebtedness amount on the new MCC, then the interest claimed is equal to all the interest paid during the year on the new mortgage.

If an MCC is reissued and the amount of the new mortgage is greater than the certified indebtedness amount on the new MCC, then the interest claimed is the interest paid during the year multiplied by the following fraction:

\[
\frac{\text{Certified indebtedness amount on the new MCC}}{\text{Original amount of the mortgage}}
\]

However, in either case the credit using the new MCC cannot be more than the credit using the old MCC.

In the year of refinancing, the applicable amount of interest paid on the old mortgage and the applicable amount of interest paid on the new mortgage are added, and the total is entered on Form 8396, Line 1.

If the new MCC has a credit rate different from the rate on the old MCC, a statement must be attached to Form 8396 showing the calculation for Lines 1, 2, and 3 for the part of the year when the old MCC was in effect, and a separate calculation for the part of the year when the new MCC was in effect.
If a home is bought after 1990 using an MCC and then sold within nine years, all or part of the benefit received from the MCC program are recaptured. The recapture of the federal mortgage subsidy applies only if both of the following conditions are met:

- The home is sold or otherwise disposed of:
  - At a gain, and
  - During the first nine years after the date of closing on the mortgage loan.
- The taxpayer’s income for the year of disposition is more than that year’s adjusted qualifying income for his or her family size for that year (related to the income requirements a person must meet to qualify for the federally subsidized program).

The recapture does not apply if any of the following situations apply:

- The mortgage loan was a qualified home improvement loan of not more than $15,000 ($150,000 if the loan was used to repair damage from Hurricane Katrina to a home in the hurricane disaster area),
- The home is disposed of as a result of death,
- The home was disposed of more than nine years after the date the mortgage loan was closed,
- The home was transferred to a spouse, or former spouse incident to a divorce, where no gain is included in income,
- The home is disposed of at a loss,
- The home is destroyed by a casualty, and repaired or replaced on its original site within 2 years after the end of the tax year when the destruction happened (within 5 years if the home was in the Hurricane Katrina disaster area and was destroyed by reason of the hurricane after August 24, 2005), or
- The mortgage loan was refinanced (unless the conditions listed previously under When the recapture applies are met).

The recapture tax is figured on Form 8828, Recapture of Federal Mortgage Subsidy. If a home is sold and the mortgage loan is subject to the recapture rules, Form 8828 is filed with Form 1040 even if there is no recapture tax.
**Farming and Ranching**

Many of the principles governing the tax treatment of farmland and ranches are the same as for other types of real estate, and are found elsewhere in this text. Only those issues peculiar to farms and ranches are discussed in this section.

**What Is A Farm?**

The business of farming includes cultivating, operating, or managing a farm for profit, either as owner or tenant. A farm includes stock, dairy, poultry, fish, fruit, truck farms, plantations, ranches, ranges, and orchards. A fish farm is an area where fish and other marine animals are grown or raised and artificially fed, protected, etc. It does not include an area where they are merely caught or harvested. A plant nursery is a farm for purposes of deducting soil and water conservation expenses.

Cultivating or operating a farm for recreation or pleasure, rather than for profit is not farming. You are not farming if you are engaged only in forestry or the growing of timber.

Rental payments from land you own based on farm production, either in cash or crop shares, are considered to be from the business of farming. If you receive a fixed rental payment not based on farm production, you are in the business of farming only if you materially participate in operating or managing the farm.

A farming operation is presumed to be engaged in for profit if it shows a profit for any two or more years in a period of five consecutive years unless IRS proves the contrary. If the activity consists in major part of breeding, training, showing or racing of horses the profit test is two out of seven consecutive years. If a farm is operated at a profit, the profit will be taxed regardless of whether the farm is run for pleasure or for profit.

**Not-for-Profit Farming**

All ordinary and necessary expenses of carrying on the business of farming are deductible on Schedule F if a farm is operated for profit. However, if it is not carried on to make a profit, the income is reported
on Line 21 of Form 1040 and the expenses are deductible only if deductions are itemized on Schedule A of Form 1040. Also, any losses cannot be used to offset income from other activities.

Activities that are a hobby, or mainly for sport or recreation, come under this limit, as do investment activities intended only to produce tax losses. The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

In determining whether a farming activity is carried on for profit, all the facts are taken into account. No one factor alone is decisive. Among the factors to consider are whether:

- The farm is operated in a businesslike manner,
- The time and effort spent on farming indicate an intent to make it profitable,
- You depend on income from farming for your livelihood,
- Losses are due to circumstances beyond the operator’s control or are normal in the start-up phase of farming,
- Methods of operation are changed in an attempt to improve profitability,
- The operator has the knowledge needed to carry on the farming activity as a successful business,
- Similar activities in the past were successful in making a profit,
- Some years result in a profit,
- The amount of profit made, and
- Whether a future profit can be expected from the appreciation of the assets used in the farming activity.

**Presumption of Profit**

A farming or ranching activity is presumed carried on for profit if it produced a profit in at least three of the last five tax years, including the current year. Activities that consist primarily of breeding, training, showing, or racing horses are presumed carried on for profit if they produced a profit in at least two of the last seven tax years, including the current year. If a taxpayer dies before the end of the 5-year (or 7-year) period, the period ends on the date of the taxpayer’s death. The activity must be substantially the same for each year within this
A profit is shown when the gross income from an activity is more than the deductions for it.

If the business or investment activity passes this 3- (or 2-) years-of-profit test, the limits discussed here do not apply. All the business deductions from the activity can be taken on Schedule F, even for the years there is a loss. If the 3- (or 2-) years-of-profit test is not passed, a farm may be considered to operate for profit by considering the factors listed above.

A new farm or ranch that does not have 3 (or 2) years showing a profit may want to take advantage of this presumption later, after it has had the 5 (or 7) years of experience allowed by the test.

This is done by filing Form 5213, Election to Postpone Determination As To Whether the Presumption Applies That an Activity is Engaged in for Profit. Filing this form postpones any determination that the activity is not carried on for profit until 5 (or 7) years have passed since the farming or ranching began. Form 5213 must be filed within 3 years after the due date of the return for the year in which you first carried on the activity, or, if earlier, within 60 days after receiving a written notice from the IRS proposing to disallow deductions attributable to the activity.

The benefit of making this choice is that the IRS will not immediately question whether the farming activity is engaged in for profit.

Accordingly, it will not limit the deductions. The farm will gain time to earn a profit in three (or two out of the first five (or seven) of its years. If a profit is shown for three (or two) years by the end of this period, deductions are not limited. If the farm does not have three (or two) years of profit (and cannot otherwise show that it was operated for profit), the limit applies retroactively to any year in the 5-year (or 7-year) period with a loss.

Filing Form 5213 automatically extends the period of limitations, for deductions of the activity and any related deductions that might be affected, on any year in the 5-year (or 7-year) period to 2 years after the due date of the return for the last year of the period.
Limit on Deductions and Losses

If the activity is not carried on for profit, deductions are allowed only in the following order, only to the extent stated in the three categories, and, for individuals, only itemized on Schedule A of Form 1040.

**Category 1**
Deductions that can be claimed for personal as well as for business activities are allowed in full. For individuals, all nonbusiness deductions, such as those for home mortgage interest, taxes, and casualty losses, belong in this category.

**Category 2**
Deductions that do not result in an adjustment to the basis of property are allowed next, but only to the extent gross income from the activity is more than the deductions taken (or that could be taken) under the first category. Most business deductions, such as those for fertilizer, feed, insurance premiums, utilities, wages, etc., belong in this category.

**Category 3**
Business deductions that decrease the basis of property are allowed last, but only to the extent the gross income from the activity is more than deductions taken (or that could be taken) under the first two categories. The deductions for depreciation, amortization, and the part of a casualty loss an individual could not deduct in category (1) belong in this category. Where more than one asset is involved, depreciation and these other deductions must be divided proportionally among those assets.

Individuals must claim the amounts in categories (2) and (3) above as miscellaneous deductions on Schedule A of Form 1040, subject to the 2%-of-adjusted-gross-income limit.

If a partnership or S corporation carries on a not-for-profit activity, these limits apply at the partnership or S corporation level. They are reflected in the individual shareholder’s or partner’s distributive shares.
Acquisition and Ownership

The purchase price of farmland, including the cost allocable to unharvested crops, must be capitalized. The cost of the crops at the time of purchase cannot be deducted, but is used in figuring net profit or loss in the tax year the crops are sold.

Capital expenses are generally not deductible, but they may be depreciable. However, the taxpayer can elect to deduct certain capital expenses, such as soil and water conservation expenses, or forestation and reforestation costs. Generally, the costs of the following items, including the costs of material, hired labor, and installation, are capital expenses:

- Land and buildings.
- Additions, alterations, and improvements to buildings, etc.
- Fences.
- Water wells, including drilling and equipping costs.
- Land preparation costs, such as:
  - Clearing land for farming,
  - Leveling and conditioning land,
  - Purchasing and planting trees,
  - Building irrigation canals and ditches,
  - Laying irrigation pipes,
  - Installing drain tile,
  - Modifying channels or streams,
  - Constructing earthen, masonry, or concrete tanks, reservoirs, or dams, and
  - Building roads.

Rents (Including Crop Shares)

Rent received for the use of farmland is generally rental income, not farm income. However, if the owner materially participates in farming operations on the land, the rent is farm income.
Example: Bob pastures Elmo’s cattle and takes care of the livestock for a fee. The income is from Bob’s farming business. He must enter it as “Other income” on Schedule F. If Elmo simply rented Bob’s pasture for a flat cash amount and Bob did not provide any services, Bob would report the income as rent on Schedule E (Form 1040), Part I.

Rent received in the form of crop shares is included in income in the year the shares are converted to money or the equivalent of money. It does not matter whether the cash method of accounting or an accrual method of accounting is used.

If you materially participate in operating a farm or ranch from which you receive rent in the form of crop shares or livestock, the rental income is reported on Schedule F and included in self-employment income.

If you do not materially participate in operating the farm or ranch, this income is reported on Form 4835, the net income or loss is carried to Schedule E (Form 1040), and the income is not included in self-employment income.

Crop shares received as a landlord and fed to the landlord’s livestock are considered converted to money when fed to the livestock. The landlord must include the FMV of the crop shares in income at that time. The landlord is entitled to a business expense deduction for the livestock feed in the same amount and at the same time he includes the FMV of the crop share as rental income. Although these two transactions cancel each other for figuring adjusted gross income on Form 1040, they are necessary to figure his self-employment tax.

Crop shares received as a landlord and given to others are considered converted to money when the gift is made. The landlord must report the FMV of the crop share as income, even though someone else receives payment for the crop share.

Any loss from a rental or crop-share lease arrangement is subject to the limits under the passive loss rules.
Conservation Reserve Program (CRP)

Under the Conservation Reserve Program (CRP), the owner or operator of highly-erodible or other specified cropland, may enter into a long-term contract with the USDA, agreeing to convert to a less intensive use of that cropland. The annual rental payments and any one-time incentive payment received under the program must be included on Schedule F, Lines 6a and 6b. Cost-share payments received may qualify for the cost-sharing exclusion. CRP payments are reported to the landowner on Form CCC-1099-G.

Cost-Sharing Exclusion (Improvements)

Part or all of payments received under certain federal or state cost-sharing conservation, reclamation, and restoration programs can be excluded from income. A payment is any economic benefit received as a result of an improvement. However, this exclusion applies only to that part of a payment that meets all three of the following tests:

- It was for a capital expense. The taxpayer cannot exclude any part of a payment for an expense you can deduct in the year paid or incurred. Payment for a deductible expense is included in income, and you can take any offsetting deduction is allowed.

- It does not substantially increase the annual income from the property for which it is made. An increase in annual income is substantial if it is more than the greater of the following amounts:
  - 10% of the average annual income derived from the affected property before receiving the improvement.
  - $2.50 times the number of affected acres.

- The Secretary of Agriculture certified that the payment was primarily made for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

If the three tests listed above are met, payments from the following programs can be excluded:

- The rural clean water program authorized by the Federal Water Pollution Control Act.
- The rural abandoned mine program authorized by the Surface Mining Control and Reclamation Act of 1977.
- The water bank program authorized by the Water Bank Act.
The emergency conservation measures program authorized by title IV of the *Agricultural Credit Act of 1978.*

The agricultural conservation program authorized by the *Soil Conservation and Domestic Allotment Act.*

The great plains conservation program authorized by the *Soil Conservation and Domestic Policy Act.*

The resource conservation and development program authorized by the *Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act.*

Certain small watershed programs, listed below.

Any program of a state, possession of the United States, a political subdivision of any of these, or of the District of Columbia under which payments are made to individuals primarily for conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife. For information about the status of those programs, contact the state offices of the Farm Service Agency (FSA) and the Natural Resources and Conservation Service (NRCS).

If the three tests listed earlier are met, payments received under the following programs for improvements made in connection with small watershed programs can be excluded from income:

- Programs under the *Watershed Protection and Flood Prevention Act.*
- Flood prevention projects under the *Flood Control Act of 1944.*
- The *Emergency Watershed Protection Program under the Flood Control Act of 1950.*
- Certain programs under the *Colorado River Basin Salinity Control Act.*

- The *Wetlands Reserve Program* authorized by the *Food Security Act of 1985*, the *Federal Agriculture Improvement and Reform Act of 1996* and the *Farm Security and Rural Investment Act of 2002.*
- The *Environmental Quality Incentives Program (EQIP)* authorized by the *Federal Agriculture Improvement and Reform Act of 1996.*
- The *Wildlife Habitat Incentives Program (WHIP)* authorized by the *Federal Agriculture Improvement and Reform Act of 1996.*
- The *Soil and Water Conservation Assistance Program* authorized by the *Agricultural Risk Protection Act of 2000.*
- The *Agricultural Management Assistance Program* authorized by the *Agricultural Risk Protection Act of 2000.*

The Forest Land Enhancement Program authorized under the Farm Security and Rural Investment Act of 2002.


The gross income realized upon getting an improvement under these cost-sharing programs is the value of the improvement reduced by the sum of the excludable portion and the landowner’s share of the costs of the improvement (if any). Determine the value of the improvement by multiplying its FMV by a fraction. The numerator of the fraction is the total cost of the improvement (whether paid by the landowner or by the government) reduced by the sum of:

- Any government payments under a program not listed earlier.
- Any part of a government payment under a program listed earlier that the Secretary of Agriculture has not certified as primarily for conservation.
- Any government payments to the owner for rent or for services.
- The denominator of the fraction is the total cost of the improvement.

The excludable portion is the present FMV of the right to receive annual income from the affected acreage of the greater of:

- 10% of the prior average annual income from the affected acreage. The prior average annual income is the average of the gross receipts from the affected acreage for the last three tax years before the tax year in which the owner started to install the improvement.
- $2.50 times the number of affected acres.
**Example:** 100 acres of land was reclaimed under a rural abandoned mine program contract with the Natural Resources Conservation Service of the USDA. The total cost of the improvement was $500,000. The USDA paid $490,000. The owner paid $10,000. The value of the cost-sharing improvement is $15,000.

The present FMV of the right to receive the annual income described in (1) above is $1,380, and the present FMV of the right to receive the annual income described in (2) is $1,550. The excludable portion is the greater amount, $1,550. Figure the amount to include in gross income as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of cost-sharing improvement</td>
<td>$15,000</td>
</tr>
<tr>
<td>Minus: Owner’s share</td>
<td>$10,000</td>
</tr>
<tr>
<td>Excludable portion</td>
<td>$1,550</td>
</tr>
<tr>
<td><strong>Amount included in income</strong></td>
<td><strong>$3,450</strong></td>
</tr>
</tbody>
</table>

When calculating the basis of property acquired or improved using cost-sharing payments excluded from income, the excluded payments are subtracted from the capital costs. Any payment excluded from income is not part of the basis.

In addition, the owner cannot take depreciation, amortization, or depletion deductions for the part of the cost of the property for which the cost-sharing payments were received and excluded from income.

The exclusion is reported by attaching a statement to the tax return (or amended return) for the tax year the last government payment for the improvement is received. The statement must include:

- The dollar amount of the cost funded by the government payment.
- The value of the improvement.
- The amount excluded.
- The total cost-sharing payments received are reported on Schedule F, Line 6a, and the taxable amount on Line 6b.

If the property is disposed of within 20 years after receiving the excluded payments, part or all of the cost-sharing payments that were excluded must be treated as ordinary income. This recapture is reported on Form 4797. See §1255 property under Disposition below.
A landowner can elect not to exclude all or part of any payments received under these programs. If this election is made, none of the above restrictions and rules apply. The election must be made by the due date, including extensions, for filing the return. If the return is timely filed for the year without making the election, the election can still be made by filing an amended return within six months of the due date of the return (excluding extensions). Write “Filed pursuant to Reg. 301.9100-2” at the top of the amended return and file it at the same address where the original return was filed.

Soil and Water Conservation Expenses

Certain expenses for soil or water conservation or for the prevention of erosion of land used in farming are deductible. Otherwise, these are capital expenses that are added to the basis of the land. Conservation expenses for land in a foreign country do not qualify for this special treatment. The deduction cannot be more than 25% of the gross income from farming.

Ordinary and necessary expenses that are otherwise deductible are not soil and water conservation expenses. These include interest and taxes, the cost of periodically clearing brush from productive land, the annual removal of sediment from a drainage ditch, and expenses paid or incurred primarily to produce an agricultural crop that may also conserve soil.

Most government payments for approved conservation practices must be included in income. However, some payments received under certain cost-sharing conservation programs can be excluded as explained previously.

Soil and water conservation expenses are deducted only if they are consistent with a plan approved by the Natural Resources Conservation Service (NRCS) of the Department of Agriculture. If no such plan exists, the expenses must be consistent with a soil conservation plan of a comparable state agency. A copy of the plan should be kept with by the landowner to support the deductions.

A conservation plan includes the farming conservation practices approved for the area where the farmland is located. There are three types of approved plans:

2009 Tax Implications of Real Estate
NRCS individual site plans. These plans are issued individually to farmers who request assistance from NRCS to develop a conservation plan designed specifically for their farmland.

NRCS county plans. These plans include a listing of farm conservation practices approved for the county where the farmland is located. You can deduct expenses for conservation practices not included on the NRCS county plans only if the practice is a part of an individual site plan.

Comparable state agency plans. These plans are approved by state agencies and can be approved individual site plans or county plans.

Individual site plans can be obtained from NRCS offices and the comparable state agencies.

Conservation expenses are deductible only for land the owner or the owner's tenant are using, or have used in the past, for farming. These expenses include, but are not limited to, expenses for the following:

- The treatment or movement of earth, such as:
  - Leveling,
  - Conditioning,
  - Grading,
  - Terracing,
  - Contour furrowing, and
  - Restoration of soil fertility.

- The construction, control, and protection of:
  - Diversion channels,
  - Drainage ditches,
  - Irrigation ditches,
  - Earthen dams, and
  - Watercourses, outlets, and ponds.

- The eradication of brush.
- The planting of windbreaks.

Do not deduct expenses to drain or fill wetlands, or to prepare land for center pivot irrigation systems, as soil and water conservation expenses. These expenses are added to the basis of the land.
Caution! If soil and water conservation expenses are deducted, do not exclude from gross income any cost-sharing payments received for those expenses.

If a new farm or new farmland is acquired from someone who was using it in farming immediately before the acquisition, soil and water conservation expenses incurred on it by the new owner are treated as made on land used in farming at the time the expenses were paid or incurred if the use of the land is substantially a continuation of its use in farming. The new farming activity does not have to be the same as the old farming activity. If the conservation expenses benefit both land that does not qualify as land used for farming and land that does qualify, the expenses are allocated.

Example: Cortland bought land that was used for grazing cattle and then prepared it for use as an apple orchard. The expenses benefit 200 acres of the land, but only 120 acres of this land are used for his orchards, and he does not use the other 80 acres. Cortland can deduct his conservation expenses because they are considered a continuation of a farming or ranching activity. He can deduct 60% \((120 \div 200)\) of the expenses. He could use another method to allocate these expenses if he could clearly show that the other method was more reasonable.

Expenses for depreciable conservation assets generally cannot be deducted currently. However, amounts paid for an assessment for depreciable property that a soil and water conservation or drainage district levies against the farm can be deducted. Otherwise, the expenses to buy, build, install, or improve depreciable structures or facilities are capitalized. These expenses include those for materials, supplies, wages, fuel, hauling, and moving dirt when making structures such as tanks, reservoirs, pipes, culverts, canals, dams, wells, or pumps composed of masonry, concrete, tile, metal, or wood. The capital investment is recovered through annual allowances for depreciation. The individual can deduct soil and water conservation expenses for nondepreciable earthen items. Nondepreciable earthen items include certain dams, ponds, and terraces.
Example: Veranda hires a crew to drill a water well to irrigate her farm. The first attempt is unsuccessful, so the drillers move their rig to a new location, where they strike water. The cost of drilling a water well for irrigation and other agricultural purposes is not deductible as a soil and water conservation expense. It is a capital expense and Veranda’s cost is recovered through depreciation, including the cost of drilling a test hole. The cost of the dry hole is added to the cost of the producing well. The total cost is recovered through depreciation deductions (generally over 20 years).

If a test hole, dry hole, or dried-up well (resulting from prolonged lack of rain, for instance) is abandoned, the unrecovered cost is deducted in the year of abandonment. Abandonment means that all economic benefits from the well are terminated. Filling or sealing a well excavation or casing so that all economic benefits from the well are terminated constitutes an abandonment.

Assessments by Conservation District

Some soil or water conservation or drainage districts levy assessments against farmers who benefit from district expenses for soil or water conservation. These assessments are deductible as a conservation expense if it:

- Covers expenses that could have been deducted if the landowner paid them directly, or
- Covers expenses for depreciable property used in the district’s business.

These include items such as pumps, locks, concrete structures (including dams and weir gates), draglines, and similar equipment. The depreciable property must be used in the district’s soil and water conservation activities. However, the following limits apply to these assessments:

- The total assessment limit.
- The yearly assessment limit.
After applying these limits, the deductible amount is added to other conservation expenses for the year. The total for these expenses is then subject to the 25% of gross income from farming limit on the deduction.

Limits on Deducting an Assessment by a Conservation District for Depreciable Property

<table>
<thead>
<tr>
<th>Total Limit on Deduction for Assessment</th>
<th>Yearly Limit on Deduction for Assessment</th>
<th>Yearly Limit for All Conservation Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>10% of: Total assessment against all members of the district for the property.</td>
<td>$500 + 10% of: Your deductible share of the cost to the district for the property.</td>
<td>25% of: Your gross income from farming.</td>
</tr>
</tbody>
</table>

- **No one taxpayer can deduct more than 10% of the total assessment.**
- **Any amount over 10% is a capital expense and is added to the basis of your land.**
- **If an assessment is paid in installments, each payment must be prorated between the conservation expense and the capital expense.**
- **If the amount you pay or incur for any year is more than the limit, you can deduct for that year only 10% of your deductible share of the cost.**
- **You can deduct the remainder in equal amounts over the next 6 tax years.**

- **Limit for all conservation expenses, including assessments for depreciable property.**
- **Amounts greater than 25% can be carried to the following year and added to that year's expenses. The total is then subject to the 25% of gross income from farming limit in that year.**
Example: The soil conservation district levied an assessment of $2,400 ($1,500 for digging drainage ditches, and $900 for depreciable equipment used in the district’s irrigation activities) on Mel’s farm. The assessment for ditches is deducted as a soil or conservation expense as if Mel had paid it directly. The total amount assessed by the district against all its members for the depreciable equipment is $7,000. The total amount Mel can deduct for the depreciable equipment is limited to 10% of the total amount assessed by the district against all its members for depreciable equipment, or $700. The $200 excess ($900 − $700) is a capital expense Mel must add to the basis of his farm.

To figure the maximum amount he can deduct for the depreciable equipment this year, Mel multiplies his deductible share of the total assessment ($700) by 10%, and adds $500 to the result for a total of $570. His deductible share, $700, is greater than the maximum amount deductible in one year, so he can deduct only $70 of the amount he paid or incurred for depreciable property this year (10% of $700). He can deduct the balance at the rate of $70 a year over the next nine years.

Mel adds $70 to the $1,500 portion of the assessment for drainage ditches. He can deduct $1,570 of the $2,400 assessment as a soil and water conservation expense this year, subject to the 25% of gross income from farming limit on the deduction, discussed below.

Example: Assume the same facts as above except that $1,850 of the $2,400 assessment is for digging drainage ditches and $550 is for depreciable equipment. The total amount assessed by the district against all its members for depreciable equipment is $5,500. The total amount Mel can deduct for the depreciable equipment is limited to 10% of this amount, or $550. The maximum amount Mel can deduct this year for the depreciable equipment is $555 (10% of his deductible share of the total assessment, $55, plus $500). Since Mel’s deductible share is less than the maximum amount deductible in one year, he can deduct the entire $550 this year. Mel can deduct the entire assessment, $2,400, as a soil and water conservation expense this year, subject to the 25% of gross income from farming limit on the deduction, discussed later.
If the land is disposed of during the 9-year period for deducting conservation expenses subject to the yearly limit, any amounts not yet deducted because of this limit are added to the basis of the property. If a farmer dies during the 9-year period, any remaining amounts not yet deducted are deducted in the year of death.

**25% Limit on Deduction**

The total deduction for conservation expenses in any tax year is limited to 25% of the gross income from farming for the year. If the deductible conservation expenses in any year are more than 25% of the gross income from farming for that year, the unused deduction can be carried over to later years. However, the deduction in any later year is limited to 25% of the gross income from farming for that year as well.

**Example:** In 2008, Dell has gross income of $16,000 from two farms. During the year, he incurred $5,300 of deductible soil and water conservation expenses for one of the farms. However, his deduction is limited to 25% of $16,000, or $4,000. The $1,300 excess ($5,300 − $4,000) is carried over to 2009 and added to deductible soil and water conservation expenses made in that year. The total of the 2008 carryover plus 2009 expenses is deductible in 2009, subject to the limit of 25% of his gross income from farming in 2009. Any expenses over the limit in that year are carried to 2010 and later years.

The deduction for soil and water conservation expenses is included when figuring a net operating loss (NOL) for the year. If the NOL is carried to another year, the soil and water conservation deduction included in the NOL is not subject to the 25% limit in the year to which it is carried.

A farmer can choose to deduct soil and water conservation expenses on his tax return for the first year he pays or incurs these expenses. If he chooses to deduct them, he must deduct the total allowable amount in the year they are paid or incurred. If he does not choose to deduct the expenses, he must capitalize them.
A change in the method of treating soil and water conservation expenses, or in the method of treating the expenses for a particular project or a single farm in a different manner, must be approved by the IRS.

**Sales of Farmland**

If farmland is held five years or less before it is sold, gain on the sale of the land is treated as ordinary income up to the amount previously deducted for soil and water conservation expenses. If the land is held less than 10 but more than 5 years, the gain is treated as ordinary income up to a specified percentage of the previous deductions.

The applicable percentage is based on the length of time the land was held. Within five years after the date acquired, the percentage is 100%. From the 6th through 9th year after acquisition, the applicable percentage is reduced by 20% a year for each year or part of a year the land is held after the 5th year. If you dispose of the land 10 or more years after it was acquired, the percentage is 0%, and the entire gain is a §1231 gain.

**Example:** Ahab acquired farmland on January 19, 2001. On October 3, 2008, he sold the land at a $30,000 gain. Between January 1 and October 3, 2008, Ahab had soil and water conservation expenses of $15,000 for the land that are fully deductible in 2008. The applicable percentage is 40% since he sold the land within the 8th year after he acquired it. Ahab treats $6,000 (40% of $15,000) of the $30,000 gain as ordinary income and the $24,000 balance as a §1231 gain.

**Cost-Sharing Payments**

Certain cost-sharing payments on property that were excluded from income may have to be treated as ordinary income (assuming the property is sold at a gain) and the balance treated as a §1231 gain. If payments were not excluded, ordinary income is not recognized under this provision.
The amount to report as ordinary income is the lesser of:

- The applicable percentage of the total excluded cost-sharing payments, or
- The gain on the disposition of the property.

Ordinary income is not reported under this rule to the extent the gain is recognized as ordinary income under §§1231 through 1254, 1256, and 1257 of the Internal Revenue Code. Nor is a gain or a part of a gain reported as ordinary income under this rule regardless of any contrary provisions (including nonrecognition provisions) under any other section of the Internal Revenue Code.

The applicable percentage of the excluded cost-sharing payments to be reported as ordinary income is based on the length of time the property is held after receiving the payments. If the property is held less than 10 years after receipt of the payments, the percentage is 100%. After 10 years, the percentage is reduced by 10% a year, or part of a year, until the rate is 0%.

Use Form 4797, Part III, to figure the ordinary income part of a gain from the sale, exchange, or involuntary conversion of §1252 property and §1255 property.

**Converted Wetland and Highly-Erodible Cropland**

Special rules apply to dispositions of land converted to farming use after March 1, 1986. Any gain realized on the disposition of converted wetland or highly-erodible cropland is treated as ordinary income. Any loss on the disposition of such property is treated as a long-term capital loss.

Converted wetland is generally land that was drained or filled to make farming possible. It includes converted wetland held by the person who originally converted it or held by any other person who used the converted wetland at any time after conversion for farming. A wetland (before conversion) is land that meets all the following conditions:

- It is mostly soil that, in its undrained condition, is saturated, flooded, or ponded long enough during a growing season to develop an oxygen-deficient state that supports the growth and regeneration of plants growing in water.
• It is saturated by surface or groundwater at a frequency and duration sufficient to support mostly plants that are adapted for life in saturated soil.
• It supports, under normal circumstances, mostly plants that grow in saturated soil.

Highly-erodible cropland is cropland subject to erosion used at any time for farming purposes other than grazing animals. Generally, highly-erodible cropland is land currently classified by the Department of Agriculture as Class IV, VI, VII, or VIII under its classification system. Highly-erodible cropland also includes land that would have an excessive average annual erosion rate in relation to the soil loss tolerance level, as determined by the Department of Agriculture.

 Converted wetland or highly-erodible cropland is also land held by any person whose basis in the land is figured by reference to the adjusted basis of a person in whose hands the property was converted wetland or highly-erodible cropland.

**Unused Soil and Water Conservation Expenses**

If a farm is sold, the basis of the land at the time of the sale cannot be adjusted for any unused soil and water conservation expenses (except for deductions of assessments for depreciable property). However, if another farm is acquired and the owner returns to the business of farming, he or she can start taking deductions again for the unused carryovers.
**SELF EMPLOYMENT TAX**

For purposes of the rules on wage withholding, individuals who perform services as “qualified real estate agents” (sales persons who are licensed real estate agents, substantially all of whose pay is directly related to sales rather than to the number of hours worked, and who have a written contract providing that the agent won’t be treated as an employee for federal tax purposes) are not considered employees [§3508(a)(1)]. This is also true for social security and unemployment tax withholding. Agents who have no written contract are considered independent contractors if they are subject to the control and direction of another only as to the result of their work, and not as to the means. As such, they are liable for self employment taxes.

Self-employment tax (SE tax) is a social security and Medicare tax primarily for individuals who work for themselves. Payments of SE tax contribute to coverage under the social security system for retirement, disability, survivor, and hospital insurance (Medicare) benefits.

Schedule SE (Form 1040) is used to figure SE tax. SE tax is due if net earnings from self-employment were $400 or more per year. One-half of the SE tax is deductible as an adjustment to income on Form 1040.

**DEDUCTIBLE EXPENSES**

**Automobiles**

Deductible auto expenses are based on the number of qualified business miles driven during the year. Trips between home and work each day or between home and one or more regular places of work are considered commuting miles and thus are not deductible. But travel between business locations or daily transportation expenses in going
between home and temporary work locations are deductible and can be counted as business miles. Examples of deductible business mileage include travel to and from:

- Client meetings
- Caravans
- Closings
- Continuing education classes or programs
- Lenders
- Out-of-town business trips
- Showings

Business miles should be documented in a record book with the:
- Date and business purpose of each trip;
- Name of the destination to which you traveled;
- Number of business miles traveled; and
- The odometer reading at the beginning and end of the tax year.

Always keep copies of auto purchase documents, and receipts for all car operating expenses: gas, oil, repairs, insurance, car washes, car loan interest, vehicle registration, etc.

Out-of-Town Travel

Expenses of traveling away from home, overnight, on employment-related and/or continuing-education trips are generally deductible. One’s home is considered to be the city or metropolitan area where the principal place of employment is located, not where one’s residence is located. Out-of-town travel expenses include:

- Meals.
- Lodging (identify separately from meals), tips, laundry, and business telephone calls.
- Airfare, car rental, parking, taxi, train, bus, and subway.
- Bell captain and porter.
- Bridge and highway tolls.
- Any other ordinary and necessary expenses.

Document away-from-home expenses by noting:
- Date.
- Destination.
- Business purpose of the trip.
Keep a detailed record of expenses as they are incurred. Meal and lodging expenses should be listed separately because different deduction rules apply to such expenses (i.e. meals are only 50% deductible).

Keep receipts to support each deductible business expense. However, if the business expense is less than $50, a receipt is not necessary if all the information is recorded in a record book.

Professional Fees and Dues

Dues paid to professional organizations related to the real estate profession are deductible if documented. These include dues and fees paid to:

- Associations.
- Chamber of commerce.
- Realty board.
- City business license.
- Other organizations directly or indirectly related to your profession.

Telephone

The basic local telephone service costs of the first telephone line provided in your residence are not deductible. However, toll calls from that line are deductible if the calls are business related. The costs (basic fee and toll calls) of a second line in your home or any other service are fully deductible, if used exclusively for business. Other deductible expenses, if supported by written records, include:

- Fax transmissions.
- Paging service.
- Telephone credit card calls.
- Cellular service and business related toll calls on your home phone.
**Continuing Education**

Correspondence course fees, school materials, supplies, textbooks, and seminar fees are deductible if made to:

- Maintain or improve skills required in one’s business or employment,
- To meet the express requirements of an employer, or
- To meet the requirements of law or regulations, imposed as a condition to retaining one’s license, status or employment.

Local transportation expenses incurred in going directly from work to school, and, if the taxpayer is regularly employed and goes to school on a strictly temporary basis, the costs of returning from school to home, for deductible education are deductible. A regularly employed taxpayer who goes from home to school on a temporary basis also may deduct the round-trip costs of transportation in going from home to school to home. In general, attendance at school is temporary if it is realistically expected to and does in fact last for one year or less.

Costs of seminar cruises or tours are disallowed if taken primarily for personal purposes even though part of the time is devoted to qualifying professional education. If not for personal purposes, a deduction of up to $2,000 per individual per year is allowed for attending conventions, etc., held aboard a cruise ship, but only if the ship is registered in the U.S. and all ports of call of the cruise ship are located in the U.S. or its possessions [§274(h)(2)]. A married couple filing a joint return can deduct $4,000 if each spent at least $2,000 for attending an otherwise deductible business-related cruise ship convention. A taxpayer claiming the deduction must attach to his return two specified written substantiation statements (including one signed by the sponsor).

**Business Supplies**

All business professionals incur expenses that are ordinary and necessary in their normal course of work. If these expenses are not reimbursed by an employer or a client then they are generally tax deductible. The following are examples of ordinary and necessary business supplies:
Briefcase.  
Stationary.  
Computer software and supplies  
Fax supplies.  
Film and processing.  
Greeting cards.  
Lock boxes, keys and locksmith  
Map books.  
Photocopy expense.  
Postage, shipping and freight.

**Other Business Expenses**

In addition to business supplies, most business professionals incur other miscellaneous business expenses that are ordinary and necessary in their normal course of work. If these expenses are not reimbursed by an employer or a client then they too are generally tax deductible. The following are examples of ordinary and necessary miscellaneous business expenses:

- Advertising.  
- Signs, flags, and banners.  
- Appraisal fees.  
- Attorney fees.  
- Bank charges.  
- Clerical services.  
- Computer database subscription fees.  
- Courier service.  
- Equipment repair.  
- Finders fees.  
- Gifts and flowers.  
- Insurance premiums (i.e. Errors and Omission and Liability).  
- Legal and professional services.  
- Multiple listing services.  
- Parking and tolls.  
- Open house expenses.  
- Referral fees.  
- Repairs to sell listed property.

**Interest**

Mortgage interest on business personal and real property (other than a personal residence) and interest paid on borrowed funds used to pay for ordinary and necessary business expenses is generally tax deductible. The following are examples of ordinary and necessary interest expenses:

- Credit card finance charges used to pay for qualified business expenses.
- Line of credit interest expense used to pay for qualified business expenses.
- Any other interest expense paid that can be traced to the real estate professional’s expenditures.
Meals and Entertainment

Except for country club dues, 50% of reasonable, necessary, and ordinary meals and entertainment expenses for shows or sporting events attended with business clients are tax deductible.

Equipment Purchases

The costs of business assets which are expected to last longer than one year are deducted differently on your tax return than are other recurring, everyday business expenses like business cards, office supplies, etc. Therefore it is important that the real estate professional record expenditures to procure such assets separately. Examples of such assets (and their depreciable lives) are:

- Answering machines (7 years).
- Desks and chairs (7 years).
- Calculators (5 years).
- Cameras (5 years).
- Computer equipment (5 years).
- Copy machine (5 years).
- Fax machine (7 years).
- Pagers (7 years).
- Cell phones (7 years).

A taxpayer who buys and places in service in the taxpayer’s active trade or business certain tangible property may elect to expense (i.e., deduct) its cost under §179 in the year the property is placed in service, subject to certain limits.

Property eligible for the §179 deduction must be tangible property or (if placed in service in 2003–2010) purchased computer software that is:

- Subject to depreciation, amortization, or other reasonable allowance for wear and tear;
- §1245 property, as defined in §1245(a)(3); 
- Acquired by purchase from an unrelated party for use in an active trade or business; and
- Used more than 50% in an active business (i.e., other than investment use).

The §179 deduction is limited to the lesser of taxable income from the taxpayer’s active trades or business, or $250,000 for 2008 and 2009.
However, any amount which can’t be deducted because of the income limitation is carried over indefinitely to later years.

Businesses may also take an extra “bonus” depreciation deduction for the first year new assets are placed in service. The bonus first-year depreciation deduction generally equals 50% of the cost of qualified property (most types of tangible property other than buildings and their structural components, improvements to certain types of leased property, and most software) acquired and placed in service during 2009. “Qualified property” is generally tangible personal property with a depreciation recovery period of 20 years or less.

“Passenger autos” are subject to depreciation limits and are not eligible for the §179 deduction if they are:

- Cars (not a trucks or vans) rated at 6,000 pounds unloaded gross vehicle weight or less; or
- Light trucks or vans (passenger autos built on a truck chassis, including minivans and SUVs built on a truck chassis) rated at 6,000 pounds gross (loaded) vehicle weight (GVWR) or less.

Sport utility vehicles (SUVs) are not subject to the passenger auto limits if they have a GVWR of more than 6,000 pounds but less than 14,001 pounds, but since 2004, the §179 deduction for an SUV in that weight range is limited to $25,000. For this purpose, an SUV does NOT include any vehicle that:

- Is designed for more than nine individuals in seating rearward of the driver’s seat;
- Is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length; or
- Has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the drivers seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.
Example: Jim, a calendar year taxpayer, acquires and places in service in 2009 an SUV with a GVWR over 6,000 pounds that costs $70,000. The vehicle is used 100% for business and otherwise fully qualifies for expensing. In 2009, Jim may expense the first $25,000 of the cost of the SUV and is allowed a regular depreciation deduction of $9,000 (($70,000 minus $25,000) × .20). Total first-year write-off: $34,000. The remaining $36,000 of cost would be recovered in 2010 and later years under the general depreciation rules.

Many full-size pickup trucks over 6,000 pounds are allowed the full §179 deduction, because they have a cargo box area of at least six feet in length which is not readily accessible directly from the passenger compartment. However, some extended cab pickups have cargo box areas of less than six feet in interior length, and would be subject to the $25,000 SUV limitation.

The standard mileage rate may not be used to compute the deductible costs of an automobile for which the taxpayer has claimed a §179 deduction. In that case the taxpayer must claim only actual operating expenses (plus depreciation allowed).

A 50% additional first year depreciation deduction is available for new (not used) automobiles acquired after 2007, and placed in service before 2010.

The total Code §179 deduction and depreciation a taxpayer can deduct for a passenger automobile (that is under 6,000 pounds and not a truck or van) he uses in his business and first placed in service in 2009 is $2,960, if the special depreciation allowance does not apply. The maximum deduction the taxpayer can take for a truck or van he use in his business and first placed in service in 2009 is $3,060, if the 50% bonus depreciation allowance does not apply. These figures are increased by $8,000 to $10,960 and $11,060 if the 50% bonus depreciation allowance applies.
Home Office Deductions

Expenses related to the business use of part of a home may be deductible if specific requirements are met. To qualify to claim expenses for business use of a home, the home must be used:

- Exclusively and regularly as a principal place of business,
- Exclusively and regularly as a place where clients or customers are met in the normal course of your trade or business,
- In the case of a separate structure which is not attached to the home, in connection with the trade or business,
- On a regular basis for certain storage use, or
- For rental use.

Employees who use a part of their home for business qualify for a deduction for its business use if the tests discussed above are met, and:

- The business use is for the convenience of the employer, and
- No part of the home is rented to the employer and used to perform services as an employee for that employer.

If the use of the home office is merely appropriate and helpful, the expenses for the business use of the home are nondeductible.

To qualify under the exclusive use test, a specific area of the home must be used only for trade or business purposes. The area used for business can be a room or other separately identifiable space. The space does not need to be marked off by a permanent partition. The requirements of the exclusive use test are not met if the area in question is used both for business and for personal purposes.

Example: You use a den in your home to write up offers and prepare advertising materials. Your family also uses the den for recreation. The den is not used exclusively in your profession, so you cannot claim a business deduction for its use.

To qualify under the regular use test, a specific area of the home must be used for business on a regular basis. Incidental or occasional business use is not regular use. All facts and circumstances are
considered in determining whether the business use is on a regular basis.

It is possible for a realtor to have more than one business location, including one’s home, for a single trade or business. To qualify to deduct the expenses for the business use of a home under the principal place of business test, the home must be the principal place of business for that trade or business. To determine whether a home is the principal place of business, consider:

- The relative importance of the activities performed at each business location, and
- The amount of time spent at each place where business is conducted.

A home office qualifies as a principal place of business if it meets the following requirements:

- It is used exclusively and regularly for administrative or management activities of the trade or business. There are many activities that are administrative or managerial in nature, such as:
  - Billing customers, clients, or patients.
  - Keeping books and records.
  - Ordering supplies.
  - Setting up appointments.
  - Forwarding orders or writing reports.

- There is no other fixed location where substantial administrative or management activities of the trade or business are conducted.

The following activities, whether performed by the real estate professional or others, do not disqualify a home office from being a principal place of business.

- Others conduct the administrative or management activities at locations other than at home. (For example, another company does your billing from its place of business.)

- Administrative or management activities are conducted at places that are not fixed locations of the business, such as in cars or a hotel rooms.

- Minimal administrative or management activities are occasionally conducted at a fixed location outside the home.

- Substantial nonadministrative or nonmanagement business activities are conducted at a fixed location outside the home, such
as meeting with or providing services to customers or clients at a fixed location of a business outside the home.

- There is suitable space to conduct administrative or management activities outside the home, but the home office is used for those activities instead.

**Business Percentage**

If the above tests are met, figure the percentage of the home used for business and the limit on the deduction by comparing the size of the part of the home used for business to the whole house. The resulting percentage is used to figure the business part of the expenses for operating the entire home.

Any reasonable method can be used to determine the business percentage. Common methods for figuring the percentage include:

Dividing the area (length multiplied by the width) used for business by the total area of the home.

**Example:** A home office is 240 square feet. The home is 1,200 square feet. The office is 20% \((240 \div 1,200)\) of the total area of the home. The business percentage is 20%.

If the rooms in the home are all about the same size, divide the number of rooms used for business by the total number of rooms in the home.

**Example:** One room in the home is used for business. The home has 10 rooms, all about equal size. The office is 10% \((1 \div 10)\) of the total area of the home. The business percentage is 10%.

Expenses for business use of a home incurred during any part of the year it is not used for business purposes are not deductible.
Example: Ima Newby began using part of her home for business on July 1, and met all the tests from that date until the end of the year. Only Ima’s expenses for the last half of the year are used in figuring her allowable deduction.

If gross income from the business use of the home equals or exceeds the total business expenses (including depreciation), all of the business expenses related to the use of the home are deductible.

If the gross income from the business use of the home is less than the total business expenses, the deduction for certain expenses for the business use of your home is limited. Otherwise nondeductible expenses such as utilities, insurance, and depreciation (with depreciation taken last), that are allocable to the business, are deductible up to the amount of the gross income from the business use of the home minus the sum of the following:

- The business part of expenses that are deductible whether or not the home is used for business (such as mortgage interest, real estate taxes, and casualty and theft losses that are allowable as itemized deductions on Schedule A, Form 1040).
- The business expenses that relate to the business activity in the home (for example, business phone, supplies, and depreciation on equipment), but not to the use of the home itself. This does not include a self-employed person’s deduction for half of the self-employment tax.

If home office deductions are greater than the current year’s limit, the excess can be carried over to the next year. They are subject to the deduction limit for that year, even if the individual does not live in the same home during that year.

**Furniture and Equipment**

There are different rules for listed property, property bought for business use, and personal use property converted to business use. If certain types of property, called listed property, are used in the home, special rules apply. Listed property includes computers and related equipment and any property of a type generally used for entertainment, recreation, and amusement (including photographic,
phonographic, communication, and video recording equipment). However, computers and related equipment used exclusively in a qualifying home office are not listed property.

**Example:** Sarah does not qualify to claim a deduction for the business use of her home, but she uses her home computer 40% of the time for a business she operates out of her home. She also uses the computer 50% of the time to manage her investments. Sarah’s home computer is listed property because it is not used in a qualified office in her home. She does not use the computer more than 50% for business, so she cannot elect a §179 deduction. She uses her combined business/investment use (90%) to figure her depreciation deduction using the Alternative Depreciation System (ADS) (straight line method) over a 5-year recovery period.

**Example:** If Sarah uses her computer 60% of the time for her business and 30% for managing her investments, her computer meets the more-than-50% use test. She can elect a §179 deduction. She can use her combined business/investment use (90%) to figure her depreciation deduction using the General Depreciation System (GDS) (straight line, 150%, or 200% methods).

Property bought for use in a business, is eligible for:
- A §179 deduction for the full cost of the property, or
- Depreciation, or
- Partial §179 deduction and depreciation of the balance.
Example: Zaphod bought a desk and three chairs for use in his office for $1,975. His taxable business income for the year is $3,000 without any deduction for the office furniture. Zaphod can elect to

1. Take a §179 deduction for the full cost of the office furniture;

2. Take part of the cost of the furniture as a §179 deduction and depreciate the balance; or

3. Depreciate the full cost of the office furniture.

The furniture is 7-year property under MACRS. If Zaphod does not take a §179 deduction, he multiplies $1,975 by 14.29% (.1429) to get his MACRS depreciation deduction of $282.23.

Property used in a home office that was used formerly for personal use purposes is not eligible for the §179 deduction or the Liberty Zone depreciation allowance. It can be depreciated, however. The method of depreciation used depends on when the property was first used for personal purposes. If the property was used for personal purposes after 1986 and changed to business use in 2006, depreciate the property under MACRS.

The basis for depreciation of property changed from personal to business use is the lesser of the adjusted basis of the property on the date of change, or the FMV of the property on the date of change.

Reporting Home Office Expenses

If self-employed and filing Schedule C (Form 1040), complete and attach Form 8829, Expenses for Business Use of Your Home. Business expenses that are not for the use of the home itself (dues, salaries, supplies, certain telephone expenses, etc.) are deducted in full on the appropriate lines of Schedule C. These expenses are not for the use of the home, so they are not subject to the deduction limit for business use of the home expenses.

Employees itemize deductions on Schedule A (Form 1040) to claim home office expenses and any other employee business expenses. This
generally applies to all employees, including outside salespersons. Form 2106 is required if either:

- Any job-related vehicle, travel, transportation, meal, or entertainment expenses are claimed; or
- The employer paid for any of the job expenses reportable on Line 20 of Schedule A. (Amounts an employer included in box 1 of the employees Form W-2 are not considered paid by the employer.)

The simpler Form 2106-EZ, instead of Form 2106, can be used if:

- The employee is not reimbursed by the employer, or the reimbursement was included in box 1 of Form W-2; or
- If claiming car expenses, the standard mileage rate is used.

Both the business and nonbusiness parts of mortgage interest are deducted on Line 10 or 11 of Schedule A.

Both the business and nonbusiness parts of real estate taxes are deducted on Line 6 of Schedule A.

**Choice of Entity**

What type of business entity to use is of great importance. Each entity type offers advantages and disadvantages. Business entities are broadly divided between “pass-throughs” and “non-pass-throughs”. The pass-through entity types include partnerships, limited liability companies, and S corporations. Partnerships are further divided into general partnerships, limited liability partnerships (LLP’s) and limited partnerships (LP’s).

**General Partnerships**

General partnerships are associations of two or more persons as co-owners to carry on a business for profit. Partnership taxation is the most complex of all the entities. The greatest downside of the general partnership is that all partners are jointly and severally liable for the partnership’s obligations. A partner’s personal assets are at risk to satisfy partnership debt.
Advantages:
- Due to multiple participants, sources of start-up capital are greater;
- There is less administrative burden than a corporation; and
- Income is taxed once at the partner level.

Disadvantages:
- Each partner is personally liable for all the debt of the business;
- All business net income is subject to self-employment tax, even if the partner is not personally active in the partnership; and
- Partnership income tax and basis adjustment rules are complex, especially with respect to transactions between a partner and a partnership.

**Limited Partnerships**

Limited Partnerships are similar to general partnerships except that one or more of the partners has limited participation in the risk of the business. As a result, limited partners are passive investors in the partnership, and normally limit their liability to the extent of their investment. General partners manage and control the daily operations of the business. Only the general partners’ personal assets are available to satisfy the debt of the business. Limited partners may lose their limited liability protection if they participate in the management activities.

Limited liability partnerships are a special type of general partnership that exists under the laws of many states. They were created to address concerns that a partner of a professional firm could be held liable for the malpractice of another partner in the firm. This type of entity is an alternative available in states where professional firms are not allowed to organize as LLC’s.

A partner in an LLP remains personally liable for the commercial and other obligations of the entity, their own acts of errors and omissions, and for the acts of error and omissions of persons they supervise. An LLP partner is not liable for acts and omission of the other LLP partners and employees not under their supervision. Thus, an LLP provides more liability protection than a general partnership, but not as much as an LLC.
Limited Liability Companies

Limited liability companies (LLC’s) are entities created under state law that can be used in all states. The company is owned by members and combines many of the tax advantages of a partnership with the liability protection of a corporation. As a result, the LLC structure is often compared to an S Corporation.

Advantages:

- LLC members have limited liability, regardless of the extent of management of the business;
- The number of members is not limited;
- Members may be individuals, corporations, trusts, partnerships, other LLC’s, and other entities;
- Income is taxed once at the member level if it chooses to be taxed as a partnership or an S corporation;
- Members can participate in the daily operations while maintaining personal liability protection;
- Distributions to members need not be pro-rata; and
- Members can have different classes of ownership.

Disadvantages:

- An LLC may have a limited life as a result of the death or bankruptcy of a member;
- Since LLC laws vary from state to state, the LLC must determine how it will be treated for both tax and liability purposes in other states; and
- Since LLC laws are relatively new, there are fewer cases as to the actual limits of a member’s liability.

Like partnerships and S corporations, the LLC is a pass-through entity and is generally not subject to double taxation. If the LLC would prefer to be taxed as an S corporation, but would have ineligible shareholders (partnerships, corporations or nonresident aliens), then an LLC is a popular choice.

S Corporations

S corporations are hybrid corporations that combine some of the tax advantages of a partnership with the liability protection of a corporation.
Start-up business will often consider this form, as profits and losses are passed through to the shareholders with no corporate tax.

Advantages:

- The double taxation affecting C Corporations is eliminated;
- Income is taxed once at the shareholder level;
- Shareholders maintain limited liability; and
- Profits of the S Corporation are not subject to self-employment tax.

Disadvantages:

- The S corporation cannot have more than 100 shareholders;
- Only one class of stock is allowed;
- Nontaxable fringe benefits for shareholders are limited; and
- Corporations, partnerships or non-resident aliens are not eligible shareholders.

**C Corporations**

In general, using a C corporation results in double taxation: a tax at the corporate level on the corporation’s taxable income, plus a tax at the shareholder level on the corporation’s after-tax income that is actually distributed to them as dividends. Unlike S corporations, C corporation losses are not passed out to shareholders. On the other hand, C corporation shareholder-employees are eligible for tax-free fringe benefits that are not allowed to S corporation shareholder-employees.

A C corporation is to be preferred over an S corporation when:

- The owners are willing to leave some earnings in the corporation, and the corporation’s annual taxable income is under $50,000;
- The owners pay relatively high marginal federal income tax rates on pass-thru earnings; or
- The corporation can avoid or offset large corporate-level gains that would trigger high corporate-level tax rates and double taxation. This involves planning for the disposition of appreciated assets, and the ultimate transfer of stock through sale or gift, rather than through liquidation (which usually triggers substantial double taxation).
There are two strategies to avoid double taxation in a C corporation:

- Form the corporation and make the S election using Form 2553, *Election by a Small Business Corporation*, so that all income is taxed once at the individual level; or
- Pay salary and bonus to the owner/shareholders in a C corporation, to effectively pass the income through to the shareholder’s individual tax return.

Since payment of salary and bonuses is an obvious strategy to avoid the double taxation in the C corporation, the IRS may reclassify payments as disguised dividends if they are unreasonably high.

C corporations should be avoided if the business owns substantial appreciating assets (such as real estate), or where it generates large cash flow and goodwill, because goodwill has zero basis, and if the assets are sold for more than their fair market value the excess will be allocated to goodwill.

**Sole Proprietorships**

Sole proprietorships should be avoided. The owner has unlimited personal liability for all business debts.

**Hiring Family Members**

Payments for the services of a child under the age of 18, who works for his or her parent in a trade or business (sole-proprietorship or a partnership in which each partner is a parent of the child), are not subject to social security and Medicare taxes (FICA). Payments for the services of a child under the age of 21, who works for his or her parent, whether or not in a trade or business, are not subject to federal unemployment taxes (FUTA).

This is not the case with a corporation (C or S), even if the corporation is completely controlled by the child’s parents.

Significant tax shelter is provided through the employment of children, by shifting income to persons in lower tax brackets. A child is allowed to earn the amount of the standard deduction tax-free every year. After that, the child can receive income and pay tax at the lower 10% and 15% rates.
Of course, the employment arrangement must be bona fide, and the compensation must be appropriate for the age and skill set of the child. But as the child matures, it is reasonable that compensation would increase.

For a parent that would like to put money away for a child’s education, the family business still provides a great opportunity.

**Example:** Iodine is self-employed. Her daughter Lysterine is 14 years old. Lysterine helps her with various office duties after school, and works longer hours during summer vacations. Lysterine’s mother pays her $8,150 in 2006.

Lysterine may receive $5,150 tax-free by deducting her standard deduction for earned income. Then, Lysterine deducts $3,000 for funding her IRA that will assist in payment of her college education. Distributions from an IRA used for education prior to attaining age 59½ are not subject to the premature distribution penalty. Lysterine’s taxable income is -0-. Iodine, who is in a 28% tax bracket, has saved $3,354 in income and SE taxes calculated as follows:

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages to Lysterine</td>
<td>$8,150</td>
</tr>
<tr>
<td>Less ½ SE Tax</td>
<td>(623)</td>
</tr>
<tr>
<td>Amount subject to tax @ 28%</td>
<td>7,527</td>
</tr>
<tr>
<td>Tax @ 28%</td>
<td>2,108</td>
</tr>
<tr>
<td>SE Tax savings</td>
<td>+ 1,246</td>
</tr>
<tr>
<td>Total tax savings</td>
<td>$3,354</td>
</tr>
</tbody>
</table>
Disposition

GAIN OR LOSS REALIZED

Character of Gain

When real estate is sold, the tax treatment depends on:
- Whether the asset is a §1221 capital asset, §1231 property used in a trade or business, or ordinary income property.
- How the property is being used at the time of the sale.
- How long the property has been held.
- The type of disposition.
- Whether a gain or loss was realized.

The term “capital asset” includes real property held by the taxpayer (whether or not connected with his trade or business), but does not include:
- Stock in trade, inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
- Depreciable property, used in his trade or business, or real property used in his trade or business; or
- Accounts or notes receivable from the sale of property.

Land and depreciable property used in a trade or business and held over one year are §1231 assets.

All real property assets that are not capital assets or §1231 property are considered ordinary income property.
Mineral Rights

The term “mineral rights” is often used to refer to the ownership of natural resources. A transaction that involves the extraction of natural resources by someone other than the owner is reported either as a sale of the ownership rights or as a lease of the mineral rights (royalty.) To extract the natural resource, the land above it and/or around it (the surface land) needs to be accessed. As with the mineral right itself, the transaction involving the land is reported either as a sale of the land or as rent of the land.

Both the Supreme Court and the IRS have adopted an “economic interest” test to determine if the contract is either a sale or lease of the mineral interest. If the payment to the land owner of the mineral rights is sourced only from the sale of the mineral, then an economic interest has been retained by that owner and the transaction is a lease. If the payment is made regardless of the amount, if any, of the mineral extraction, and the landowner agrees that he has made a complete disposition of his mineral rights, then the landowner has not retained an economic interest and the transaction is a sale.

The use of the surface land is often a forgotten part of the mineral rights contract. A review of local law may be necessary to see if the right for the use of the land can be implied in the mineral rights contract or if the use or rent of the land needs to be separately stated. The reporting treatment of the surface land use is reported either as a sale or as rent.

Refer to the following chart for the treatment of mineral rights transactions.
### Sale of the Mineral Rights:

If the transaction is a sale, the income is a capital gain. Depending on how long the client owned the land, it is reported as either a long-term or short-term capital gain in the year the proceeds are received from the sale. The basis of the mineral rights is zero, unless a basis was determined when the land was purchased.

### Lease of the Mineral Rights:

If the transaction is a lease, the income is treated as ordinary income as it is received. The economic interest retained by the landowner is normally referred to as a "royalty interest." The economic interest retained by the lessee is referred to as a "working interest." Royalty income received is normally reported to the taxpayer on Form 1099 Miscellaneous, which is reported on Form 1040, Schedule E, Line 4. Because a royalty owner is deemed to have retained an economic interest in the mineral rights, he or she may be eligible for a percentage depletion deduction. Percentage depletion is entered on Line 20 on Schedule E.

### Sale of the Surface Land:

If the right of way or easement is sold, and never reverts back to the land owner, then such an agreement could be a "sale" of a capital asset reported on Schedule D. For this to occur, the contract must be worded properly. The right of way must be perpetual and can never revert back to the grantor-taxpayer.

### Rent of the Surface Land:

If the transaction provides for payment for use of the surface land, that payment is rent. Rent of the land as a separate payment not associated with the mineral rights is nondepletable and would need to be identified separately on Schedule E as rental income.

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### Sale of Personal Residence with Business Use

#### General Rule

The general rule that governs how the §121 exclusion applies to the sale of a residence that has business use indicates that if the ENTIRE property is used as a principal residence in two-out-of-five-years preceding the sale, and the other §121 conditions are met, the exclusion applies to all of the gain EXCEPT that part of the gain attributable to depreciation taken after May 6, 1997.
Example: John had an office in his home used for business purposes during tax years 1994-1997. During this period, the allowed depreciation was $1,000 and the depreciation allowed after May 6, 1997 was $100. In 2008, John sold his home for $200,000. His adjusted basis in the property was $100,000. Since John used the entire property as a principal residence for more than two-out-of-five-years prior to the sale, the §121 exclusion applies to the gain. John’s total gain is $100,000 ($200,000 sales price minus $100,000 cost basis). Of this amount, $1,000 of gain was due to depreciation. However, under the rules, only the depreciation taken after May 6, 1997 cannot be excluded. Therefore, John may exclude $99,900 of gain and report $100 of gain due to depreciation taken after May 6, 1997 as taxable.

If John had stopped using his home office in 1996, all $100,000 of the gain would have been excludable.

Mixed-use Property

If property is mixed-use property (part residence and part nonresidence) and was not used entirely as a principal residence during the five years preceding the sale, the reporting depends on where the nonresidential use takes place. If the nonresidential use takes place WITHIN the dwelling unit, all the gain is eligible for the §121 exclusion EXCEPT the gain attributable to depreciation taken after May 6, 1997.

If the nonresidential use takes place OUTSIDE the dwelling unit, only the gain attributable to the dwelling unit is eligible for the §121 exclusion. Use outside the dwelling unit might include a separate structure or just be a separate part of a building that is not used as a personal residence.
Example: Sid used one bedroom in his five-year-old home for business purposes during the past five years and is selling the residence in 2009. The selling price of the home is $175,000 and his adjusted basis is $50,000. The allowable depreciation for the period was $3,000. Of the $125,000 gain ($175,000 sales price minus $50,000 basis), $3,000 is not eligible for the §121 exclusion. The remaining $122,000 is excludable since the nonresidential use took place WITHIN the dwelling unit. The $3,000 gain due to depreciation is taxed as unrecaptured §1250 gain.

Example: In the prior example, suppose that Sid could not take the allowable depreciation because the business terminated. What will his allowable §121 exclusion be in that case? Since Sid got no tax benefit from the depreciation that was allowed, he will not have to adjust his basis by that amount (his basis is $53,000 instead of $50,000). His gain is $122,000 ($175,000 sales price minus $53,000 basis) and is all excludable. There is no unrecaptured §1250 gain in this case.

Example: Agnes bought a two-unit rental building in 1998 for $250,000. She lived in one unit and collected rent for the other unit. The units are of equal size. Agnes sells the building in 2008 for $400,000. The allowable depreciation for the period was $23,000 for the rental unit. Agnes reports this transaction as two separate sales since the nonresidential use took place OUTSIDE the dwelling unit. One sale was for the personal residence where Agnes lived and the other sale was for the rental unit. The gain on the personal residence side is $75,000 [($400,000 sales price x ½) - ($250,000 x ½)]. This gain is eligible for the §121 exclusion. The rental portion of the gain is $98,000 [($400,000 sales price x ½) - (($250,000 x ½) - $23,000)] and is reported on Form 4797 as the sale of rental property. No part of this gain is excludable and the $23,000 of gain due to depreciation is taxed as unrecaptured §1250 gain.
The rules also make it clear that any depreciation that is allocable to the nonresidential part of any transaction will not affect the exclusion of the residential part of any sale.

**Example:** Jack bought a two-unit building in 1998 for $150,000. He used one unit as his personal residence and used the other unit as rental property. Starting in 1999, Jack claimed home office expenses for a small office he used for business in his unit. He sold both units in 2008 for a sales price of $160,000. The allowed depreciation for the rental portion of the property was $10,000, while the allowable depreciation for the home office was $1,000, during the period of ownership.

Jack will report the sale transaction in two parts: one as the sale of a personal residence and one as the sale of rental property.

For the personal residence portion, the total gain will be $6,000 [$80,000 sales price minus an adjusted basis of $74,000 ($75,000 cost minus $1,000 depreciation allowed)]. Of this $6,000, Jack may exclude $5,000 of the gain under §121. The $1,000 gain due to the depreciation of the home office is not excludable.

For the rental portion, Jack will have a total gain of $15,000 [$80,000 sales price minus an adjusted basis of $65,000 ($75,000 cost minus $10,000 depreciation)]. Of this $15,000 gain, $10,000 is considered to be unrecaptured §1250 gain taxable at a maximum rate of 25%.

The $10,000 allowed depreciation taken on the rental has no effect on the amount of the exclusion Jack can take for the home portion of the sale. The home sale exclusion is only limited by the depreciation allowed in that portion of the sale.

The primary benefit of the rules is that any appreciation of the nonresidential portion of a sale of a principal residence is eligible for the §121 exclusion if the nonresidential portion is contained with the dwelling unit.
**Dwelling Unit Defined**

A dwelling unit is a house, apartment, condominium, mobile home, boat, or similar property, but does not include detached structures [§1.121-1(e)(2)].

**Dealer Versus Investor Status**

Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss.

Tax law allows preferential treatment with respect to gain realized on the sale of a capital asset. Section 1221(1) defines a capital asset as “property held by the taxpayer . . . but does not include . . . property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” Whether property held by a taxpayer was sold in the ordinary course of business is a question of fact. The term “primarily” for purposes of §1221 means “of first importance” or “principally.”

In determining whether gains realized by the taxpayer from the sales of property were capital gains or income derived from the sale of the property in the ordinary course of business, one must ask:

- Was the taxpayer engaged in a trade or business, and, if so, what business?
- Was the taxpayer holding the property primarily for sale in that business?
- Were the sales by the taxpayer ordinary in the course of that business?
- Relevant factors considered in determining whether property is held primarily for sale to customers in the ordinary course of business include:
  - The frequency, continuity, and substantiality of sales;
  - The extent and nature of the taxpayer’s efforts to sell the property;
  - The time and effort the taxpayer habitually devoted to the sales;
  - The extent of improvements and advertising to increase sales; and
  - The nature and purpose of the acquisition of the property and the duration of ownership.
No one factor is determinative, and neither is the presence or absence of any single factor determinative. Each case is considered in light of its own facts and circumstances.

**Example:** Ursula Major owned real estate she used in her nursery business. The property was platted some years before she bought it. In 2007 the city built streets through the property at its own expense in accordance with the original plats. This was not desired or requested by Ursula, whose property was thus increased in value for residential purposes but decreased in value for use as a nursery.

In 2008 Ursula sold 25 lots to various purchasers. She made no active efforts to sell, but accepted such satisfactory offers as were made. She did not advertise the property for sale, hired no agents, erected no signs, did not list the property, or construct any improvements to facilitate its sale for residential purposes.

The profit is taxable as long term capital gain and not as ordinary income, because the property was not held primarily for sale to customers in the ordinary course of Ursula’s trade or business.

While sales of nondealer real property may be made under the installment method, dealers in real estate are generally barred from using the installment method. Dealer dispositions are not installment sales; therefore, the gains associated with those dispositions cannot be reported under the installment method [§453(b)(2)(A)].

The term dealer disposition does not include any dispositions of timeshares and residential lots on the installment plan if the taxpayer elects to pay interest on the delayed income tax for any tax year for which delayed payments are reported. An election does not apply with respect to any installment obligation which is guaranteed by any person other than an individual [§453(l)(2)].

It is certainly possible for a property owner’s intent to change from development (ordinary income treatment) to investment (capital gain treatment). However, it will be difficult to prove that a voluntary change was not merely a response to changes in economic conditions.
Involuntary changes of intent are more easily proven, and factors that might support such a change include:

- A need to raise cash.
- Illness, old age, or death.
- Unfavorable zoning changes, or inability to obtain desired zoning.
- Threat of condemnation (but see the following example).
- Property that is no longer fit for its intended purpose.
- Casualty or natural disaster.

**Example:** Bill and Charlotte bought property adjacent to a state park with the intent of selling off parcels. Thus, they were dealers in the ordinary course of business, right up to the time they received a notice of the state’s intent to condemn their property and add it to the park. They originally reported their sales proceeds as ordinary income. There was no distinction on their books between the property next to the park and other property they were subdividing and selling. The court ruled the condemnation notice didn’t turn the property into an investment capital asset. The condemnation proceeds paid to them was ordinary income, not capital gain. [Daugherty v. Commissioner, 78 TC 623 (1975)]

### Subdivision and Development

Real estate that cannot be depreciated is a capital asset, and gain from its sale is capital gain, if the property is held for investment. However, if the owner is in the trade or business of developing and/or subdividing real estate and then selling it, the owner is a dealer and the gain from the sale is ordinary income.

There are strategies, none of which is fool-proof, one can use to support the contention that a property owner is an investor and not a dealer.

- If a taxpayer has both investment property and dealer properties, they should be segregated in the taxpayer’s books and records.
- Changes of intent from dealer to investor property should be documented in their books and records, such as corporate minutes, correspondence, or memos to the file, and by transferring the property from inventory to an investment property account.
■ Expenses of investment property should be consistently reported as investment expenses, and not lumped in with other trade or business expenses.

■ Keep records of time spent on real estate activities. If the time spent is minimal compared to the time spent on other occupations, investment treatment is more likely.

■ Sell undeveloped land prior to its development to a controlled corporation (not a partnership or an LLC classified as a partnership). The formalities of a sale should be observed, and the sale should be at FMV. If the sale is an installment sale, the corporation should wait two years before selling lots, or part or all of the installment sale gain may be accelerated.

An individual who subdivides real property held for investment purposes is likely to be held a dealer and subjected to ordinary income tax rates on the entire long-term gain. However, an individual holding real property for investment may find that the only way to dispose of it at a reasonable price is to subdivide it into lots. IRC §1237 permits a taxpayer subdividing real estate under special circumstances to report long-term capital gains on the sales of lots.

Taxpayers, other than C corporations, can subdivide a single tract of property without losing the investment intent (and more favorable capital gains treatment) if certain conditions are met. Even then, a part of the gain is treated as ordinary income, up to 5% of the selling price of each lot will be ordinary income beginning in the tax year in which the sixth lot is sold [Reg. §1.1237-1(a)(5)].

The taxpayer must also meet the following conditions:

■ No part of the real estate could have been held for sale to customers in the ordinary course of business. Furthermore, the taxpayer can hold no other real estate for sale to customers.

■ No substantial improvements to the property can be made by the taxpayer, either before the sale or pursuant to a contract of the sale. However, improvements such as roads, curbs, gutters, and utilities, are not considered substantial improvements if they are necessary to make the lots marketable at the current market price, and the taxpayer has held the land for at least 10 years.

■ The taxpayer has held the property for at least five years unless it was inherited.
**Example:** Art Vandelay sells the sixth lot in a tract. Art’s sales of lots from this tract qualify for §1237 treatment. Assume the selling price of the sixth lot is $10,000; the basis of the lot in Art’s hands is $5,000; and the expenses of the sale are $300. The gain realized by Art is $4,700. The amount of gain characterized as ordinary income is $200, computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$10,000</td>
</tr>
<tr>
<td>Basis</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Excess of sales price over basis</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>5% of selling price</td>
<td>$ 500</td>
</tr>
<tr>
<td>Less selling expenses</td>
<td>(300)</td>
</tr>
<tr>
<td>Amount of gain realized treated as ordinary income (but not less than zero)</td>
<td>$ 200</td>
</tr>
<tr>
<td>Excess of sales price over basis</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Less the sum of:</td>
<td></td>
</tr>
<tr>
<td>5% of selling price</td>
<td>$ 500</td>
</tr>
<tr>
<td>Excess of expenses over 5% of selling price, if any</td>
<td>0</td>
</tr>
<tr>
<td>Amount of gain realized from sale of property not held for sale in ordinary course of business (capital gain)</td>
<td>$ 4,500</td>
</tr>
</tbody>
</table>

The term tract means either (1) a single piece of real property, or (2) two or more pieces of real property if they were contiguous at any time while held by the taxpayer. Property is treated as being contiguous if it is contiguous except for the interposition of a road, street, railroad, stream or similar property. Properties are contiguous if their boundaries meet at one or more points. The single piece of contiguous properties need not have been conveyed by a single deed. The taxpayer may have assembled them over a period of time and may hold them separately, jointly, or as a partner, or in any combination of such forms of ownership.

If, following the sale of any lot or parcel from a tract, the taxpayer does not sell or exchange any lots from the tract for a period of five years, the remainder of the tract is treated like a new tract. The pieces in the new tract need not be contiguous. If they ever were contiguous in the taxpayer’s hands, the five-year period is measured between the dates of the sales or exchanges [§1237(c) and Reg. §1.1237-1(g)(2)].
**Domestic Production Activities Deduction**

Developers may claim a Domestic Production Activities deduction (DPAD) under Code §199 equal to a percentage of the lesser of their “qualifying net income” or taxable income. Qualifying net income equals revenues earned from specific activities performed within the U.S. less the cost of goods sold and other allocable expenses.

The applicable deduction percentage for 2007 to 2009 is 6%. For 2010 and after it will be 9%. The deduction is further limited to 50% of W-2 wages.

For the construction and real estate development industries, there are three primary requirements for qualifying revenue-generating activities:

- The taxpayer must currently conduct construction activities on a regular, ongoing basis. Land subdivision and construction management qualify, though construction does not have to be your only or your primary line of business.

- Construction activities must involve real property in the U.S., defined as substantial renovation or erection of real property. Infrastructure improvements qualify and include roads, water systems, sewers, sidewalks, etc. Sales of tangible personal property are specifically excluded.

- The taxpayer must derive qualifying revenues from the activities, i.e., revenues earned performing construction services on real property. Sales of land by itself generally do not qualify. Other service revenues (materials delivery, debris removal, grading, demolition, painting or landscaping) may qualify if they are part of a larger project. General contractor activities like project management and oversight also qualify.

For taxpayers whose nonqualifying receipts equal less than 5% of total receipts (and are thus considered de minimis), the IRS considers that 100% of the receipts qualify. In addition, the regulations allow a similar 5% de minimis exception based on total project revenue.

Land sales alone do not generate qualifying receipts. However, there is a safe harbor allowed for real estate developers. With the land safe harbor, taxpayers can calculate their land receipts by identifying land costs plus an estimated appreciation percentage. The safe harbor percentages are 5% if land is held less than 60 months, 10% if held 60 months to 120 months and 15% if held 120 months to 180 months.
The safe harbor eliminates the need to perform an appraisal to determine the land value.

To claim the deduction, taxpayers must pay W-2 wages. For example, sole proprietors or partners with no employees (and thus no wages) will not benefit from the §199 deduction.

Taxpayers who use professional employee organizations, employee leasing companies or multipartied, multitiered partnerships may have trouble proving or identifying their wages. However, wages could be allocated via common-law employer rules in these situations.

If a developer operates as a partnership or S corporation, it must report specific information to the partners/shareholders to allow them claim the deduction.

Taxpayers may claim a §199 deduction even if the alternative minimum tax is triggered, but in that case the calculation’s income limitation is adjusted.

**Converting Rentals into Condominiums**

If apartment buildings are converted into condominiums which are then sold, it is not always clear whether the profit is capital gain from the liquidation of investment property, i.e., the apartment house, or ordinary income because the owner has gone into the business of selling condos. The IRS has not been of much help in clarifying the issue. As a result, many building owners sell the buildings to professional converters to protect the capital gain treatment for their pre-conversion appreciation.

Congress apparently intended that the sale of condominium units by a building owner generally does not qualify for capital gain treatment (House Ways and Means Committee Report 98-432, Part 2 on H.R. 4170, 3/5/84, p. 1703). IRC §1237 allows qualifying taxpayers to report a capital gain on the sale of subdivided real property, but Rev. Rul. 80-216 held that §1237 does not apply to the conversion of rental units in an apartment building into condominiums which are sold to the general public.

On the other hand, the IRS in two private letter rulings stated that although Rev. Rul. 80-216 prevents using §1237 to qualify for capital gain treatment, it does not preclude a taxpayer from qualifying for
capital gains treatment under some other code section. Unfortunately, the rulings do not say under what circumstances a sale of condominium units can qualify for capital gain treatment. They merely say that Rev. Rul. 80-216 does not preclude such treatment (PLR 8212001 and PLR 8204031).

**Rehabilitation, Renovation and Resale**

Taxpayers in the trade or business of renovating and reselling homes do not report renovation expenses as costs of goods sold. The expenses are capitalized and reduce the recognized gain at the time of sale. At the time of sale, the expenses should be listed on Part V of Schedule C (if a sole proprietor) under other expenses as “Section 263A costs for 123 Maple Street” (for example). Sales are reported on Schedule C on Line 1, “Gross receipts or sales.”

A dealer in or developer of real property may not use inventory accounting, but must instead capitalize the costs of each item and subtract them in computing gross income on a sale of the item [Homes by Ayres v. CIR, 795 F2d 832 (9th Cir. 1986)]. Inventory methods may not be used for land because land is not “merchandise,” even if held for sale to customers in the ordinary course of business, and because “the use of inventory accounting for land does not clearly reflect income” [Atlantic Coast Realty Co. v. CIR, 11 BTA 416 (1928); Rev. Rul. 69-536].

According to the IRS, this item-by-item accounting is used instead of inventories because real estate is unique and is particularly subject to specific accounting of costs, and an inventory method for real estate could be so cumbersome and uncertain as to be generally impractical. The principal effects of barring taxpayers from using inventories in this situation are that an item may not be valued at the lower of cost or market in order to deduct an unrealized reduction in market value and that the cost of the item is specifically identified rather than determined by the FIFO or last in, first out (LIFO) conventions (Rev. Rul. 86-149).
Depreciation Recapture

While most taxpayers are comfortable with the general computation of gains and losses [i.e. proceeds less basis = gain(loss)], the concept of depreciation recapture and unrecaptured depreciation and how it relates to gains is much more perplexing. Sections 1231, 1245, and 1250 are related somehow, but how? And how does it affect a taxpayer’s gain or loss on the sale of an asset? This section is designed to clear up all the confusion.

In a discussion of recapture, in its many forms, it is important to first have a good grasp on the required vocabulary.

§1231

This section of the code specifies how to treat gains or losses from the sale or involuntary conversion of business assets. Business assets for purposes of §1231 include all depreciable assets and real property used in a trade or business, which have been held longer than one year. Section 1231 does not include inventory or any assets primarily held for sale to customers.

§1245

Section 1245 explains how to treat the gain from the sale of depreciable personal property and certain other property.

§1250

Section 1250 explains how to treat the gain from the sale of depreciable real property, which is not §1245 property.
All §§1245 and 1250 assets are also §1231 assets.
But §§1245 and 1250 recapture is not §1231 gain.
There is no such thing as a §1245 or 1250 loss.

Recapture (Under §§1245 & 1250)

Recapture is much more than simply adjusting the basis by the amount of depreciation allowed/allowable.

Recapture is ordinary income taxed at the taxpayer’s highest tax bracket. There is no maximum tax bracket like capital gains. In addition, recapture cannot be recognized on the installment basis. If there is recapture on an asset, all of it must be recognized in the year of sale regardless of how much money is actually received.

Recapture is not offset by §1231 losses. IRC §1231 gains and losses are netted to determine whether there is a net §1231 gain or loss for the year. Amounts that are to be recaptured are not §1231 gains and; therefore, are not included in the netting.

This is a common error when reporting the sale of a business. Each asset must be evaluated separately for recapture before determining §1231 gain or loss.
§1245

Code §1245 property includes, but is not limited to:
- Tangible depreciable personal property;
- ACRS nonresidential real estate that was depreciated using an accelerated method (1981 through 1986); and
- Other real property specifically defined as being subject to §1245, bulk storage facilities of fungible commodities, etc.

All §1245 depreciation is recaptured to the extent of gain realized.

Along the way, it was decided that §1231 was just a little too nice. Congress decided to “recapture” depreciation taken to the extent of any gain realized, on the sale of §1245 assets.

**Note:** For §1245 recapture, §179 expensing is considered depreciation.

Leasehold Improvements

Any gain realized due to amortization allowed on leasehold improvements under §162 is recaptured under §1245.

§1250 Recapture

Code §1250 recapture seems to have been a compromise between recapturing all depreciation and none at all. The definition of §1250 property is one of those negative definitions: “All real property subject to recapture that is not §1245 property is §1250 property.” Basically, §1250 can be identified as:
- MACRS
  - Property placed in service after December 31, 1986.
  - Residential real property.
  - 27.5 year class life.
  - Nonresidential real property.
  - 31.5 year class life, pre May 13, 1993.
  - 39 year class life, post May 12, 1993.
ACRS

- Property placed in service between January 1, 1981 and December 31, 1986.
- Residential rental property that was depreciated under either the 19, 18 or 15-year class life, and was depreciated under an optional straight-line method.
- Note that all ACRS nonresidential real estate is excluded from §1250.
- Certain subsidized low-income housing.
- Certain foreign realty.

Most pre-ACRS and MACRS real property — Real property placed in service prior to 1981 is §1250 property unless specifically designated as §1245 property, regardless of whether accelerated or straight-line methods of depreciation were used.

§1250 Unrecapture

The use of the term “unrecapture” is misleading. While §1250 depreciation is not recaptured in the same way as §1245 depreciation, §1250 requires that all depreciation, even if only straight-line methods were used, for property sold after July 28, 1997, be subjected to a maximum tax bracket of 25%. For §1250 unrecapture to apply, the property must have been held more than twelve months. Property held one year or less is not §1250 property.
Example: Mr. Beck purchased a commercial office building in 1996 for $150,000. While he owned the building, Mr. Beck was allowed and properly deducted $34,000 of straight-line depreciation.

In 2008, the building sold for $280,000. Mr. Beck realizes a $164,000 profit. First, we note that §1250 recapture rules do not apply; no accelerated depreciation was taken. However, there is §1250 unrecapture of $34,000, to the extent gain is attributable to depreciation allowed (even though all depreciation was straight-line), that will be taxed at up to a maximum of 25%, not treated as a §1231 gain (long-term capital gain).

The balance of the gain, $130,000, is taxed as §1231 gain, which flows from form 4797 to schedule D where it will receive long-term capital gain treatment; maximum tax rate is 5% or 15%.

Unlike §§1245 and 1250 recapture, §1250 unrecapture may be reported using the installment method. If an asset is sold and §1250 unrecapture applies, unrecapture is reported first.

Recapture and Like-Kind Exchanges

If a like-kind exchange is truly tax-free, no boot is received, and no gain is recognized, there is no recapture recognized. However, if any gain is recognized in the exchange, that gain is considered recapture to the extent required by §1245 or §1250, whichever is applicable. It is important to remember that if the like-kind exchange is successful in deferring taxation on recapture, that recapture potential is transferred to the replacement assets.

Dispositions of Passive Activities

Passive activity losses that have not been allowed are generally allowed, in full, in the year of disposition of the entire interest in the passive activity.
To be allowed, the disposition must be in a transaction in which all realized gain or loss is recognized:

- The sale of the activity is reported as normal, with any gain taxable and any loss deductible.
- The current year’s operations are reported in full whether a profit or a loss, as a nonpassive activity.
- The suspended losses are deductible in full as a nonpassive activity.

This gain/loss from sale, profit/loss from operations, and suspended losses are combined to arrive at a “net amount.”

- If this “net amount” is a negative amount, there is no additional reporting.
- If this “net amount” is a positive amount, the “net amount” is reported on Form 8582 as passive income. This will permit the taxpayer to claim passive losses from other activities, up to the amount of the passive income including this “net amount.” In other words, if the “net amount” is positive, it is treated as passive income.
Example: Samantha sold her interest in a rental activity for a $15,000 profit. She also had a $2,000 loss from the current year operations of the rental, and a $6,000 suspended loss carryover from prior years. She also has a limited partnership, which has a $10,000 loss.

She reports the sale on Form 4797, Sale of Business Property, showing the $15,000 profit and an $8,000 deductible loss on Schedule E to show the current year loss and the suspended loss. Her “net amount” is $7,000 profit. Therefore this profit is also shown on Form 8582 as an active participation rental real estate activity. This $7,000 profit will permit Samantha to claim $7,000 worth of the limited partnership’s passive loss. The remaining $3,000 limited partnership loss carries over to the following year.

Net result:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit from sale</td>
<td>$15,000</td>
</tr>
<tr>
<td>Loss from operations</td>
<td>-2,000</td>
</tr>
<tr>
<td>Suspended loss from rental released due to sale</td>
<td>-6,000</td>
</tr>
<tr>
<td>“Net amount”</td>
<td>$7,000</td>
</tr>
<tr>
<td>Loss allowed from partnership</td>
<td>-7,000</td>
</tr>
<tr>
<td>Net result</td>
<td>$0</td>
</tr>
</tbody>
</table>

If the taxpayer has a capital loss from the disposition of a passive activity, the loss may be limited by the capital loss rules.

Example: Ray sold his interest in a limited partnership for $30,000. His adjusted basis in the limited partnership was $42,000 and he had a passive loss carryover of $2,000. Ray realized a capital loss on the disposition of $12,000 ($30,000 - $42,000). The capital loss limit is $3,000 for the year, which gives Ray a capital loss carryover of $9,000. With an allowable capital loss of $3,000 and a passive loss carryover of $2,000, Ray’s current deductible loss is $5,000.
The amount of a suspended passive loss is prorated if the disposition is reported using the installment method. The current year loss is the total loss multiplied by a fraction derived by the gain recognized in the current year over the remaining gain to be recognized as of the beginning of the year.

**Example:** John has a total gain of $10,000 from the sale of an entire interest in a passive activity. His suspended losses total to $15,000. Under the installment method he reports $2,000 of gain each year, including the year of the sale. For each year, since 20% \((2,000/10,000)\) of the total gain is reported, 20% \((3,000)\) of the suspended losses are allowed.

**Example:** During 2008, Rusty sold her rental property for $150,000, with a total gain of $90,000. Her suspended losses total $60,000. Under the installment method she reports gain each year based on the principal received and the gross profit percentage (60% in this case).

During 2008, Rusty receives $50,000 in principal payments (including the down payment) resulting in a taxable gain of $30,000 \((50,000 \times 60\% \text{ gross profit ratio})\). Since 33% \((30,000/90,000)\) of the total gain is reported, 33% \((20,000)\) of the suspended losses are allowed.

During 2009, Rusty receives $10,000 in principal payments, resulting in a taxable gain of $6,000 \((10,000 \times 60\%)\). Since 6.67% of the gain is reported, Rusty can claim 6.67% \((4,000)\) of the original suspended losses as a deduction.
PARTNERS AND S CORPORATIONS

A complete discussion of the advantages and disadvantages of partnerships or corporations is beyond the scope of this book. However, certain aspects of “pass through” entities must be emphasized.

Partnerships and S corporations both pass through income, deductions and credits to the partners or shareholders, which are reported on their personal returns and generally not taxed at the entity level. Those items are reported to the partners or shareholders on a Schedule K-1 by type (trade or business income or loss, interest, dividends, rent income or loss, capital gain or loss, etc.). Thus, for example, the passive loss rules apply at the partner or shareholder level, not at the partnership or S corporation level.

Income items increase the basis of a partnership interest or S corporation stock, while losses and distributions reduce that basis. Once basis is reduced to zero, additional distributions are taxed at capital gains rates, while losses are suspended until basis is increased either by capital contributions or income allocations.

Partners’ basis is also increased by partnership debt for which the partner is liable, and this basis can also be used to offset distributions. However, an S corporation shareholder’s basis is increased only by loans the shareholder makes to the S corporation.

Partners and S corporation shareholders may also claim a current deduction for suspended passive activity losses when they dispose of their entire interest in the partnership or the corporation or when the partnership or S corporation disposes of all of the property used in the passive activity.
**Example:** Medusa sold her entire interest in a partnership in which she did not materially participate for $80,000 in 2008. Her partnership basis was $30,000 at the beginning of the year. Her 2008 income from the partnership was $20,000. She has $44,000 of suspended passive losses from the partnership from prior years.

Medusa has an overall net income of $26,000 (a $50,000 gain on disposition plus the $20,000 of net income minus the freed-up suspended prior year losses of $44,000). The prior year losses are deductible in full. The gain of $50,000 on the disposition is reflected on Schedule D, while the $24,000 net loss ($44,000 loss reduced by $20,000 income) is reflected on Schedule E in the nonpassive loss column.

**Example:** Triple AAA, Inc., is an S corporation that owns a rental building. Triple AAA sells the building to an unrelated party. On its Form 1120S for the year, Triple AAA notifies the shareholders on a separate statement attached to Schedule K-1 that the property has been sold. If the rental activity was disposed of in a fully taxable transaction to an unrelated party, the shareholders can deduct all of their suspended passive losses arising from the rental activity.

### Nonrecognition of Gain or Loss

**§121 Exclusion**

Taxpayers can exclude up to $250,000 ($500,000 if married filing jointly) of realized gain from the sale of a principal residence. The taxpayer must meet the following tests for the exclusion to apply.

**Ownership** — The taxpayer must have owned the residence for periods totaling at least two of the last five years ending on the date of the sale or exchange.

**Use** — The taxpayer must have occupied the residence as his or her principal residence for periods totaling at least two years during the five-year period. Short, temporary absences such as vacations or other
seasonal absences are usually counted as periods of use. However a one-year sabbatical leave is not considered a short, temporary absence [Reg. §1.121-1(c)(4), Example 4].

**One Sale in Two Years** — The taxpayer must not have used the exclusion during the two-year period ending on the date of the current sale or exchange.

The date of sale is generally the earlier of the date the deed passes (is conveyed) or the time possession and the burdens and benefits of ownership are transferred to the buyer (Rev. Rul. 69-93). This is usually the date of the closing statement.

**Principal Residence**

A residence includes a houseboat as well as a house trailer, but does not include personal property that is not a fixture under local law. If a taxpayer uses two or more residences in the same year, a safe harbor provision allows the taxpayer to claim as his or her principal residence the one that was occupied for the majority of the year for purposes of the “used as a principal residence two-out-of-five year test.”

If a taxpayer does not want to follow this safe harbor provision, factors that can be used to make a determination include, but are not limited to:

- The taxpayer’s place of employment.
- The principal place of abode of the taxpayer’s family members.
- The address listed on the taxpayer’s federal and state tax returns, driver’s license, automobile registration, or voter registration card.
- The taxpayer’s mailing address for bills and correspondence.
- The location of the taxpayer’s banks.
- The location of religious organizations and recreational clubs with which the taxpayer is affiliated.
**Example:** Ole and Lena owned homes in Wisconsin, Florida, and Arizona throughout a five-year period. From March 1999 to 2002 they lived in Wisconsin and Florida until they sold their home in Florida. Then they lived in Wisconsin and Arizona from 2002 to September 2004, at which time they sold their home in Wisconsin. In general, they lived in Wisconsin during the warmer months and Florida or Arizona for the rest of the year. No Wisconsin state income tax returns were filed, but Florida and Arizona returns were filed. They weren’t registered to vote in Wisconsin, but were registered in Florida and Arizona. They did not have a Wisconsin driver’s license, but both had licenses in Florida and Arizona. They did their banking in each state, not just one state, and they had different vehicles registered in each state. During the entire five-year period before the date of sale, taxpayers lived in the Wisconsin residence for more days than either one of the other two residences alone. However, the Wisconsin residence was not used more often each year in four of the five tax years. It was only used more often in the first year. They undisputedly owned and used the Wisconsin residence for two out of five years before the date of sale. However, was the Wisconsin residence used as their principal residence?

Reg. §1.121-1(b)(2) states that if a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer’s principal residence. The regulation looks at each tax year separately, not the entire five-year period in total.

Reg. §1.121-1(b)(2) also considers all the facts and circumstances to determine a taxpayer’s principal residence. Relevant factors, such as location of family members, mailing address, etc. were discussed previously under the definition of principal residence.

As a result, the Wisconsin residence was not used as their principal residence. The gain on the sale of the Wisconsin residence cannot be excluded under §121. (Guinan v. U.S., 91 AFTR 2d 2003-2174)
**Vacant Land**

Vacant land is not part of a taxpayer’s principal residence unless:

- The land is adjacent to land containing the dwelling unit of the taxpayer’s principal residence.
- The taxpayer owned and used the vacant land as part of the taxpayer’s principal residence.
- The taxpayer sells the dwelling unit in a sale that meets the requirements of §121 within two years before or two years after the date of the sale of the land.
- The requirements of §121 have been met with respect to the vacant land.

If the vacant land is sold and the taxpayer’s tax return for that year is filed before the dwelling unit is sold, the gain from the sale of the vacant land is taxable. If the dwelling unit is later sold within the two-year period mentioned above, the taxpayer can amend his or her tax return to claim the exclusion.

The $250,000/$500,000 exclusion applies to the combined gains from both the qualifying vacant land and the dwelling unit, not to each sale separately.

The sale dates of the vacant land and the dwelling unit are treated as one sale for purposes of the “one sale every two years” provision in regard to another sale of this property. However, both of the sale dates are treated as separate sales in regard to any other principal residence sales. Therefore, the taxpayer cannot have used the §121 exclusion for another property’s sale taking place within two years prior to the first sale date, nor for another property’s sale taking place within two years after the second sale.
Example: A taxpayer sells Property A on March 1, 2006, Vacant Land B (adjacent to Property B which includes house B) on August 1, 2007, Property B on September 1, 2005, and Property C on December 1, 2009. The August 1, 2007 and September 1, 2008 sales are treated as one sale in regard to each other and; therefore, do not disqualify each other. However, the sale date of Vacant Land B is within two years of the sale date of Property A; therefore, only one of these two sales can be excluded under §121. Also, the sale date of Property B is within two years of the sale date of Property C; therefore, only one of these two sales can be excluded under §121.

Disregarded Entities

A single owner entity, under Reg. §301.7701-3(a), that is a disregarded entity will result in the single owner being treated as the owner for satisfying the two-out-of-five year ownership test. Likewise, an individual treated as owning the corpus of a grantor trust under §§671-679 is treated as the owner of a residence owned by the trust for the two-year ownership requirement. Revocable trusts are grantor trusts, but an irrevocable trust may also be a grantor trust if the grantor retains certain control, enjoyment, or income rights as specified in §§671-679. Any sale or exchange of the property while the grantor is alive is treated as if made by the grantor [Reg. §1.121-1(c)(3)(i)].

Partial Use for Nonresidential Purposes

If a taxpayer used part of his or her principal residence for a business activity, the §121 gain may or may not apply. If the nonresidential portion is not part of the dwelling unit, then the sale of the property must be treated as two properties: one as a principal residence and one as business property. The §121 exclusion does not apply to the business portion unless the two-out-of-five year test is met for that portion. If the nonresidential portion is part of the dwelling unit, then the sale of the entire property can be excluded under §121, except for depreciation applicable to the period after May 6, 1997.
Example: Anne owns a property that consists of a house, a stable, and 35 acres. Anne uses the stable and 28 acres for nonresidential purposes for more than three years out of the five-year period ending on the date of the sale. She uses the remaining seven acres and the dwelling unit as her principal residence. Anne cannot use the §121 exclusion against any of the gain from the stable and 28 acres.

Example: Barry owns a house and uses 50% as a law office, residing in the rest of the house. He claimed $2,000 of depreciation during the five years that he owned the house. He sells the house at a $13,000 gain. He can claim the §121 exclusion to exclude $11,000 of gain. The remaining $2,000 of gain represents the depreciation after May 6, 1997, that is not excludible and must be taxed as unrecaptured §1250 gain. He is not required to treat the law office portion as a separate property because it is located in his dwelling unit.

Joint Owners

Each joint owner has a $250,000 exclusion available to offset the gain from his or her portion of the property, providing he or she meets the two-out-of-five year ownership and use tests.

Surviving Spouses

Prior to the passage of the Mortgage Forgiveness Debt Relief Act of 2007, the §121 exclusion was available only if a husband and wife filed a joint return for the year of sale. Thus, if the home was sold in a year after the year of a spouse’s death—when a joint return would no longer be filed—the surviving spouse could only get a maximum homesale exclusion of $250,000.

For sales and exchanges after December 31, 2007, the Mortgage Forgiveness Debt Relief Act allows surviving spouses who have not remarried to qualify for the up-to-$500,000 exclusion if the sale occurs not more than two years after their spouse’s death and the
requirements for the $500,000 exclusion were otherwise met immediately before the spouse’s death.

Example: Orville Snook died January 9, 2008. On March 31, 2009, his grieving widow Olive (who has not remarried) sold their residence. The measuring period is two years from Orville’s death. The sale in the second tax year following his death will qualify for the relief provision because it occurs less than two years after January 9, 2008.

Apart from the homesale exclusion, Olive’s basis in Orville’s half of the property is stepped-up to its date-of-death or alternate-valuation-date value. That is, half of the gain on the property is virtually eliminated since the gain (sales proceeds – property basis) on Orville’s half of the property is only the difference between the fair market value of the property on the date of sale and on the date of his death (or alternate valuation date).

Sales of Partial Interests

The §121 exclusion is available for the sale of a partial interest, such as a 25% ownership interest or a remainder interest. However, the exclusion is limited to the normal $250,000/$500,000 limits for all of a taxpayer’s interests in the same property combined. The limit is applied starting with the first sale. For example, if a single taxpayer sells 25% ownership in his or her principal residence and excludes $100,000 of gain, the taxpayer is only able to exclude $150,000 of additional gain when he or she sells the remaining 75% ownership.

These two sales are treated as one for purposes of the “one sale every two years” provision in regard to the other transaction. However, they are treated as two separate sales in regard to any other principal residence sales.

If the partial interest sold is a remainder interest, the taxpayer can apply the §121 exclusion, but cannot exclude the gain from the sale or exchange of any other interest in the residence. The exclusion does not apply to the sale of a remainder interest if the sale is to a related party as defined in §267(b) or §707(b). (These sections include all normal related parties including family members, controlled corporations, etc.)
Partial Exclusions and Unforeseen Circumstances

A taxpayer who fails to meet the §121 ownership and use requirements or the one-sale-in-two-years requirement is eligible for a partial gain exclusion if the principal residence was sold or exchanged by reason of:

- A change in place of employment;
- Health; or
- Unforeseen circumstances.

The partial exclusion is the normal exclusion, multiplied by a fraction. The numerator of the fraction (expressed in days or months) is the shorter of:

- The lesser of the aggregate amount of time during the five-year period ending on the date of the sale or exchange that the taxpayer either
  - Owned the residence or
  - Used it as his or her principal residence, or
- The amount of elapsed time since the taxpayer last used the $250,000 (or $500,000) exclusion.

The denominator of the fraction is 730 days or 24 months (i.e., two years), depending on the measure of time used in the numerator.

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

The regulations provide safe harbor provisions. If the safe harbor provisions do not apply, items the IRS will examine include, but are not limited to:

- The sale, and the circumstances giving rise to the sale, is proximate in time.
- The suitability of the property as the taxpayer’s principal residence materially changes.
- The taxpayer’s financial ability to maintain the property materially changes.
- The taxpayer uses the property as the taxpayer’s residence during the period of the taxpayer’s ownership of the property.
- The circumstances giving rise to the sale are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer’s principal residence.
- The circumstances giving rise to the sale occur during the period of the taxpayer’s ownership and use of the property as the taxpayer’s principal residence.

**Change in Place of Employment**

The safe harbor provided in the regulations is the same test used for claiming moving expenses under §217, which is 50 miles further to commute to the new place of employment compared to the commute to the former place of employment. This applies to employees as well as self-employed individuals.

If this safe harbor provision does not apply, the facts and circumstances will be reviewed to determine if the primary reason for the sale is due to a change in place of employment.

**Example:** In July 2008, Dr. Ben K. Sea, who works as an emergency medicine physician, buys a condo five miles from his place of employment and uses it as his principal residence. In February 2009, Ben gets a job located 51 miles from his condo. He may be called in to work unscheduled hours and, when called, must be able to arrive quickly. Because of the demands of the new job, Ben sells his condo and buys a townhouse four miles from his new place of employment. Because his new job is only 46 miles farther from the condo than is his former place of employment, the sale is not within the safe harbor. However, Ben can claim a reduced maximum exclusion under §121(c)(2) because his main reason for the sale is the change in his place of employment.
**Health**

Acceptable health reasons include selling and moving to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. Selling merely to benefit the general health or well-being of the individual is not a qualifying sale.

The primary reason for the sale is deemed to be health if a physician recommends a change of residence for reasons of health as mentioned above.

**Example:** Hal’s father has a chronic disease. In 2007, Hal and his wife Joyce buy a principal residence. In 2008, they sell their house in order to move into the house of Hal’s father so that they can provide the care he requires as a result of his disease. Because, under the facts and circumstances, the primary reason for the sale of their house is the health of Hal’s father, Hal and Joyce can claim a reduced maximum exclusion under §121(c)(2).

**Unforeseen circumstances**

This is defined as the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence. Safe harbor events include:

- The involuntary conversion of the residence.
- Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence [whether or not deductible under §165(h)].
- An event determined by the Commissioner to be an unforeseen circumstance to the extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer.
- In the case of a qualified individual, one of the following events:
  - Death.
  - The cessation of employment as a result of which the qualified individual is eligible for unemployment compensation.
  - A change in employment or self-employment status that results in the taxpayer’s inability to pay housing costs and reasonable
basic living expenses for the taxpayer’s household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production of income, but not for the maintenance of an affluent or luxurious standard of living).

- Divorce or legal separation under a decree of divorce or separate maintenance.
- Multiple births resulting from the same pregnancy.

A qualified individual is the taxpayer, the taxpayer’s spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer.

For sales related to health, a qualified individual also includes a person defined in §152(a)(1) through §152(a)(8) as well as a descendant of the taxpayer’s grandparent. These sections include anyone who is related to any of the above qualified individuals as a son or daughter or a descendent of a son or daughter; a stepson or stepdaughter; a brother, sister, stepbrother, or stepsister; a father or mother or an ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister; a brother or sister of the father or mother; a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law. The term “qualified individual” also applies to a change in place of employment, although the wording in the regulations only uses the term “taxpayer” as opposed to “qualified individual.”

**Example:** The Goforth family moved to a new state due to a new job. After moving into their new home, they became aware of criminal activities occurring in their neighborhood and their son was assaulted and threatened.

Mr. Goforth was also assaulted by several neighbors, which resulted in a trip to the emergency room. Because of the assaults and the general nature of the neighborhood, they sold the home and purchased a new home in a different neighborhood. The IRS allowed the reduced exclusion based on unforeseen circumstances (PLR 200601009).
Example: After living in Home 1 for 40 years, the taxpayers retired and bought Home 2 in an age-restricted retirement community in another state. Subsequent to their move, their daughter lost her job and was in the process of a divorce. Because of the daughter’s changed financial and marital situation, it became necessary for she and her daughter to live with her parents. However, because of the age restriction in the taxpayer’s retirement community, they needed to sell Home 2. They moved back to their previous state and purchased Home 3 where the daughter and their grandchild also resided. The IRS ruled the sale of Home 2 was due to unforeseen circumstances and allowed a reduced exclusion (PLR 200601023).

A sale is considered due to ill health if the primary reason is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of a disease, illness, or injury of a qualified individual, or to obtain, or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. However, a sale that is merely beneficial to the general health or well-being of an individual would not qualify [Reg. §1.121-3(d)(1)].

A qualified individual includes a taxpayer, a spouse, a co-owner of the home, a person whose principal place of abode is in the same household as the taxpayer, and certain family members [Reg. §1.121-3(f)].

§1031 Exchanges

The like-kind exchange provisions under §1031 allow a taxpayer to defer the payment of tax on gains realized in the exchange of business or investment property until the replacement property is disposed of in a taxable transaction.
Example: Marcia DePenguins owns an office building with a FMV of $3 million. It has an outstanding mortgage of $1.5 million and a basis of $750,000. If she sells the building, she will have a gain of $2,250,000. ($3,000,000 - $750,000). She would be in the 35% tax bracket and federal taxes on the sale would be $787,500. After she pays her mortgage and the federal taxes she would have $712,500 left with which to purchase new property.

If Marcia disposed of the building in a tax-deferred like-kind exchange she would still have a realized gain of $2,250,000, but she would pay no federal taxes because the gain would not be recognized at the time of the exchange.

Property qualifying under §1031 must be “property held for productive use in a trade or business or for investment.” It does not include “stock in trade or other property held primarily for sale, ... stocks, bonds, or notes, ... other securities or evidences of indebtedness or interest, ... interests in partnership, ... certificates of trust or beneficial interest, or ... choses in action.”

To qualify under §1031, the property transferred and the property received in an exchange must be held by the taxpayer either for productive use in his trade or business or for investment. Retired property maintains its character as long as its use is not changed.

Unproductive real estate held by nondealers for future use or appreciation in value is held for investment and not primarily for sale [Reg. §1.1031(a)-1(b)]. Investment is generally the passive holding of property for more than a temporary period, with the expectation that it will rise in value. Property is not disqualified if it is being held ultimately for sale as long as it in not being treated as inventory for sale in the immediate future.

Real estate is a broad category under the like-kind rules. Almost any real estate parcel is like-kind to any other real estate parcel regardless of its location, whether it is improved or unimproved, or its capacity for profitable use.
Example: Amahl Shookup owns a duplex that he has held for rent for several years. He would like to sell the rental and replace it with an unimproved parcel of land that he intends to hold for investment. A properly structured like-kind exchange will allow Amahl to exchange the duplex for the land, avoiding recognition of gain.

Note: The term like-kind extends to leases of real property as long as there is at least 30 years remaining on the lease.

A transfer of an interest in natural resources for real property may qualify for like-kind exchange treatment. The interests must be inherently the same in character under both federal and state law. In order for an exchange of interests in oil, gas, and other natural resources to qualify as a like-kind exchange, both the interest transferred and the interest received must be characterized as the same type of property.

Example: Mineral rights in Louisiana are treated as real estate under state law (K. J. Crichton, 122 F2nd 181). The right to cut and remove timber in Oregon was treated as personal property (Oregon Lumber Company, 20 TC 192).

Identification of Property

The IRS believes, and the code concurs, that the taxpayer should have some limits imposed on the number of properties to be identified. For this reason, the code implements the “three-property”, and “200%” rules, allowing a taxpayer to identify more than one replacement property regardless of the number of properties he or she has relinquished in the same exchange.

Under the three-property rule, a taxpayer can select up to three properties without regard to their aggregate FMV. Alternatively, a
taxpayer, under the 200% rule, can select any number of properties as long as their aggregate FMV doesn’t exceed 200% of the aggregate FMV of all the relinquished properties. If more than three properties are identified, the 200% rule applies.

**Example:** On May 17, 2009, under a like-kind exchange agreement, Ed transfers unencumbered real property to Tom with a FMV of $100,000 (Property #1). On or before July 1, 2009, before the end of the 45-day identification period, Ed is required to identify like-kind replacement property.

Ed identifies three replacement properties (Properties #2, #3, and #4) in a written document that he signs and personally delivers to Tom on June 28, 2005. The written designation also provides that Ed will inform Tom by August 1, 2009, which of the three identified properties he wants to receive.

As of July 1, 2009 (the last day of the identification period) the FMVs of the identified properties are:

- $75,000 – Property #2
- $100,000 – Property #3
- $125,000 – Property #4

Since Ed didn’t choose more than three properties, all three have been properly identified before the end of the identification period. It doesn’t matter that their aggregate FMV ($300,000) exceeds 200% of the FMV of the relinquished property ($200,000).

Had Ed identified more than three properties, the exchange would still qualify provided the aggregate FMV of all four properties was less than 200% of the FMV of the relinquished property.
**Intent of Property Ownership**

The language of §1031 states the property must be held for productive use in a trade or business or held for investment. Property that has been acquired with the intent to be used as such may qualify even if it is never actually used in the trade or business. The determination of whether property is held for investment is made at the time of the exchange, even though the taxpayer’s intent at the time of original acquisition may have been entirely different.

When determining whether a transaction qualifies as a like-kind exchange under §1031, the intent of the taxpayers involved is very important.

If a taxpayer acquires (or constructs) property solely for the purpose of exchanging it for like-kind property, the IRS has ruled that the taxpayer did not hold the property for productive use in a trade or business or for investment. In this instance, the exchange did not qualify for nonrecognition treatment under §1031.

**Example:** Rush Intuit wanted to acquire a tract of land and a factory owned by Andy. Rush entered into a written agreement with Andy for the purchase of the land and factory that Andy owned.

Pursuant to the agreement, Rush acquired another tract of land and constructed a factory on that land solely for the purpose of exchanging the tract of land and new factory for Andy’s land and existing factory. Since Rush acquired the property he transferred to Andy immediately before the exchange specifically to complete the exchange, Rush did not hold the property transferred in the exchange for productive use in a trade or business or for investment.

For Rush, the exchange doesn’t qualify for nonrecognition treatment under §1031. The exchange qualifies for nonrecognition treatment for Andy (Rev. Rul. 75-291).
However, in Bolker, Joseph v. Com., 85-1 USTC ¶9400, the Ninth Circuit held that if a taxpayer owns property that he does not intend to liquidate or to use for personal pursuits, he is “holding” that property “for productive use in trade or business or for investment” within the meaning of §1031. The ruling states that a taxpayer who acquires property intending to exchange it for like-kind property satisfies the holding requirement, because he does not intend to liquidate the investment or to use it for personal pursuits. Thus, the court held that property acquired by a shareholder from his liquidating corporation was held for productive use in a trade or business or investment, even though it was promptly exchanged for like-kind property.

A different case produced the opposite result. In Barker, Francis v. U.S., 87-2 USTC ¶9444, a district court agreed with the IRS, denying like-kind treatment. A farmer, wanting to acquire additional farmland, bought a restaurant and, on the same day, exchanged the restaurant for the farmland. The court held that the farmer did not hold the restaurant for productive use in a trade or business or for investment, and the exchange, therefore, didn’t qualify for nonrecognition treatment.

**Holding Period for Property**

There is no specified holding period for property to be held for use in a trade or business or for investment. This means that the code does not specifically state that the relinquished property or the replacement property is required to be held for any length of time. This is why the “intent” of the taxpayer is critical when determining whether a transaction is a like-kind exchange.

Property acquired for the mere purpose of facilitating an exchange is generally not eligible for the nonrecognition provisions because it is difficult to prove under audit that the original intent was to hold the property for use in a trade or business, investment, or for the production of income.

On the other hand, there is nothing specific in §1031 that states a taxpayer must “hold” property for a certain amount of time (with the exception of related-party exchanges) before it can be sold, converted to personal use, or exchanged. In these situations where the use of the property changes after a like-kind exchange, original intent becomes more crucial.
Note: Since the American Jobs Creation Act of 2004, a taxpayer who converted a rental property that was acquired in a like-kind exchange to a personal residence, must own that residence for a period of five years before any gain can be excluded from a sale under §121.

Example: On January 1, 2005, Condaleaser Rice acquired a condominium to be used as rental property in a tax-free like-kind exchange under §1031. Condaleaser rents the condominium to unrelated parties during 2005 and 2006. On January 1, 2007, Condaleaser moves into the condominium and uses it as her principal residence until she sells the condominium on January 2, 2009. Since she acquired the condominium in a tax-free like-kind exchange four years before the date of the sale, the five-year holding period provided in §121(d)(10) isn’t satisfied. Thus, §121(d)(10) prevents the application of the exclusion to the sale of her condominium even though she satisfied the two-year ownership and use requirements of §121(a). Had Condaleaser waited one more year before selling her condominium, she would have been allowed to exclude the gain.

For determining whether the gain from the sale of property acquired in a like-kind exchange qualifies as either long-term or short-term capital gain, the holding period of the property surrendered tacks onto the holding period of the property acquired.

Identification Period

The replacement property that is to be received must be identified on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property. To be considered “identified,” the property must be designated as replacement property in a written document, signed by the taxpayer, and delivered to the person obligated to transfer the replacement property to the taxpayer.
Since the 45-day period is specified by §1031(a)(3)(A), no extensions of time are available. Exceptions apply for postponements for certain taxpayers affected by Presidentially declared disasters, a military or a terroristic action, or certain taxpayers serving in combat zones and contingency operations.

**Example:** Randy, a calendar-year taxpayer, enters into an agreement with Ron for an exchange of rental properties. The agreement requires Randy to transfer a duplex to Ron, and identify replacement property that Ron is required to purchase and transfer to Randy. Randy transfers the duplex to Ron on November 16, 2008. The identification period ends at midnight on December 31, 2008, the day which is 45 days after the date of the transfer of the duplex.

An identification of replacement property can be revoked at any time before the end of the 45-day identification period. However, the revocation is only recognized, for purposes of the three-property and 200-percent rules.

**Exchange Period**

The exchange period also begins on the date of transfer of the relinquished property, and ends on the earlier of:

- 180 days thereafter; or
- The due date, including extensions, of the tax return for the year the relinquished property is transferred.

The exchange must be a completed transaction. This means that the replacement property must be received by the earlier of the 180th day after relinquishing the property, or by the due date of the taxpayer’s return for the year in which the exchange takes place. If the unextended due date is earlier, it may be to the taxpayer’s advantage to request an extension of time to file his or her tax return.
Note: If the taxpayer relinquishes two or more properties on more than one date, the identification period and the exchange period start running from the earliest date on which any of the properties was transferred [Reg. §1.1031 (k)-1(b)(2)(iii)].

There is no good-faith exception to the requirement that a taxpayer receive replacement property within the 180-day exchange period. A postponement may apply for certain taxpayers affected by Presidentially declared disasters, a military or a terroristic action, or certain taxpayers serving in combat zones and contingency operations.

Related Party Exchanges

For related party exchanges, there is a two-year holding period rule. If the related party sells the exchanged asset in a disqualifying disposition, the original seller must recognize gain when the related buyer sells.

Disqualifying dispositions do not include dispositions by reason of any of the following:

- The death of either party.
- The compulsory or involuntary conversion of the exchanged property.
- Any other disposition if neither the disposition nor the exchange had as one of its principal purposes the avoidance of federal income tax.

A related party for this purpose includes the following under §267(b) and §707(b)(1):

- Members of the family, including brothers and sisters, spouse, ancestors, and lineal descendents.
- An individual and the corporation in which the individual owns, directly or indirectly, more than 50% of the stock.
- Two corporations in the same controlled group.
- A grantor and a fiduciary of any trust.
- A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts.
- A fiduciary of a trust and a beneficiary of such trust.
- A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of the trust.
- A fiduciary of a trust and a corporation if more than 50% of the value of the outstanding stock is owned, directly or indirectly, by the trust or the grantor of the trust.
- A person and a §501(c)(3) organization for educational or charitable purposes if the organization is controlled, directly or indirectly, by such person or a family member of such person.
- A corporation and a partnership if the same person owns 1) more than 50% in value of the outstanding stock of the corporation, and 2) more than 50% of the capital interest, or the profits interest, in the partnership.
- An S corporation and another S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- An S corporation and a C corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- A partnership and a person owning, directly or indirectly, more than 50% of the capital or profits of the partnership.
- Two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interest.

**Qualified Intermediary**

A key component of a like-kind exchange is that the taxpayer wants to avoid an inadvertent sale. For this reason, it is critical that the taxpayer does not have constructive receipt of any sales proceeds. Since a like-kind exchange rarely is the result of two parties participating in a simultaneous exchange, there are four safe-harbor options the taxpayer can utilize to avoid constructive receipt of sales proceeds.

**Qualified Intermediaries** — A qualified intermediary (QI) can be a person or a company. The qualified intermediary acts to facilitate the exchange by entering into an agreement with the exchanger for the exchange of properties. The qualified intermediary generally charges a fee for this service.
Security or Guarantee Arrangements — Securing or guaranteeing the transfer of property can be accomplished by a mortgage, deed of trust, or other security interest (other than cash), or a standby letter of credit.

Qualified Escrow Accounts and Trusts — An escrow account is considered qualified if the exchanger is not the escrow account owner, or the escrow account holder is not a related party. The exchanger must not have any rights to the cash or other property in the account until the exchange has been successfully completed. A qualified trust is one in which the exchanger, or a related party is not the trustee.

Interest and Growth Factors — The taxpayer is treated as being entitled to receive interest or a growth factor if the amount of money or other property to which the taxpayer is entitled depends upon the length of time that elapses between the transfer of the property to be relinquished and the receipt of the replacement property.

For purposes of this text, the focus is on qualified intermediaries and escrow accounts.

The use of a qualified intermediary to facilitate a like-kind exchange is sanctioned as a safe harbor only if the agreement between the taxpayer and the intermediary expressly limits the taxpayer’s right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the intermediary.

A qualified intermediary is a person who is not the taxpayer, related party, or disqualified person who facilitates a deferred like-kind exchange by entering into an agreement with the taxpayer for the exchange of properties. He/she then acquires the relinquished property from the taxpayer, transfers it, and acquires the replacement property and transfers it to the taxpayer.

Disqualified Person

A disqualified person is any of the following:

- A person who is an agent of the transferor at the time of the transaction.
- A person related to the transferor, if a 10% test were substituted for the 50% test under §267(b) or §707(b).
- A person related to an agent of the transferor, if a 10% test were substituted for the 50% test under §267(b) or §707(b).
Agent of the Transferor

An agent of the transferor is one who, within the two-year period ending on the date of the transfer of the first of the relinquished properties, is any of the following:

■ An employee of the transferor.

■ An accountant or an attorney of the transferor. An attorney is considered an agent of the taxpayer if the attorney provided services for the taxpayer at any time during a two-year period ending on the date of the exchange.

■ An investment banker, broker, or real estate agent of the transferor.

■ Any person who has an agency relationship with the transferor at the time of the transfer.

■ An individual who represents the transferor in the purchase or sale of a property unrelated to the like-kind exchange.

Example: On November 1, 2007, you hired an attorney to prepare your will. You cannot use this same attorney to hold escrowed funds for the purpose of acquiring replacement property in a like-kind exchange at any time prior to November 1, 2009. Work in connection with a prior exchange is disregarded under this rule.
**Like-Kind Exchange Terms**

<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Boot</strong></td>
<td>The common term used to refer to nonlike-kind property that is transferred as part of an otherwise tax-free exchange. This consists of cash, unlike property, and obligations (net liabilities). Boot may be paid or received. When boot is received, taxable income may occur. Boot property is generally valued at its FMV at the time of transfer and is given a FMV basis.</td>
</tr>
<tr>
<td><strong>Partially Tax-Deferred Exchange</strong></td>
<td>An exchange in which like-kind and nonlike-kind property are received. Gain is recognized in this type of exchange to the extent of the FMV of the unlike property or money received.</td>
</tr>
<tr>
<td><strong>Qualified Intermediary</strong></td>
<td>A person who is not the taxpayer or a related party and who acts to facilitate a deferred like-kind exchange by entering into an agreement with the taxpayer for the exchange of properties, acquires the relinquished property from the taxpayer, transfers it, and acquires the replacement property and transfers it to the taxpayer.</td>
</tr>
<tr>
<td><strong>Realized Gain</strong></td>
<td>The sum of all money received, net liabilities given up, and the FMV of all property received, minus the basis of the property traded.</td>
</tr>
<tr>
<td><strong>Recognized Gain</strong></td>
<td>The lesser of realized gain or boot at FMV. This is the amount that is taxable. In the case of multiple properties exchanged, recognized gain is the lesser of the realized gain or the exchange group deficiency.</td>
</tr>
<tr>
<td><strong>Reverse Exchange</strong></td>
<td>An exchange where the taxpayer acquires the replacement property before transferring the relinquished property.</td>
</tr>
</tbody>
</table>

**Boot**

Boot is defined as the money or other un-like (nonqualifying) property received in the exchange. This includes net liabilities assumed or attached to property received.

Giving boot along with qualified property does not void the §1031 rules. For the nonqualifying property, the transferor is deemed to have received an amount equal to its FMV as determined on the date of the exchange.
Example: Schlomo Replay transferred rental property and stock for another rental property. Schlomo’s rental property had an adjusted basis $25,000 and a FMV of $26,000.

On the date of the exchange, Schlomo’s adjusted basis in the stock was $6,000 with a FMV of $4,000.

The rental property Schlomo received had a FMV of $30,000. Since the FMV of the stock was $4,000, Schlomo is deemed to have received $4,000 worth of real estate for the stock. Stock for real estate does not qualify for like-kind exchange treatment, therefore, Schlomo is entitled to a $2,000 capital loss on the transfer of the stock. His basis in the real estate received is the adjusted basis of the property transferred ($25,000 + $6,000), reduced by the loss recognized on the stock ($2,000) for a total basis of $29,000 ($25,000 + $6,000 – $2,000).

Net liabilities relieved are considered boot received. The transferor is allowed to net the liabilities assumed against the liabilities relieved.

If the assumed liabilities are greater than the liabilities discharged, no boot is received.

Example: Neera Nuff exchanged an office building with a FMV of $150,000 for an apartment complex with a FMV of $235,000. The office building was subject to a $25,000 mortgage. The apartment complex carried a $110,000 mortgage. Each party to the exchange assumed the other mortgage. The net liabilities assumed by Neera were $85,000 ($110,000 – $25,000). Since the liability assumed by Neera was greater than the liability transferred, Neera does not recognize boot.

If cash is received and the net liabilities assumed are greater than the liabilities given up, the increase in liabilities does not offset the cash received. The cash results in taxable income from the exchange.

Liabilities discharged may be netted against liabilities assumed and cash paid.
Example: Barb Dwyer owns an apartment building with a basis of $100,000, a FMV of $220,000, and is subject to a mortgage of $80,000.

Susan owns an apartment building with a basis of $175,000, a FMV of $250,000, and is subject to a mortgage of $150,000. Susan and Barb exchange properties with Barb receiving an additional $40,000 cash. The liabilities were also exchanged.

Barb’s realized gain from the exchange is $120,000:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of property received</td>
<td>$250,000</td>
</tr>
<tr>
<td>Cash received</td>
<td>$40,000</td>
</tr>
<tr>
<td>Liability transferred</td>
<td>$80,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$370,000</td>
</tr>
<tr>
<td>Less adjusted basis of property transferred</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less debt assumed</td>
<td>$150,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$250,000</td>
</tr>
<tr>
<td>Total</td>
<td>$120,000</td>
</tr>
</tbody>
</table>

Since Barb assumed more debt than she gave up, the boot is limited to the $40,000 cash. The gain recognized is the lesser of the realized gain ($120,000) or the boot ($40,000).

Susan realized a gain of $75,000:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of property received</td>
<td>$220,000</td>
</tr>
<tr>
<td>Plus debt relief</td>
<td>$150,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$370,000</td>
</tr>
<tr>
<td>Less adjusted basis of property transferred</td>
<td>$175,000</td>
</tr>
<tr>
<td>Less cash paid</td>
<td>$40,000</td>
</tr>
<tr>
<td>Less liability assumed</td>
<td>$80,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$295,000</td>
</tr>
<tr>
<td>Total</td>
<td>$75,000</td>
</tr>
</tbody>
</table>

Since Susan paid cash in the transaction, she is able to add the cash paid to the liabilities assumed before netting it against the liabilities relieved. After the netting, Susan is relieved of $30,000 of debt [$150,000 − ($40,000 + $80,000)]. As such, Susan has a recognized gain of $30,000.
An individual may receive as boot an installment obligation issued by the other party.

The transferor’s basis in the property transferred will first be allocated to the like-kind property received by the taxpayer up to, but not in excess of, the FMV of such property. If the transferor’s basis exceeds the FMV of the permitted property, that excess is “excess basis.”

In making installment sale determinations, the exchange is treated as if the taxpayer had made an installment sale of appreciated property in which the consideration received was the installment obligation and any other boot.

The selling price is the sum of the face value of the installment obligation, any net qualified indebtedness, any cash received, and the FMV of any other boot. The basis is the excess basis. The total contract price is the selling price less any qualifying indebtedness that does not exceed the excess basis.

The effect of this allocation is to maximize the percentage of each payment received on the installment obligation to be reported as gain from an installment sale.

**Example:** Denton Fender holds qualified property with an adjusted basis of $40,000 and a FMV of $100,000. Denton exchanges his property for other qualifying property with a FMV of $20,000, cash of $20,000, and an installment obligation of $60,000.

Denton’s basis in the property given up ($40,000) is allocated to the property received up to the FMV ($20,000) leaving $20,000 of excess basis.

Denton is treated as selling this appreciated property for $20,000 and the $60,000 installment obligation ($80,000).

The contract price is $80,000 with a gross profit of $60,000 ($80,000 – $20,000). The gross profit percent is 75% ($60,000 ÷ $80,000). Denton recognizes a gain of $15,000 on the receipt of the cash ($20,000 x 75%) and $45,000 on the receipt of the installment payments ($60,000 x 75%). His basis in the property he acquired is $20,000.
Realized Gain

Receiving boot triggers gain recognition if there is realized gain. Gain realized is the excess of the FMV of property received over the tax basis of the property given up. All, part, or none of the gain realized in a like-kind exchange may be recognized at that time for tax purposes. However, in no case can the gain recognized exceed the gain realized.

Recognized Gain

The recognized gain is the lesser of the boot received or the realized gain. Realized gain serves as the ceiling on the amount of gain that can be recognized.

Example: Tim and Tom exchange land in a transfer qualifying as a like-kind exchange under §1031. Tim’s adjusted basis in his land is $20,000 with a FMV of $24,000. Tom’s land is worth only $19,000, so Tom also gives Tim $5,000 cash. Tim’s recognized gain is $4,000, the lesser of the realized gain ($24,000 – $20,000) or the FMV of the boot received ($5,000).

Basis of Property Received in an Exchange

The basis of like-kind property received is computed as follows:

- The adjusted basis of the property traded,
- PLUS
- Boot paid, exchange expenses paid, and gain recognized,
- MINUS
- Boot received, and any loss recognized on the exchange.

When a loss is realized and property other than like-kind property is received in an exchange, no loss is recognized. The basis of the like-kind property received in the exchange is reduced by the boot received.
Example: Janice transferred land with a basis of $45,000 for land with a FMV of $30,000 plus $10,000 in cash. A loss of $5,000 is realized, but not recognized. The basis of the new land Janice acquired is $35,000 ($45,000 – $10,000).

The basis of nonlike-kind property received in a like-kind exchange is the property’s FMV.

Example: Ann Drogeny exchanged a residential rental building for a duplex. Using the information below and the Like-kind Exchange Worksheet on the following page, Ann’s recognized gain and basis in the new property are as follows:

Property transferred:
- FMV $100,000
- Adjusted basis $25,000
- Mortgage balance $35,000

Property acquired:
- FMV $100,000
- New mortgage $50,000
- Cash received $15,000

Using the worksheet, Ann would have:
- Realized gain $75,000
- Recognized gain $15,000
- Basis in new property $40,000
### Like-kind Exchange Worksheet

#### A. Realized Gain

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>+ FMV of all property received</td>
</tr>
<tr>
<td>2.</td>
<td>+ Total cash received</td>
</tr>
<tr>
<td>3.</td>
<td>+ Liabilities transferred</td>
</tr>
<tr>
<td>4.</td>
<td>Total additions (Add lines 1, 2, and 3)</td>
</tr>
<tr>
<td>5.</td>
<td>- Adjusted basis of property(s) transferred</td>
</tr>
<tr>
<td>6.</td>
<td>- Cash paid</td>
</tr>
<tr>
<td>7.</td>
<td>- Liabilities received</td>
</tr>
<tr>
<td>8.</td>
<td>- Expenses of exchange</td>
</tr>
<tr>
<td>9.</td>
<td>Total subtractions (Add lines 5, 6, and 7)</td>
</tr>
<tr>
<td>10.</td>
<td>Gain realized (line 4 minus line 9)</td>
</tr>
</tbody>
</table>

#### B. Boot Received

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Cash received</td>
</tr>
<tr>
<td>2.</td>
<td>FMV of non-like-kind property received</td>
</tr>
<tr>
<td>3.</td>
<td>Liabilities transferred</td>
</tr>
<tr>
<td>4.</td>
<td>Liabilities received</td>
</tr>
<tr>
<td>5.</td>
<td>Cash paid</td>
</tr>
<tr>
<td>6.</td>
<td>FMV of non-like-kind property transferred</td>
</tr>
<tr>
<td>7.</td>
<td>Add lines 4, 5, and 6</td>
</tr>
<tr>
<td>8.</td>
<td>Line 3 minus line 7 (not less than zero)</td>
</tr>
<tr>
<td>9.</td>
<td>Line 7 minus line 3</td>
</tr>
<tr>
<td>10.</td>
<td>Add lines 1, 2, and 8</td>
</tr>
<tr>
<td>11.</td>
<td>Expenses of exchange</td>
</tr>
<tr>
<td>12.</td>
<td>Smaller of line 10 or line 11</td>
</tr>
<tr>
<td>13.</td>
<td>Boot received (line 10 minus line 12)</td>
</tr>
<tr>
<td>14.</td>
<td>Boot paid (line 9 plus line 11, minus line 12)</td>
</tr>
</tbody>
</table>

#### C. Recognized Gain

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Realized gain (Section A, line 10)</td>
</tr>
<tr>
<td>2.</td>
<td>Gain or loss on non-like-kind property transferred</td>
</tr>
<tr>
<td>3.</td>
<td>Realized gain from the exchange (line 1 minus gain or plus loss from line 2)</td>
</tr>
<tr>
<td>4.</td>
<td>Recognized gain from the exchange (lesser of lines B.13 or C.3)</td>
</tr>
</tbody>
</table>

#### D. Basis of Property Received

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Adjusted basis of property transferred (Section A, line 9)</td>
</tr>
<tr>
<td>2.</td>
<td>Recognized gain (Section C, line 2 plus line 4)</td>
</tr>
<tr>
<td>3.</td>
<td>Add lines 1 and 2</td>
</tr>
<tr>
<td>4.</td>
<td>Cash received (Section B, line 1)</td>
</tr>
<tr>
<td>5.</td>
<td>Liabilities transferred (Section B, line 3)</td>
</tr>
<tr>
<td>6.</td>
<td>Loss on non-like-kind property (Section C, line 2)</td>
</tr>
<tr>
<td>7.</td>
<td>Add lines 4, 5, and 6</td>
</tr>
<tr>
<td>8.</td>
<td>Basis of property received (line 3 minus line 7)</td>
</tr>
<tr>
<td>9.</td>
<td>Basis of non-like-kind property received (FMV)</td>
</tr>
<tr>
<td>10.</td>
<td>Basis of like-kind property received (line 8 less line 9)</td>
</tr>
</tbody>
</table>
**Basis Allocation**

If more than one property is received in an exchange, the basis is allocated to each property. The basis is allocated in the following order to nonqualified, nondepreciable (basis is allocated to nondepreciable property up to FMV), and depreciable property. Remaining basis is allocated on a pro-rata basis. The parties to the exchange must allocate the excess consideration using the residual method to determine the amount realized from, and the basis in, each of the transferred assets.

**Example:** Fred has an adjusted basis in his land and building of $430,000. He exchanges his property for land, $8,000 cash and a truck with a FMV of $10,000. The basis is allocated first to the cash, then to the truck. This leaves an adjusted basis in his new land of $412,000 ($430,000 – $8,000 – $10,000).

**Exchange Expenses**

Expenses such as brokerage expenses and commissions related to the tax-free exchanges are applied in three different ways (Rev. Rul. 72-456). Finder’s fees and legal expenses may receive the same treatment.

- Expenses can be deducted or offset in computing the amount of gain or loss that is realized in a like-kind exchange.
- Expenses paid can be offset against cash payments received in determining the amount of gain that may be recognized in such exchanges.
- Expenses may also be included in the basis of the property received.

Money received as part of the §1031 exchange can be used to pay the selling expenses and exchange expenses. Only the net remaining money would be taxable boot. Some examples of allowable expenses include:

- Commissions.
- Loan origination fees.
- Tax service fees.
- Transfer fees.
- Legal fees.
- Escrow fees.
- Title policy premiums.
- Recording fees.

This can be tricky because there are nonexchange expenses often paid out of the escrow holding the proceeds from the sale of the relinquished property. In TC Memo 1994-48, the court considered nonexchange expenses paid out of escrow as boot separate from the relief of liabilities. Therefore, nonexchange expenses will need to be offset by “cash” boot paid in, not the increase in liabilities assumed or obtained. The case did not expand on what the nonexchange expenses were, nor is there any guidance in the instructions to Form 8824, Like-Kind Exchanges. Therefore, it would seem logical to use the rules for when a property is sold and/or there is a purchase of property.

Examples of expenses which may be paid out of escrow that are not considered exchange expenses include:
- Loan origination fees.
- Property taxes (not amounts owed by the seller that the buyer pays, those add to the purchase price of the replacement property.)
- Mortgage interest.
- Appraisal fee to obtain a loan.

Although they are not used as exchange expenses for a like-kind exchange, they are reported as expenses elsewhere on the return (i.e. loan origination fees and appraisal fees to obtain a loan are amortized over the life of the loan, mortgage interest is currently deductible as well as property taxes.) This holds true in an outright sale as well. When reporting the sale of property, gain recognized is not reduced by the proceeds from the sale being used to pay property taxes or mortgage interest.

If the taxpayer does not want to pay tax on the boot that is generated by nonexchange expenses being paid, “cash” boot should be contributed to offset the payment of these expenses so that there will be no net boot received as a result of these expenses being paid out of the escrow.
**Deferred Exchanges**

A deferred exchange is one in which the replacement property is not received immediately upon the transfer of the relinquished property. The deferred exchange rules are the result of the Starker case, which first allowed exchanges that were not simultaneous.

Most real property and some personal property transactions using §1031 are deferred exchanges. Actual exchanges are difficult to set up due to trying to match a buyer and a seller with properties the other desires.

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**Note:** If the deferred exchange begins at a time when the 180th day falls into the following year, it is important to be conscious of the due date of the return. A return can be extended to allow the full use of the 180 days. If it is not extended, the replacement period ends with the due date of the return. If the return is filed and the property has not been replaced by that time, the like-kind exchange becomes void. This causes realization of income in the year that the property was given up, but recognition comes when the money or property is received.

The return that has been filed needs to be amended to report the sale as an installment sale with no payment received in the year of sale. In the following year, the gain is recognized.

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**Example:** Dot Matrix entered into a deferred exchange by giving up a parcel of land on November 1, 2008. This started the running of the 45-day identification period and the 180-day delivery period. The 180-day delivery period ends on April 29, 2009. Since Dot’s tax return is due on April 15, 2009, without an extension, the exchange property must be delivered by April 15, 2009.
With the transfer of relinquished property in a deferred exchange, gain or loss must be recognized if the transferor actually or constructively receives money or other property before receiving the like-kind property. Actual or constructive receipt would cause the transaction to be treated as a sale and purchase, even though like-kind property would eventually be received.

The obligation of the recipient to transfer replacement property is permitted to be secured by cash or a cash equivalent if it is held in a qualified escrow account or in a qualified trust. The trustee cannot be the taxpayer or a disqualified person, and the taxpayer’s rights to receive, pledge, borrow, or otherwise receive benefits of the account are limited.

The taxpayer’s transferee may be the taxpayer’s agent as long as the transferee is a qualified intermediary (QI) and the taxpayer’s right to receive money or other property from the QI are limited.

The taxpayer is permitted to receive interest or a growth factor with respect to the deferred exchange, provided the taxpayer’s rights to receive such are expressly limited to certain circumstances.

**Requirements for a Deferred Exchange**

The requirements for a deferred exchange should encourage most practitioners to work with an attorney familiar with §1031 and a title company. The most often used method is through a QI. A general outline of steps to follow for a §1031 deferred exchange is to have the property owner or agent do the following:

- Sell the current property but not close on it.
- Assign all rights, title, and interest in the sale contract to a QI.
- Agree to notify the QI when all contingencies of the assigned contract have been removed.
- Require the QI to pay all normal selling expenses out of proceeds.
- Direct the QI to hold all net proceeds, and state in the agreement language clearly indicating that the seller has no right to receive, pledge, borrow, or otherwise obtain any benefit from such proceeds until: (1) The seller fails to identify a replacement property within 45 days of closing, or (2) The passage of 180 days after closing or due date of the tax return.
- Identify in writing replacement property or properties. The property’s legal description mailed or hand delivered within 45 days will satisfy this requirement.
- Notify the QI of the closing date of the replacement property or properties.
- Notify the QI to pay all costs of acquiring the replacement property, including reimbursing the seller for any funds that have been expended prior to closing.
- Put a statement in the agreement noting that it is the intent of the seller to qualify the QI as a “Qualified Intermediary” as defined by Reg. §1.1031(k)-1(G)(4).
- Put a statement in the agreement that the QI is entering into this agreement only to facilitate an exchange on behalf of the seller.

Reverse Exchanges

Situations in which a taxpayer receives the replacement property before he or she transfers the property to be relinquished are called “reverse-Starker” transactions. In general, these types of transactions are not covered by the like-kind regulations under Reg. §1.1031(k)-1, and do not qualify as like-kind exchanges.

To get around that problem, taxpayers can use “parking” arrangements where a replacement property is parked with a third party until the taxpayer transfers the relinquished property, or the relinquished property is parked with a third party who holds it until a transferee is identified.

These transactions must be structured so that the third party, or the “accommodation party,” is treated as the owner of the replacement, or relinquished property for federal income tax purposes. The safe harbor rules in Rev. Proc. 2000-37 allow these accommodation transactions to qualify as like-kind exchanges.

In order to qualify for the benefits of §1031, the replacement property that was purchased prior to relinquishing the property must be held or “parked” in a “Qualified Exchange Accommodation Agreement” (QEAA). Property is considered held in a QEAA if all the following requirements are met:

- The taxpayer must use the service of an intermediary who meets special standards that are somewhat more strict than for normal qualified intermediaries.
At the time title is transferred to the QEAA intermediary, it must be the taxpayer’s intent to use the property to complete a tax-deferred exchange.

Within five business days of the title being transferred to the QEAA intermediary, there must be a written agreement between the taxpayer and the intermediary establishing the intent to use the property to complete the exchange. 

Within 45 days of the QEAA intermediary receiving title to the new property, the taxpayer must identify the property to be relinquished.

Within 180 days of the QEAA intermediary receiving title to the new property, the title must be transferred to the taxpayer. 

The total time that the received and given property are held in the QEAA must not exceed 180 days.

In Rev. Proc. 2000-37, the IRS took the position that the first property to be transferred is treated as if it were the relinquished property, even if it is actually the replacement property, and the date the taxpayer (or an intermediary) receives it starts the statutory period (45-day identification period). Therefore, under Rev. Proc. 2000-37, the taxpayer must identify the property he or she will exchange (or relinquish) within 45 days after the transfer of the replacement property, which is a reverse of the exchange period prescribed by §1031(a)(3)(A) and Reg.§1.1031(k)-1(c).

**Additional §1031 Rules**

When qualified properties are exchanged, the holding periods are added together for the purpose of selling the replacement property. If nonqualified property is received in an exchange, the holding period for that property starts on the exchange date. It should also be noted here that there is no defined holding period for the property given up. The code states it must have been held for business or investment.

Money received as part of an exchange is taxable to the extent it is not used for expenses of the exchange. If the taxpayer wants to get money out of a transaction tax-free, the safer route would be additional financing against the property received in the exchange. If pre-exchange refinancing is done, there is a risk of the refinancing being considered as a part of the exchange itself. If the IRS took that position, it would lead to taxable boot. If the refinancing is done after the exchange, no such problem appears to exist.
The interest or earnings on the escrowed money belong to the party named in the agreement. This is normally the seller, not the QI. If an exchange is not completed by year-end, the party entitled to the earnings must report the income on their return. This is the case even though the seller cannot use, pledge, borrow, or assign the money.

A §1031 exchange will qualify for property not yet in existence. If it is a personal property exchange, the property must be produced or constructed within 180 days after the other property is given up. If it is real property, the replacement property does not have to be completed, but it must be transferred within the 180 days, and only the value at that time can be used as part of the exchange. There is also a concern that if the property is not finished, the cost of finishing it after the 180 days could be pro-rata boot [Reg. §1.1031(k)-1(e)].

Partnerships can use deferred exchanges on property not yet built. A partnership exchanging properties does not complicate the transaction if all partners agree.

Although the exchange of a partnership interest generally does not qualify for like-kind exchange treatment, a partnership (and other entities) can exchange property owned using §1031.

Quite often, using §1031 with personal property leads to not being able to recognize a loss. In most cases, it is not difficult to disqualify the transaction with planning.

Exchange tax savings on real property is at a maximum rate of 20% for sales prior to May 6, 2003. For sales on or after May 6, 2003, the maximum rate is reduced to 15%. There is a maximum rate of 25% on unrecaptured §1250 gain, while forgone depreciation could be at 35%, the highest individual rate.

Within the 45-day identification period the transferor is allowed to revoke previously identified properties and identify new ones.

If multiple properties are being sold or transferred in a deferred exchange, the important date is the first sale date. It starts the exchange period for all properties.

When a deferred exchange fails within the identification period or replacement period, the failure date becomes the recognition date. This would allow moving the taxable event into another year by failing either the 45-day or 180-day tests.
If there are suspended losses, the transferor may want to receive at least enough taxable boot to free up the suspended losses.

**Depreciation of Property Acquired in a Like-Kind Exchange**

In February 2004, the IRS released temporary regulations explaining how to depreciate property acquired in like-kind exchanges. The regulations adopt a modified form of the “split basis” concept that was detailed in Notice 2000–4. The guidance may be beneficial, but because of its complexity, taxpayers can elect not to apply them.

**Note:** The election is made by the due date (including extensions) of the return for the year of replacement on Form 4562, Depreciation and Amortization. A separate election is required for each like-kind exchange the taxpayer would like to not apply the temporary regulations to. Your tax software should have some sort of box to check or some other way of indicating that the taxpayer would like to elect out.

Under Notice 2000-4, MACRS property acquired in a like-kind exchange for new MACRS property was depreciated in the same manner as the exchanged property for the portion of the taxpayer’s basis in the acquired property that didn’t exceed the taxpayer’s adjusted basis in the exchanged or involuntarily converted property. In simple terms, the acquired MACRS property was depreciated over the remaining recovery period of the exchanged MACRS property, using the same depreciation method and convention as that of the exchanged or converted MACRS property.

However, any excess of the basis in the acquired MACRS property over the adjusted basis in the exchanged or converted MACRS property was treated as newly purchased MACRS property. This was a simple concept. Unfortunately, the IRS issued temporary regulations under §168 that complicated the depreciation rules exponentially. Notice 2000-4 is now obsolete for exchanges occurring after February 27, 2004.
The temporary regulations covering the depreciation of property acquired in a like-kind exchange contain a new set of terms that form the basis for these rules. It is necessary to understand the usage of these terms in order to accurately apply the rules of the temporary regulations. These key terms are:

**Exchange Basis:** The taxpayer’s depreciable basis in the replacement property determined after calculating year-of-disposition depreciation for the relinquished property. The exchange basis usually equals the adjusted basis of the relinquished property after subtracting year-of-disposition depreciation.

**Excess Basis:** The taxpayer’s additional depreciable basis (if any) in the replacement property over and above the amount of exchange basis. The excess basis usually equals the amount of additional consideration paid to acquire the replacement property. The excess basis amount is reduced by the amount of replacement property basis expensed under §179 (if any).

**Depreciation of Excess Basis**

The depreciation of excess basis is pretty straightforward under the rules provided in the temporary regulations. Under these rules, any excess basis in the replacement property is treated as property that is placed in service in the year of replacement. This means that the depreciation allowances for the depreciable excess basis are determined by using the applicable recovery period, depreciation method, and convention prescribed under the MACRS rules for the replacement property at the time of replacement.

**Depreciation of Exchange Basis**

The temporary regulations provide not-so-straightforward rules for determining the depreciable exchange basis of MACRS replacement property involved in a like-kind exchange.

If both the recovery period and the depreciation method under the MACRS rules for the replacement property are the same as the recovery period and the depreciation method under the MACRS rules for the relinquished property, the depreciation allowances for the replacement property beginning in the year of replacement are determined by using the same recovery period and depreciation
method that were used for the relinquished property. Thus, the replacement property is depreciated over the remaining recovery period, and by using the depreciation method of the relinquished property.

If the recovery period and/or the depreciation method under the MACRS rules for the replacement property are different than the recovery period and/or the depreciation method under the MACRS rules for the relinquished property, the depreciation allowances for the replacement property beginning in the year of replacement is determined as follows:

- If the recovery period for the replacement property is longer than the recovery period for the relinquished property, then the depreciable exchange basis of the replacement property is depreciated over the recovery period of the replacement property that would remain if the replacement property had been placed in service when the relinquished property had been placed in service.

**Example:** Mia Culpa placed in service a residential rental property in 1998 with a recovery period of 27.5 years. In 2008, Mia completes a like-kind exchange under §1031 and replaces the residential rental property with nonresidential real property. Since nonresidential real property has a recovery period of 39 years (longer recovery period), Mia will depreciate the property using the remaining years of the longer 39 year recovery period as if it had been placed in service in 1998.

- If the recovery period for the replacement property is shorter than the recovery period for the relinquished property, then the depreciable exchange basis of the replacement property is depreciated over the remaining recovery period of the relinquished property.
Example: Mia placed in service a nonresidential real property in 1998 with a recovery period of 39 years. In 2008, Mia completes a like-kind exchange under §1031 and replaces the nonresidential real with residential rental property. Since the residential rental property has a shorter recovery period of 27.5 years, Mia will depreciate the replacement property over the remaining years of the longer 39 year recovery period.

This would be an instance where it would be to the taxpayer’s benefit to elect not to apply these new rules because the remaining years of depreciation for the relinquished 39 year property is longer than the recovery period of the new 27.5 year replacement property.

If the depreciation method for the replacement property is less accelerated than the relinquished property, the depreciation allowance for the depreciable exchange basis beginning in the year of replacement is determined as though the replacement property had originally been placed in service at the same time the relinquished property was placed in service, but the less accelerated depreciation method will be used. In other words, the depreciable exchange basis is depreciated using the less accelerated depreciation method.
Example: The depreciation method of the replacement property in the year of replacement is the 150% declining balance method (less accelerated) and the depreciation method of the relinquished property in the year of replacement is the 200% declining balance method (more accelerated method.) Neither method had been switched to the straight line method in the year of replacement nor any prior taxable year.

The applicable depreciation rate for the year of replacement and subsequent taxable years is determined by using the depreciation rate of the replacement property (the less accelerated 150% declining balance method) as if the replacement property was placed in service at the same time the relinquished property was placed in service (that is until the 150% declining balance method has been switched to the straight-line method.)

If the depreciation method of the replacement MACRS property is the straight-line method, the applicable depreciation rate for the year of replacement is determined by using the remaining recovery period at the beginning of the year of disposition.

If the depreciation method for the replacement property is more accelerated than the relinquished property, the depreciation allowance for the depreciable exchange basis for the replacement property beginning in the year of replacement is determined using the same depreciation method as the relinquished property. In other words, the depreciable exchange basis is depreciated using the more accelerated depreciation method.
Example: The depreciation method of the replacement property in the year of replacement is the 200% declining balance method (more accelerated), and the depreciation method of the relinquished property in the year of replacement is the 150% declining balance method (less accelerated.) Neither method had been switched to the straight-line method in the year of replacement nor any prior taxable year.

The applicable depreciation rate for the year of replacement and subsequent taxable years is the same depreciation rate that applied to the relinquished property in the year of replacement (the more accelerated 200% declining balance method and until the 150% declining balance method has been switched to the straight-line method.)

If the depreciation method is the straight-line method, the applicable depreciation rate for the year of replacement is determined by using the remaining recovery period at the beginning of the year of disposition.

If that was not enough, there is one more thing to consider, convention. The applicable convention for the exchange basis is deemed to be the mid-month convention for replacement property that is nonresidential real property, residential rental property, or any railroad grading or tunnel bore. Thus, if the relinquished property was depreciated using the mid-month convention, then the replacement property is deemed to have been placed in service in the same month as the relinquished property and must continue to be depreciated using the mid-month convention.

If nonresidential real property, residential rental property, or any railroad grading or tunnel bore is received as a result of an exchange of property that was depreciated using the mid-quarter convention, the replacement property is deemed to have been placed in service in the month that includes the mid-point of the quarter that the relinquished property was placed in service and must be depreciated using the mid-month convention.

If nonresidential real property, residential rental property, or any railroad grading or tunnel bore is received as a result of an exchange or an involuntary conversion of property that was depreciated using
the half-year convention, the replacement property is deemed to have been placed in service in the month that includes the mid-point of the placed-in-service year and must be depreciated using the mid-month convention (for example, for a calendar-year taxpayer with a full 12-month taxable year, the mid-point is July 1st).

§1245 and §1250 Recapture

When an exchange leads to nonrecognition, most depreciation recapture is only carried forward. However, a tax trap can be created when one of the following situations exists:

■ ACRS §1245 nonresidential real property is exchanged for nondepreciable real estate. If property subject to §1245 depreciation recapture is transferred, recapture income is triggered to the extent of:
  □ Gain recognized on the exchange determined without regard to §1245 recapture, plus
  □ The FMV of like-kind property received that is non-§1245 property and that is not taken into account under item (1).

**Example:** Dolly Lama exchanged a warehouse (without the land) for 200 acres of undeveloped land. Dolly purchased the warehouse in 1986. The adjusted basis of the warehouse was $250,000, with accumulated depreciation of $130,000. The FMV of the land Dolly acquired is $400,000. The gain is recognized as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) §1245 ACRS recapture</td>
<td>$130,000</td>
</tr>
<tr>
<td>(2) Gain recognized under §1031</td>
<td>0</td>
</tr>
<tr>
<td>(3) FMV of non-§1245 received</td>
<td>$400,000</td>
</tr>
<tr>
<td>(4) Total of (2) + (3)</td>
<td>$400,000</td>
</tr>
<tr>
<td>(5) Recognized gain [lower of (1) or (4)]</td>
<td>$130,000</td>
</tr>
</tbody>
</table>

■ ACRS §1245 nonresidential real property (placed in service between 1981 and 1986) is exchanged for §1250 real property whether ACRS property or MACRS property. The §1245 recapture rule can be particularly harsh and cause unexpected results when the property exchanged is ACRS nonresidential real property for which
accelerated ACRS depreciation was used. Under §1245(a)(5), before repeal by the *Tax Reform Act of 1986*, such property is treated as §1245 recovery property, rather than §1250 property, which normally applies to depreciable real property. Thus, the exchange of such property for other real estate is likely to be an exchange of §1245 property for §1250 property (i.e., non-§1245 property), causing recapture income.

**Example:** Tammy bought an office building for $300,000 in 1984. The building was depreciated under accelerated ACRS.

In 2008, when the building was fully depreciated, Tammy traded it for another office building (§1250 property) in a transaction qualifying as a like-kind exchange. No boot was involved.

The building she received was worth $500,000. Tammy realized a $500,000 gain ($500,000 FMV received less $0 basis given up) on the exchange.

Because the property given up was §1245 property, her previous depreciation deductions are subject to recapture, as follows:

1. Depreciation subject to recapture $300,000
2. §1245(b) limitation:
   - A. Gain recognized before §1245 recapture, plus
   - B. FMV of non-§1245 property received $500,000
   
   Depreciation recapture [lesser of (1) or (2)] $300,000

Therefore, Tammy recognizes $300,000 of ordinary income (depreciation recapture) and takes a basis of $300,000 in the building received in the exchange. [Reg. §1.1245-5(a)]

- ACRS §1250 property that is replaced by property in which the FMV of §1250 property received is less than the amount of excess depreciation on the property transferred. Depreciation under §1250 is recaptured to the extent of any gain recognized under §1031, or if greater, to the extent that the excess depreciation recapturable
as ordinary income exceeds the FMV of §1250 property received in the exchange.

When §1250 property is transferred, §1250 recapture is recognized to the extent of:
- Gain recognized on the exchange, or
- The amount by which potential §1250 recapture income exceeds the FMV of the §1250 property received in the transaction. Any §1250 recapture that is not recognized carries over to the property received in the like-kind exchange.

**Reporting Like-kind Exchanges**

Like-kind exchanges are reported for tax purposes in the tax year in which the taxpayer relinquishes the property to be exchanged. This applies regardless of whether the replacement property is received in the same tax year, or the next.

Form 8824, *Like-kind Exchanges*, is used to report the exchange. Additional forms, such as Form 4797, *Sales of Business Property*, and Schedule D, *Capital Gains and Losses*, may also be needed.

**Deferring Gains With Private Annuity Trusts**

Private annuity trusts have been used by property owners to accomplish the deferral of capital gains tax and depreciation recapture tax and have been used as an estate planning tool since the 1950s. Until recently, U.S. Appeals Court decisions as well as IRS revenue rulings assured sound legal footing for this unique planning vehicle. However, in October of 2006 the IRS issued proposed regulations that would apply the same rule to exchanges for both private annuities and commercial annuities.

A decades-old IRS ruling generally postpones tax on the exchange of appreciated property for a private annuity, a result inconsistent with the tax treatment of exchanges for commercial annuities or other kinds of property. This ruling was originally based in part on the assumption that the value of a private annuity contract could not be determined for federal income tax purposes. The IRS feels this assumption is no longer correct. The ruling had its roots in authorities
that applied the “open transaction doctrine,” which has been eroded in recent years. In addition, the Treasury Department and the IRS believe that the ruling has been relied upon inappropriately in a number of transactions that are designed to avoid U.S. income tax. The guidance issued proposes to declare the ruling obsolete. Charitable gift annuities would not be affected by the proposed guidance.

If adopted, the guidance would be effective immediately for transactions not completed before October 17, 2006. Recognizing, however, that many legitimate estate planning transactions may currently be in process, the effective date is postponed for six months for some transactions that pose the least likelihood of abuse.

Prop Reg. § 1.1001-1. Computation of gain or loss.

(j) Certain annuity contracts received in exchange for property.

(1) In general. If an annuity contract (other than an annuity contract that either is a debt instrument subject to sections 1271 through 1275, or is received from a charitable organization in a bargain sale governed by §1.1011-2) is received in exchange for property, receipt of the contract shall be treated as a receipt of property in an amount equal to the FMV of the contract, whether or not the contract is the equivalent of cash. The amount realized attributable to the annuity contract is the FMV of the annuity contract at the time of the exchange, determined under §7520. For the timing of the recognition of gain or loss, if any, see §1.451-1(a). In the case of a transfer in part a sale and in part a gift, see paragraph (e) of this section. In the case of an annuity contract that is a debt instrument subject to §§1271 through 1275, see paragraph (g) of this section. In the case of a bargain sale to a charitable organization, see §1.1011-2.

(2) Effective date.

(i) In general. Except as provided in paragraph (j)(2)(ii), this paragraph (j) is effective for exchanges of property for an annuity contract (other than an annuity contract that either is a debt instrument subject to sections 1271 through 1275, or is received from a charitable organization in a bargain sale governed by §1.1011-2) after October 18, 2006.

(ii) This paragraph (j) is effective for exchanges of property for an annuity contract (other than an annuity contract that either is a debt instrument subject to
sections 1271 through 1275, or is received from a charitable organization in a bargain sale governed by §1.1011-2) after April 18, 2006 if the following conditions are met—
(A) The issuer of the annuity contract is an individual;
(B) The obligations under the annuity contract are not secured, either directly or indirectly; and
(C) The property transferred in exchange for the annuity contract is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange. For purposes of this provision, a disposition includes without limitation a transfer to a trust (whether a grantor trust, a revocable trust, or any other trust) or to any other entity even if solely owned by the transferor.

**Involuntary Conversions**

No gain is recognized when property is compulsorily or involuntarily converted into property similar or related in service or use as a result of destruction, theft, seizure, condemnation, or threat thereof. A taxpayer may elect to defer gain on an involuntary conversions to the extent the cash (or “dissimilar” property) realized upon conversion is not more than the cost of replacement property purchased by the taxpayer, if the replacement property is similar or related in service or use. Thus, gain is recognized only to the extent that the amount realized upon conversion is more than the cost of the replacement property or the stock of a controlled corporation owning such property. The amount realized includes money or property that is not similar or related in use to the converted property. If property is converted directly into similar or related-use property, nonrecognition is mandatory and an election is not necessary.

Any taxpayer can make the election. This is an entity-level election, which is made by excluding the deferred portion of the gain from gross income on the return for the year of the involuntary conversion and by attaching a statement to the return reporting all details of the conversion. Although the information statement is required by the regulations, failure to provide the statement will not invalidate the election. Merely excluding the deferred portion of the gain is a deemed election under §1033.
Replacement must occur within two years (three years for condemned real property used in a trade or business or held for investment and replaced with like-kind property, and four years for a principal residence involuntarily converted as the result of a Presidentially declared disaster) after the close of the year that any gain is realized. A taxpayer may apply to the IRS to extend the replacement time based on reasonable cause.

The basis of the replacement property is reduced by the amount of unrecognized gain. The holding period of the converted property generally tacks on to the replacement property. For depreciation purposes, the replacement property is treated as a newly acquired asset.

Replacement property must be similar or related in service or use to qualify for gain deferral [§1033(a)]. That is, the taxpayer-owner’s use of the replacement property must be substantially the same as his use of the original property. For example, replacing unimproved real estate with improved real estate, or a mobile home park with a motel, would probably not qualify as similar-use replacement property. Residential property in one city replaced with residential property in another city would qualify.

The gain on an involuntary conversion of a taxpayer’s principal residence can also qualify for deferral under §1033. An involuntary conversion of a residence is treated as a sale, eligible for the §121 gain exclusion [§121(d)(5)]. For §1033 purposes, amounts realized from the conversion are reduced by the gain excluded under §121 [§121(d)(5)(B)].
**Example:** Minnie Van Driver’s home was destroyed in September 2004 by a tornado that was subsequently declared a disaster by the President. In the same year, she received insurance proceeds of $120,000. Minnie’s adjusted basis in the land and house was $100,000. The house was subject to a mortgage on which she continued to make payments. She did not rebuild, but instead sold the land for $10,000 in November 2006. In March 2008, she bought another home for $130,000 and used it as her principal residence.

Because her home before the disaster included both the dwelling and the land that she later sold after the destruction of the dwelling, the sale of the land is treated as part of a single involuntary conversion. Minnie’s period for purchasing replacement property began when the dwelling was destroyed and ended 4 years after the close of the taxable year in which gain is first realized. The replacement period would have been only 2 years if the home had not been in a Presidentially declared disaster area.

Minnie realized $120,000 of insurance proceeds. Thus, she realized a gain from the insurance proceeds of $20,000 and her basis in the property was reduced to $0. She then realized an additional $10,000 of gain on the sale of the land, for a total gain of $30,000.

Because Minnie bought a new home within this period at a cost ($130,000) that was not less than the insurance proceeds ($120,000) and the sales proceeds ($10,000), she may defer recognition of the entire $30,000 gain. Her basis in the new house is $100,000 ($130,000 cost less the $30,000 unrecognized gain).

She may continue to deduct otherwise deductible mortgage interest for the time between the destruction of the residence and its sale or reconstruction and reoccupation (Rev. Rul. 96-32).

Section 1033(g) has a special rule for condemned real estate. Real estate used in a business or held for investment that is threatened with or actually condemned is converted into similar-use property if it is replaced with like-kind property within three years. Thus, gain is deferred even if the replacement property does not meet the tougher similar-use requirement. For example, unimproved real estate replaced by improved real estate is not similar-use replacement.
property. It would, however, qualify for gain deferral under §1033(g) because it is like-kind property. On the other hand, replacement of real estate that is not like-kind may qualify under the similar-use test. For example, the use of condemnation proceeds to construct a building on land already owned by the taxpayer does not qualify as like-kind property, but could qualify under the similar-use test (Rev. Rul. 71-41).

**Example:** Chris Mascarol, a calendar-year taxpayer, owns an office building with an adjusted basis of $175,000 on land that cost $30,000. The property was condemned and taken in return for a condemnation award of $250,000. She received the condemnation proceeds on March 18, 2005. Because her real property was condemned, Chris can replace it with either similar-use or like-kind property. If Chris buys like-kind property costing at least $250,000 by December 31, 2008, (the end of the three-year replacement period), none of the $45,000 realized gain will be recognized. (Alternatively, if the replacement property is not like-kind but is similar-use, the replacement period ends on December 31, 2007.)

The basis of the replacement property will be its cost less the deferred gain of $45,000.

If she does not reinvest by that date, the entire gain must be recognized. If Chris acquires like-kind property for $180,000, the excess of the conversion amount ($250,000) over the cost of the replacement property is $70,000, and the entire $45,000 realized gain is recognized. The basis of the replacement property is $180,000 because there was no gain deferred.

If she acquires like-kind property for $230,000, the excess of the condemnation award over the cost of the new property is $20,000. In this situation, she recognizes only the $20,000, and the basis of the replacement property will be $205,000 ($230,000 cost – $25,000 deferred gain).

Alternately, if the award had been only $180,000, the loss of $25,000 (basis of $205,000 less award of $180,000) is recognized regardless of any replacement. §1033 deferral applies only to gains.
Disaster Area Losses

Special rules apply to Presidentially declared disaster area losses. A Presidentially declared disaster is a disaster that occurred in an area declared by the President to be eligible for federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Note: A list of the areas warranting assistance under the Act is available at the Federal Emergency Management Agency (FEMA) web site at www.fema.gov.

A deductible loss from a disaster that occurred in a Presidentially declared disaster area, can be deducted on a return or amended return for the tax year immediately preceding the tax year in which the disaster happened. If deducted on the prior year’s return, the loss is treated as having occurred in that preceding year.

No gain is recognized if the involuntarily converted property was held for use in a trade or business or for investment and is replaced with tangible property used in a trade or business, even if the replacement property is not similar-use to the converted property [§1033(h)(2)].

Example: Moe’s Tavern was destroyed by a flood in a Presidentially declared disaster area. Moe decides not to reopen the tavern and uses the insurance proceeds to purchase a bowling alley. He recognizes no gain on the transaction because the new property is trade or business property (treated as being similar-use to the property destroyed in the Presidentially-declared disaster). If Moe used the insurance money to buy sports memorabilia for investment, he could not defer the gain on the conversion of the tavern.

If Moe had lost the sports memorabilia in a Presidentially declared disaster and purchased a bowling alley with the insurance proceeds, the gain deferral provisions would apply because he replaced investment property with business property.
These rules also apply to a taxpayer’s principal residence [§1033(h)(1)]. When a taxpayer’s principal residence (or any of its contents) is involuntarily converted in a Presidentially declared disaster area no gain is recognized on the insurance proceeds for unscheduled personal property that was part of the contents of such residence, regardless of the taxpayer's basis in the unscheduled personal property or how the insurance proceeds are used (Rev. Rul. 95-22).

Any insurance for the residence or its separately scheduled contents can be treated as a common pool of funds, allowing the owner to elect to recognize gain only to the extent that the funds exceed the cost of replacing the residence and its contents. Both separately scheduled and unscheduled replacement contents qualify for this purpose. Reimbursements for separately scheduled property like jewelry or art do not have to be used to purchase the same type of property. Replacements must be made within four years after the close of the year gain is first realized [§1033(h)(1)(B)].

The *Katrina Emergency Tax Relief Act of 2005* (KETRA) extended from two to five years the period in which a taxpayer may replace involuntarily converted property in the case of property converted due to Hurricane Katrina. The replacement period is extended to five years if:

- Converted property was located in a Hurricane Katrina disaster area;
- The converted property was compulsorily or involuntarily converted after Aug. 24, 2005, by reason of Hurricane Katrina; and
- Substantially all of the use of the replacement property is within the Hurricane Katrina disaster area.

**Disaster Grants to Businesses**

As part of disaster relief, businesses often receive grants under a state reimbursement program. As generous as these may seem, the IRS has ruled (Rev. Rul. 2005-46) that these grants are not excluded from gross income. The IRS does allow any gain realized to be deferred under the involuntary conversion rules of §1033.

In supporting their decision to tax grants, the government concluded that these business owners would eventually derive economic gain from the grants. In addition, they considered these payments to be for uncompensated losses to businesses, similar to insurance proceeds,
but because the businesses did not pay any premiums, they are fully taxable to the recipients.

This ruling does not apply to individuals or families who receive government payments for housing, education, and basic subsistence expenses. Those general welfare payments remain nontaxable (§139).

In order to qualify under the §1033 involuntary conversion rules, the business grant proceeds must be used to buy property similar or related in use to that which was destroyed or damaged. The replacement purchases must be completed within two years after the close of the tax year in which the business realized any gain. If they choose to reinvest, the nonrecognition of the gain is mandatory and an election is not necessary. If the taxpayer does not replace the property within two years, or replaces it at a lower cost, the tax liability for the year of gain is recomputed on an amended return.

To elect to exclude the deferred portion in the year of casualty, the taxpayer needs to attach a statement to the return reporting the details of the casualty. By not including a statement, the mere exclusion of the gain is deemed an election under §1033.

**Replacement Property Acquired from Related Person**

Taxpayers recognize gain if the replacement property is acquired from a related person, as defined in §267(b) and §707(b)(1), unless:

- The gain realized from the involuntary conversion is $100,000 or less; or
- The related party acquired the replacement property from an unrelated party during the taxpayer’s replacement period [§1033(i)].

**Other Rules**

If converted property is not replaced within the required time or is replaced at a lower cost than anticipated, an amended return must be filed and the tax liability for the year the gain was originally realized must be recomputed.

An election to defer the gain from an involuntary conversion can be revoked by filing an amended return recognizing the gain before the
replacement property is actually acquired. However, once the taxpayer has purchased the replacement property under either a formal or deemed election, the election becomes irrevocable.

The statute of limitations for any gain year remains open until three years after the IRS is notified of replacement or failure to replace. Therefore, a statement should be included in the return for the year of replacement (if no gain is recognized), or with the amended return for the gain year (if gain must be recognized).

Although the regulations say the election can be made any time during the replacement period, it is unclear how to do so if the return for the conversion year was filed without an election. Presumably, including the information required by the regulations in a return filed for a year within the replacement period is enough. Then, the taxpayer would generally file a refund claim on an amended return for any tax paid on the gain in the conversion year. While the election must be made during the replacement period, the claim for the refund can be made as long as the statute of limitations is open for that year.

**Divorce**

The tax treatment of items of property transferred from a taxpayer and his or her spouse or former spouse pursuant to a divorce is as follows:
<table>
<thead>
<tr>
<th><strong>IF the taxpayer transfers ...</strong></th>
<th><strong>THEN the taxpayer ...</strong></th>
<th><strong>AND his or her spouse or former spouse ...</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income-producing property (such as an interest in a business, rental property, stocks, or bonds),</td>
<td>Includes on his or her tax return any profit or loss, rental income or loss, dividends, or interest generated or derived from the property during the year until the property is transferred,</td>
<td>Reports any income or loss generated or derived after the property is transferred.</td>
</tr>
<tr>
<td>An interest in a passive activity with unused passive activity losses,</td>
<td>Cannot deduct his or her accumulated unused passive activity losses allocable to the interest,</td>
<td>Increases the adjusted basis of the transferred interest by the amount of the unused losses.</td>
</tr>
<tr>
<td>Investment credit property with recapture potential,</td>
<td>Does not have to recapture any part of the credit,</td>
<td>May have to recapture part of the credit if he or she disposes of the property or changes its use before the end of the recapture period.</td>
</tr>
<tr>
<td>Nonstatutory stock options and nonqualified deferred compensation,</td>
<td>Does not include any amount in gross income upon the transfer,</td>
<td>Includes an amount in gross income when he or she exercises the stock options or when the deferred compensation is paid or made available to him or her.</td>
</tr>
</tbody>
</table>

**Transfers in Trust**

If a taxpayer makes a transfer of property in trust for the benefit of his or her spouse (or former spouse, if incident to a divorce), the taxpayer generally does not recognize any gain or loss.

However, the taxpayer must recognize gain or loss if, incident to the divorce, he or she transfers an installment obligation in trust for the benefit of his or her former spouse.

The taxpayer must also recognize gain on the transfer of property in trust in the amount by which the liabilities assumed by the trust, plus the liabilities to which the property is subject, exceed the total of his or her adjusted basis in the transferred property.
**Example:** Myron’s ex-wife Atilla owns real property with a FMV of $100,000 and an adjusted basis of $10,000. Pursuant to their property settlement, Atilla places the property into a trust for Myron’s benefit. The trust did not assume any liabilities. The property is subject to a $50,000 liability. Atilla’s recognized gain on the transfer of the property in trust for the benefit of her spouse is $40,000 ($50,000 - $10,000).

**Reporting Income From Property**

A taxpayer report income from property transferred to his or her spouse or former spouse as shown in the previous table.

When a taxpayer transfers property to his or her spouse (or former spouse, if incident to a divorce), the taxpayer must give his or her spouse sufficient records to determine the adjusted basis and holding period of the property on the date of the transfer. If the taxpayer transfers investment credit property with recapture potential, he or she also must provide sufficient records to determine the amount and period of the recapture.

**Property Received**

Property a taxpayer receives from his or her spouse (or former spouse, if the transfer is incident to a divorce) is treated as acquired by gift for income tax purposes. Its value is not taxable to the recipient spouse.

Basis in property received from a taxpayer’s spouse (or former spouse, if incident to a divorce) is the same as his or her spouse’s adjusted basis. This applies for determining either gain or loss when the recipient spouse later disposes of the property. It applies whether the property’s adjusted basis is less than, equal to, or greater than either its value at the time of the transfer or any consideration the recipient spouse paid. It also applies even if the property’s liabilities are more than its adjusted basis.
**Personal Residence**

There are several options available when determining what is to be done with a divorcing couple’s personal residence. The home can be transferred to one spouse, sold, or remain titled in joint names until the occurrence of a specified event.

For sales of a personal residence after May 6, 1997, the gain may be excluded if certain qualifications are met.

Taxpayers who own and use a home as their principal residence in two out of the five years preceding the date of sale may exclude $250,000 of gain. Taxpayers who file a joint return may exclude up to $500,000 of gain if either spouse owns the home and both spouses use the home for two of the preceding five years.

A spouse who vacates the personal residence prior to its sale but maintains ownership can still meet the two of the preceding five years test. Solely for purposes of §121, an individual is treated as using property as a principal residence during any period of ownership while an individual’s spouse or former spouse is granted use of the property under a divorce or separation instrument [§71(b)(2)].

A spouse who receives a personal residence as part of a property settlement incident to a divorce includes the former spouse’s holding period (ownership test). The use test must still be met before the gain can be excluded.

**Example:** Hugh and Jane Bickerson were married in August 1986 and bought a home later that year. They owned and occupied the home until June 3, 1998, when they were granted a divorce and Hugh moved to a different residence. Jane was granted use of the home until their daughter Calamity reached age 18, after which the home was to be sold and the proceeds split between them. She lived there until August 14, 2008, when the home was sold for a gain of $100,000.

Both Hugh and Jane can each exclude up to $250,000 of the gain on the sale of the residence even though Hugh did not live in the home for the entire five-year period prior to the sale. Jane’s use is counted as use by Hugh. Thus, Hugh can exclude his entire share of the gain ($50,000) from tax.
**Gift Tax**

The federal gift tax does not apply to most transfers of property between spouses, or between former spouses because of divorce. The transfers usually qualify for one or more of the exceptions explained below. However, if a transfer of property does not qualify for an exception, or qualifies only in part, the taxpayer must report it on a gift tax return.

A transfer of property by a taxpayer to his or her spouse or former spouse is not subject to gift tax if it meets any of the following exceptions:

- It is made in settlement of marital support rights.
- It qualifies for the marital deduction.
- It is made under a divorce decree.
- It is made under a written agreement and the taxpayer is divorced within a specified period.
- It qualifies for the annual exclusion.

This treatment does not apply to transfers to which Reg. §1.1041–2 of the regulations (certain stock redemptions) applies.

**Settlement of Marital Support Rights**

A transfer in settlement of marital support rights is not subject to gift tax to the extent the value of the property transferred is not more than the value of those rights. This exception does not apply to a transfer in settlement of dower, curtesy, or other marital property rights.

**Marital Deduction**

A transfer of property to a taxpayer’s spouse before receiving a final decree of divorce or separate maintenance is not subject to gift tax. However, this exception does not apply to:

- Transfers of certain terminable interests.
- Transfers to the taxpayer’s spouse if his or her spouse is not a U.S. citizen.
Transfer Under Divorce Decree

A transfer of property under the decree of a divorce court having the power to prescribe a property settlement is not subject to gift tax. This exception also applies to a property settlement agreed on before the divorce if it was made part of or approved by the decree.

Transfer Under Written Agreement

A transfer of property under a written agreement in settlement of marital rights or to provide a reasonable child support allowance is not subject to gift tax if the taxpayer is divorced within the three-year period beginning one year before and ending two years after the date of the agreement. This exception applies whether or not the agreement is part of or approved by the divorce decree.

Sale to a Related Party

A loss on the sale or exchange of property, directly or indirectly, between certain related parties is not deductible [§267(a)]. This is to prevent taxpayers from generating losses for tax purposes when there has been no true economic loss. There are exceptions to this rule for complete corporate liquidations [§267(a)(1)] and transfers of property between spouses or incident to divorce [§267(g)]. Generally, the rule applies to a loss from any voluntary or involuntary sale or exchange, even if the terms are determined on a fair market basis. However, gains from related-party sales are still recognized.

Related parties under §267(b) and §707(b)(1) for purposes of the loss disallowance rules include:

- Individuals and their spouse; siblings (including half-brothers and half-sisters); parents and grandparents (or any other ancestor); and children, grandchildren, or any other lineal descendants. Note: The loss-disallowance rules do not apply to bona fide sales to in-laws, stepparents, stepchildren, aunts, uncles, nieces, nephews, or cousins.
- An individual and a corporation (C or S corporation) in which the individual owns more than 50% in value of the outstanding stock.
- A partnership and a person who owns more than 50% of either a capital or profits interest.
- An individual and a controlled tax-exempt organization.
- A fiduciary of a trust and
- A grantor.
- A beneficiary of that trust.
- A fiduciary or beneficiary of another trust if both have the same grantor.
- A corporation in which more than 50% of the stock is owned by either the trust or an individual who is a grantor of the trust.
- An executor of an estate and an estate beneficiary, except for sales or exchanges in satisfaction of a pecuniary bequest.

Constructive ownership of corporate stock is also considered in determining whether parties are related. Stock owned by one person is considered owned by another in the following situations:

- Stock owned, directly or indirectly, by a corporation, partnership, estate, or trust is considered owned proportionately by its shareholders, partners, or beneficiaries.
- Stock owned, directly or indirectly, by or for the taxpayer’s family (as defined in the previous list).
- Stock owned, directly or indirectly, by or for a taxpayer’s partner.

**Example:** Julio owns 30% and his wife owns 25% of the stock of Acme Corporation. Julio is considered to constructively own his wife’s stock, so his total ownership of Acme stock will be 55%.

Stock attributed from a family member or a partner cannot be reattributed to someone else. Stock owned directly by related family members can be owned indirectly by multiple family members. Stock owned indirectly through a corporation, partnership, or trust can be attributed to another individual [§267(c)].
Example: Donald owns 20% of the stock of Quackers, Inc. His brothers Huey, Dewey, and Louie each own 10%. The remaining 50% is owned by Mickey, who is unrelated to any of them. In 2006, Donald sells land with a basis of $170,000 to Quackers for its FMV of $150,000 (a loss of $20,000). Donald is considered to own 50% of Quackers stock, by reason of the stock held by his brothers. However, Donald must own more than 50% of the stock for the limitation to apply. Therefore, Donald can deduct the loss, since his direct and indirect ownership of the stock was not more than 50%. Quackers’ basis in the land is its cost of $150,000.

If several parcels are sold to a related party in one transaction, the seller must calculate gain or loss separately for each one. A gain from one property cannot be used to offset a loss on another (Rev. Rul. 76-377).

If a loss from a sale to a related party is disallowed, the buyer may reduce the gain when property is later sold, by the amount of the disallowed loss from the first sale [§267(d)]. However, if the related buyer later sells the property for a loss, the disallowed loss from the original sale to the related party is never recognized.

Caution! Other potential tax traps concern the sale of depreciable property to a related party which results in a gain. The gain could be taxed at ordinary income rates rather than at the more favorable capital gain rates.

Depreciable Property

Gain on property sold or exchanged, directly or indirectly, between related persons is ordinary income if the property is depreciable by the transferee [§1239(a)]. Related persons for purposes of §1239 include:

- A person and all controlled entities with respect to that person. A controlled entity is defined as:
  - A corporation or a partnership in which the person owns (directly or indirectly) more than 50% of the value of the outstanding stock or capital or profits interest;
Two corporations that are members of the same controlled group;

A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation, and more than 50% of the capital or the profits interest in the partnership; and

An S corporation and another S corporation, or an S corporation and a C corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.

A taxpayer and any trust of which the taxpayer or the taxpayer’s spouse is a beneficiary.

An executor and a beneficiary of an estate.

An employer, or a person related to the employer, and a welfare benefit fund controlled by the employer or by the related person.

Sales Between Partnership and Controlling Partner

If there is a sale or exchange, directly or indirectly, of property:

Between a partnership and a person owning, directly or indirectly, a more than 50% interest in that partnership; or

Between two partnerships in which the same persons own, directly or indirectly, more than a 50% interest or profits interests; and

The property in the hands of the buyer is not treated as a capital asset;

then any gain recognized on the sale is ordinary income \([\text{§707}(b)]\).

Example: Eureka is a 60% partner in Flybynyght Partnership. She sells land that she was holding for investment to the partnership for $600,000. Her basis in the land was $500,000. The partnership intends to subdivide the property into 100 lots and sell them. Since the land is inventory to the partnership, Eureka must recognize $100,000 of ordinary income, not capital gain on the sale. If the partnership held the land as an investment, Eureka would report a $100,000 capital gain because the land would be a capital asset in the hands of the partnership.
Installment sales to related parties are discussed below in the Installment Sales section of this text.

**INSTALLMENT SALES**

If a sale qualifies as an installment sale, the gain must be reported under the installment method unless the taxpayer elects out of the installment method (discussed later).

**Sales Eligible for Installment Method**

The installment method is available for the sale of:
- Real or personal property, but not the sale of inventory or dealer sales.
- Property used or produced in the trade or business of farming.
- Dealer sales of timeshares and residential lots, if certain conditions are satisfied.

**Dealer Sales of Timeshares and Residential Lots**

Timeshares and residential lots may qualify for the installment method if the sale is in the ordinary course of the taxpayer’s trade or business to an individual, and the installment obligation is not guaranteed by anyone other than an individual. This applies to dealer sales of:
- A timeshare right to use or a timeshare ownership interest in residential real property for not more than six weeks per year, or the right to use a specified campground for recreational purposes.
- Any residential lot, but only if the seller (or any related party) is not to make any improvements to the lot.

**Note:** The regulations do not specifically address the meaning of improvements. However, the expired Temp. Reg. §1.453C-8T(a)(4) provided that a parcel of land would not be considered improved just because roads and sewers had been added.
As a trade-off for the right to use the installment method for dealer sales of timeshares and residential lots, the taxpayer must agree to pay interest on the tax attributable to the deferred gain.

- The interest is calculated by multiplying the tax due on the payments received for the year by the applicable federal rate (AFR) in effect at the time of the sale, compounded semiannually for the period from the date of sale to the date of the payment.
- The interest is reported on Form 1040, Line 63. Write “Section 453(l) interest” on the dotted line (PLR 9133002).
- No interest is required to be paid on the payments received in the year of sale [§453(l)(3)(B)(iii)].

**Example:** The cost to purchase the right to use a vacation condominium for one week each year is $10,000. In April of 2006, the buyer agreed to pay ABC Realty $1,000 per year plus interest. Assuming a gross profit percentage of 100%, ABC is allowed to report the payments of $1,000 each year as long as the additional interest is included. Based on the date of sale, the AFR would be 4.56%. Assuming ABC remains in the 35% tax bracket and receives payments at the same time each year, the interest is due as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Interest Due</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>no interest due in year of sale</td>
<td>$0</td>
</tr>
<tr>
<td>2007</td>
<td>$1,000 x .35 x 1 year x 4.56%</td>
<td>16</td>
</tr>
<tr>
<td>2008</td>
<td>$1,000 x .35 x 2 year x 4.56%</td>
<td>32</td>
</tr>
<tr>
<td>2009</td>
<td>$1,000 x .35 x 3 year x 4.56%</td>
<td>48</td>
</tr>
<tr>
<td>2010</td>
<td>$1,000 x .35 x 4 year x 4.56%</td>
<td>64</td>
</tr>
<tr>
<td>2011</td>
<td>$1,000 x .35 x 5 year x 4.56%</td>
<td>80</td>
</tr>
<tr>
<td>2012</td>
<td>$1,000 x .35 x 6 year x 4.56%</td>
<td>96</td>
</tr>
<tr>
<td>2013</td>
<td>$1,000 x .35 x 7 year x 4.56%</td>
<td>112</td>
</tr>
<tr>
<td>2014</td>
<td>$1,000 x .35 x 8 year x 4.56%</td>
<td>128</td>
</tr>
<tr>
<td>2015</td>
<td>$1,000 x .35 x 9 year x 4.56%</td>
<td>144</td>
</tr>
<tr>
<td>Total</td>
<td>Total interest paid over the term</td>
<td>$720</td>
</tr>
</tbody>
</table>

Multiplying by years takes into account that the tax due on that payment has been deferred for that many years.
S Corporation Installment Obligations

The installment method may be used when a shareholder of an S corporation receives an installment obligation of the liquidating S corporation in exchange for the shareholder’s stock in the corporation. The installment obligation must have been entered into by the S corporation within the 12-month period beginning on the date a plan for complete liquidation is adopted and the liquidation must be completed during that 12-month period. The shareholder will treat the payments received on the installment obligation as payments for the surrender of the S corporation’s stock. [§453(h)]

Example: Wonder S Corporation entered into a plan for complete liquidation on January 5, 2006. Corporate assets were sold on the installment basis on January 12, 2006. The obligation was distributed to Sam, Wonder S Corporation’s only shareholder, on May 15, 2006, when Wonder S Corporation completed the liquidation. Sam includes the income from the installment sale as it is received. His basis in the stock is allocated to each payment.

Installment Method Unavailable

The installment method cannot be used to report gain from the sale of the following:

- Stock or securities traded on an established securities market [§453(k)].
- Personal property by anyone who regularly sells the same type of property on an installment plan, unless the farming exception below applies.
- Real property held for sale to customers in the ordinary course of a trade or business, unless the exception below applies.
- Inventory.
- Property sold at a loss.
**Exception:** The installment method is available for sales of real or personal property used or produced in farming and certain dealer sales of timeshares and residential lots.

### Reporting Requirements

An installment sale is reported on Form 6252, *Installment Sale Income*.

- In the year of sale, the seller completes Lines 1 through 26. If the sale was to a related party, Lines 27 through 37 are also completed.
- In any year after the year of sale, Lines 1 through 4 are completed. If payments are received, Lines 19 through 26 are completed. If the sale was to a related party, Lines 27 through 37 are completed for at least two years following the year of sale.
- Gain from Form 6252 is carried to Form 4797 or Schedule D. The Schedule D could be the Schedule D for individuals, partnerships, corporations, estates, or trusts.

### Installment Sale Income

Each payment on an installment obligation usually consists of three components:

- Interest income.
- A return of the taxpayer’s basis in the property.
- Gain on the sale.

### Interest Income

The interest component is reported as ordinary income in the year received. If the debt instrument has no stated interest or insufficient stated interest (less than AFR), the taxpayer may have to treat part of each payment as interest which is determined under the imputed interest rules (discussed later). In this case, the buyer and the seller both have to treat part of the installment sales price as interest.
**Basis**

The taxpayer’s adjusted basis in the property for installment sale purposes includes three items:
- The taxpayer’s adjusted basis in the property.
- The taxpayer’s selling expenses.
- Any depreciation recapture.

The total of these three items is the taxpayer’s installment sale basis.

**Gain**

The gross profit is the total gain that will be reported on the installment method. The gross profit equals the selling price (excluding interest) reduced by the installment sale basis and any gain that can be excluded under the home sale exclusion rules.

The gross profit divided by the contract price provides the gross profit percentage. The taxpayer multiplies the payments received each year (less interest) by the gross profit percentage to determine the taxpayer’s installment sale income (gain) for the year.

**Payments**

Payments include amounts actually or constructively received in the taxable year from an installment obligation. Payments include the down payment and subsequent payments of principal on the buyer’s debt.

**Buyer Pays Seller’s Expenses**

If a buyer pays any of the seller’s expenses of selling the property, the amount paid is considered a payment received by the seller in the year of sale.
**Buyer Assumes Mortgage**

Whether or not any part of a mortgage is included as a payment depends on the seller’s installment sale basis and the amount of mortgage that the buyer is assuming.

- If the buyer assumes a mortgage that is less than the seller’s installment sale basis, it is not considered a payment. The contract price equals the selling price less the mortgage.

**Example:** Sarah sold a commercial building for $100,000 with the buyer assuming a $30,000 mortgage. She has a basis of $60,000. She will receive $10,000 cash in the year of sale and the remainder over the next nine years.

<table>
<thead>
<tr>
<th>Contract price ($100,000 – $30,000)</th>
<th>$70,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross profit ($100,000 - $60,000)</td>
<td>$40,000</td>
</tr>
<tr>
<td>Gross profit percentage</td>
<td>57.14%</td>
</tr>
<tr>
<td>Installment sale income ($10,000 x 57.14%)</td>
<td>$5,714</td>
</tr>
</tbody>
</table>

- If the mortgage is more than the basis, the seller recovers his or her entire basis and is relieved of an obligation to repay the amount borrowed. The part of the mortgage in excess of basis is considered a payment. Contract price is the selling price less the mortgage plus this payment. In this situation, the contract price will always equal the gross profit, and the gross profit percentage will always be 100%.

**Example:** Using the information from above except that the buyer assumed a mortgage of $75,000, Sarah receives $10,000 cash in the year of sale, and the remaining $15,000 will be paid over the next three years. Sarah’s basis in the building was $60,000. Since the assumed mortgage exceeded her basis, she will recognize gain equal to the excess.

<table>
<thead>
<tr>
<th>Contract price ($25,000 + $15,000)</th>
<th>$40,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross profit ($100,000 - $60,000)</td>
<td>$40,000</td>
</tr>
<tr>
<td>Gross profit percentage</td>
<td>100%</td>
</tr>
<tr>
<td>Installment sale income ($15,000 + $10,000) x 100%</td>
<td>$25,000</td>
</tr>
</tbody>
</table>
**Wraparound Mortgage**

A “wraparound mortgage” is one that is not assumed by the buyer and is not immediately paid off by the seller. The seller is still liable for payments. A wraparound mortgage is not considered a payment.

**Mortgage Canceled**

If the buyer is the party holding the mortgage on the property, the debt is not assumed, but canceled. The seller is considered to have received a payment equal to the amount of the canceled debt.

**Buyer Assumes Other Debts**

Generally, if the buyer pays off or assumes any other debts of the seller, that amount is treated as a payment. If the debt is assumed, instead of paid off, it is treated similar to a mortgage in that only the amount in excess of the installment sale basis is treated as a payment.

The latter rule applies only to the following debts the buyer may assume:

- Debts the taxpayer acquired from owning the property (such as mortgages, liens, back taxes, etc.), or
- Debts the taxpayer acquired in the ordinary course of a trade or business.

**Property Used as Payment**

Payments of property are treated as payments in the year received to the extent of the FMV of the property on the date received.

- If the buyer gives the seller a third party note, the FMV of the note is treated as a payment.
- A bond or other evidence of indebtedness that is payable on demand is treated as a payment.

A deposit received before the year of sale is treated as a payment in the year of sale if the deposit becomes part of the down payment.
**Pledge Rule**

Under the pledge rule, if an installment obligation is used to secure another debt, the net proceeds from that debt are treated as a payment on the installment obligation. The pledge rules apply as follows:

- Nondealer dispositions of real property used in a trade or business, or held for the production of rental income with a sales price in excess of $150,000, where the installment contract is used as security for a loan after December 17, 1987.
- The disposition of any property under the installment method after 1988 where the sale price on the installment obligation used as security for the loan is greater than $150,000. Farm property and personal use property disposed of by an individual are excluded.
- Pledges made after December 17, 1987, to refinance the principal amount of the debt outstanding on that date may not be subject to the special rules. Each specific situation should be examined.
- The amount treated as a payment cannot exceed the contract price of the obligation over any payments received prior to the pledge.

**Escrow Account**

If the sales agreement calls for the buyer to place funds in an irrevocable escrow account out of which the remaining installment payments are to be made, the sale cannot be reported using the installment method. If the sale was previously reported using the installment method and an irrevocable escrow account was set up at a later time to make the remaining payments, the amount placed in escrow represents a payment of the balance of the installment obligation (Rev. Rul. 79-91).

**Like-kind Exchange**

In a like-kind exchange, gain is recognized to the extent of money or unlike property received. If the taxpayer receives an installment obligation in addition to like-kind property, the following rules apply:

- The contract price does not include the FMV of the like-kind property received.
- The gross profit is reduced by any gain that can be postponed.
The like-kind property received is not considered a payment on the installment obligation.

**Electing Out of the Installment Method**

A taxpayer can elect not to use the installment method. In this case, the taxpayer reports the entire gain in the year of sale even though he or she does not receive all the sale proceeds in that year.

The election must be made on or before the due date (including extensions) for filing the tax return for the year in which the sale occurred.

Once made, the election is irrevocable without IRS permission to change. A revocation is not allowed when one of the primary purposes for requesting it is to avoid federal income tax or when the tax year is closed.

**Note:** Rev. Proc. 92-85 provides for an automatic six month extension from the due date of the return, not including extensions, for making certain elections prescribed by statute as required to be made by the due date of the return or the due date of the return including extensions. If a return was timely filed without an extension and the taxpayer did not elect out of installment reporting, that taxpayer could amend that return within six months and make the election to report the sale in full in the year of disposition.

A taxpayer makes the election by reporting the gain in full in its proper place (such as Schedule D or Form 4797). The taxpayer does not report the sale on Form 6252.
Related Party Installment Sales

Sale of Depreciable Property

Under §453(g), the installment method may not be used for the sale of depreciable property to certain related parties as defined in §318 (controlled entities). As a result, the gain on sale will be recognized in full in the year of disposition, because all payments to be received are considered received in the year of sale.

Note: Depreciable property for this purpose is any property the purchaser can depreciate.

The purpose of this rule is to deter taxpayers from structuring transactions so that the related buyer can claim a depreciation deduction based on the purchase price, while the related seller has not yet included the gain from the sale in income.

The definition of related party for purposes of §453(g) is more restrictive than §267 (discussed earlier). The following relationships are considered related for this purpose:

- A person and all controlled entities. Controlled entities with respect to such person include:
  - An individual and a corporation with more than 50% of the stock owned directly or indirectly by the individual.
  - An individual and a partnership with more than 50% of the capital interest or profit interest owned directly or indirectly by the individual.
  - Any entity that is related to an entity related to the individual such as:
    - Two corporations that are members of the same controlled group.
    - A corporation and a partnership if the same person owns 50% or more of the value of each entity.
    - An S corporation and another S corporation if the same persons own more than 50% of the value of the outstanding stock of each corporation.
- An S corporation and a C corporation if the same persons own more than 50% of the value of the outstanding stock of each corporation.

- A taxpayer and any trust in which such taxpayer (or his spouse) is a beneficiary unless the beneficiary’s interest is a remote contingent interest. (A remote contingent interest exists if the trustee’s power allows a maximum benefit to the beneficiary of less than 5% of the trust assets [§318(a)(3)(B)(i)].)

- An executor and a beneficiary of an estate except in the case of a sale in satisfaction of a pecuniary (financial) bequest.

There is an exception to this rule. If the taxpayer can prove to the satisfaction of the IRS that tax avoidance was not the principal motive for the disposition, the taxpayer can use the installment method.

Tax-free transfers to a controlled corporation or partnership and transfers pursuant to a liquidation–reincorporation are also not affected by this rule.

**Note:** This rule only applies to the relationships described above. It does not apply to individuals who are related as members of a family (i.e., father and son). They may sell depreciable property to each other and use the installment method.

**Two-Year Rule**

The installment method of accounting is not prohibited between certain related parties as defined in §267. However, it cannot be used as a means of deferring or reducing the amount of tax due by shifting income to a relative in a lower tax bracket.

The two-year rule applies if the seller makes an installment sale to a related party and the related party sells the property before making all of the payments within two years of the first sale. The first seller would treat all or part of the amount realized by the related party as if he or she had received it from the first sale at the time of the second sale [§453(e)].
This rule will not apply to a second disposition if the taxpayer can show to the satisfaction of the IRS that neither sale had as one of its principal purposes the avoidance of federal income tax.

The amount realized by the original seller when the rule applies cannot exceed:

- The lesser of: (a) the amount realized on the second disposition occurring before the close of the tax year, or (b) the contract price for the first disposition, over
- The sum of: (a) all payments received from the first sale before the close of the tax year, plus (b) the aggregate amount treated as received by the original seller pursuant to the rules regarding second dispositions.

**Example:** John sells nondepreciable property to his wholly owned S corp, JD Inc., for $5,000. John reports the sale on the installment method. John’s basis in the property is $2,000. Gain on the sale is $3,000, the gross profit is $3,000, the contract price is $5,000, and the gross profit percent is 60%. John receives $2,000 in the year of sale, of which $1,200 is reported as gain from the sale. The following year, JD Inc. sells the property to a third party for $6,000 after making a $500 payment to John. John will report gain of $300 ($500 x 60%) on the second payment and gain of $1,500 on the disposition by JD Inc.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount realized on the second disposition</td>
<td>$6,000</td>
</tr>
<tr>
<td>The lesser amount is</td>
<td>$5,000</td>
</tr>
<tr>
<td>Reduced by the total John received on the first sale</td>
<td>$2,500</td>
</tr>
<tr>
<td>Deemed payment</td>
<td>$2,500</td>
</tr>
<tr>
<td>Taxable gain ($2,500 x 60%)</td>
<td>$1,500</td>
</tr>
</tbody>
</table>

Related parties for this purpose are defined in §267. Related parties include:

- Brothers, sisters, spouse, ancestors, and lineal descendants.
- An individual and a corporation in which the individual owns more than 50% of the value of the outstanding stock of the corporation.
- Two corporations which are members of the same controlled group.
- A grantor and fiduciary of any trust.
- A fiduciary of a trust and a fiduciary of another trust if the same person is the grantor of both.
- A fiduciary of a trust and a beneficiary of such trust.
- A fiduciary of a trust and a corporation in which the trust owns more than 50% of the value of the outstanding stock of the corporation.
- A person and a §501 organization which is controlled by the person or members of that person’s family.
- A corporation and a partnership if the same persons own more than 50% of the value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.
- An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock in each corporation.
- An S corporation and a C corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.

Gain recognition on the second disposition is not required by the original seller in the following situations:
- Reacquisition of stock by the issuing corporation will not be treated as a first disposition.
- An involuntary conversion is not treated as a second disposition if the first disposition occurred before the conversion or the threat of conversion.
- A disposition after the death of the original seller or the related party buyer.
- If it is established to the satisfaction of the IRS that neither disposition had as one of its purposes the avoidance of federal income tax.
- The original seller has the responsibility of notifying the IRS if there was a second disposition. The statute of limitations for assessing a deficiency does not expire until two years after the IRS receives a notice from the original seller.
Depreciation Recapture Income

If depreciable property is sold on installment, the rules for the recapture of gain due to depreciation apply. Depreciation recapture income cannot be reported on the installment method. The depreciation recapture is reported as ordinary income in the year of sale, even though the seller may not receive an equivalent amount of cash in that year. Recapture income reduces the gross profit so that a smaller percentage of principal payments will be reported as gain on the sale.

Form 4797 is used to calculate and report the amount of recapture income. The asset is entered in Part III of Form 4797 just as if the sale were to be reported in full. The recapture income is calculated and carried to Part II of the form and reported as ordinary income on the face of Form 1040. The remainder of the gain that would have been carried to Part I of the form is not entered on Form 4797. Instead, “N/A” is entered on Line 32.

On Form 6252, the sale information is reported. On Line 12, the recapture income calculated above is entered. This amount, reported as income on Form 4797, increases the basis in the installment contract and affects the calculation of the gross profit percentage.

Unrecaptured §1250 Gain

Unrecaptured §1250 gain is the gain due to depreciation, which is taxed at a maximum rate of 25% rather than the 5 or 15% maximum capital gain rates.

The effect this has on the installment sale is that when payments are received, the character of the payment is first unrecaptured §1250 gain to the extent it exists in the contract. Once the unrecaptured §1250 gain has been realized, the remainder of the contract gets regular capital gain treatment under §1231.
Example: Jane sold her rental property (straight-line depreciation) on installment for $125,000. Jane will receive payments over the next 20 years in equal installments of $6,250 per year, plus 8% interest on the unpaid balance. The details are as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Sales price</th>
<th>Basis</th>
<th>Depreciation</th>
<th>Gross Profit</th>
<th>GP%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$25,000</td>
<td>15,000</td>
<td>0</td>
<td>10,000</td>
<td>40.00%</td>
</tr>
<tr>
<td>Building</td>
<td>100,000</td>
<td>75,000</td>
<td>34,542</td>
<td>59,542</td>
<td>59.54%</td>
</tr>
</tbody>
</table>

Two Form 6252s should be used. The payment is allocated 20% ($25,000/$125,000) to the land and 80% to the building. The gain is recorded as follows:

Land: $6,250 x 20% = $1,250 per year x 40% = $500, which will receive capital gain treatment at a maximum rate of 15%.

Building: $6,250 x 80% = $5,000 per year x 59.54% = $2,977, which will be taxed as unrecaptured §1250 gain until $34,542 is received; after which, the gain is taxed as capital gain.

Single Sale of Several Assets

If two or more assets of the same class are sold as one sale, the disposition can be treated as a single sale reported as one transaction under the installment method. However, if one of the assets was sold at a loss, that asset is not eligible for installment treatment and must be reported separately.

Example: Matt sold a grader and backhoe on the installment basis. Both items were sold at a gain. Since both items are 7-year property, they can be sold using the same installment contract.

If the grader was sold at a gain and the backhoe at a loss, the backhoe does not qualify for installment treatment and is reported in full in the year of sale. The grader is eligible for installment treatment.
If a sale consists of two or more assets from different classes, the seller must allocate the selling price among the different classes of assets based on their FMV.

**Sale of a Business**

A sale of a business generally consists of several different classes of assets. The sales price and payments received must be allocated to each asset class.

The buyer and the seller must use the residual method to allocate the sales price to each of the assets based on their FMV. In addition, they both must file Form 8594, *Asset Acquisition Statement*, to provide this information to the IRS.

**Example:** The following business was sold for $210,000. A down payment of $42,000 was received in the year of sale with a note for the balance. The sale included the following items. The down payment is allocated to each item based on its proportionate net FMV.

<table>
<thead>
<tr>
<th>Item sold</th>
<th>FMV</th>
<th>% of FMV</th>
<th>Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$2,000</td>
<td>0.95</td>
<td>$399</td>
</tr>
<tr>
<td>Building</td>
<td>130,000</td>
<td>61.91</td>
<td>26,002</td>
</tr>
<tr>
<td>Land</td>
<td>20,000</td>
<td>9.52</td>
<td>3,998</td>
</tr>
<tr>
<td>Equipment</td>
<td>8,000</td>
<td>3.81</td>
<td>1,600</td>
</tr>
<tr>
<td>Goodwill</td>
<td>50,000</td>
<td>23.81</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$210,000</strong></td>
<td><strong>100.00</strong></td>
<td><strong>$42,000</strong></td>
</tr>
</tbody>
</table>

**Contingent Sales**

A contingent sale is a sale in which the total sales price cannot be determined by the end of the tax year in which the sale takes place.

The installment method of reporting still applies even if the gross profit and contract price cannot be determined. Reg. §15a.453-1(c) provides the rules to be applied to allocate the seller’s basis and selling
expenses to the payments to be received throughout the year. The rules are designed to distinguish contingent payment sales:

- For which a maximum selling price is determinable;
- For which a maximum selling price is not determinable, but the time over which payments will be received is determinable; and
- For which neither a maximum selling price nor a definite payment period is determinable.

Additional rules provide for the seller to recover basis under an income forecast computation method.

Sales for which a maximum selling price is determinable are reported as if all contingencies will be met and the selling price is the maximum amount stated in the contract.

- If at a later time, the actual selling price is determined to be an amount other than the maximum, the gross profit ratio will be redetermined for payments received in and after that year.
- Special rules apply if the imputed interest rules have to be used, or if the use of this method will substantially and inappropriately accelerate or defer recovery of the seller’s basis.

**Example:** Baker sells his office building to Charlie. Baker receives $40,000 down payment and is to receive 5% of the gross annual rental receipts, from January 1 through December 31, for each year of the next seven years. Each payment is due on January 31 of the year following the close of the calendar year. The maximum amount that Baker will receive under the contract is $120,000 (not including the interest determined at 9%). Baker’s basis in the stock and the selling expenses total $70,000.

The contract price is $120,000 and the gross profit is $50,000, which yields a gross profit percent of 41.67%.

In the year of sale, Baker reports gain of $16,668 ($40,000 x 41.67%) and a recovery of basis of $23,332 ($40,000 – $16,668).
When there is a fixed payment period, but no maximum selling price, the seller’s basis, including selling expenses, is allocated equally to each of the years for which payments are to be received.

- If, under the terms of the agreement, the arithmetic formula for determining the amount differs, basis will be allocated based on the formula to be applied.
- If no payment is made for a year, or if the payment is less than the basis to be allocated to that year, no loss is allowed. The unrecovered basis is carried to the next year. If it is the final year of the contract, then a loss would be allowed.

**Example:** Using the same contract as in the prior example, except the maximum that Baker will receive is not set at $120,000. The arithmetic allocation is consistent at 5% of the gross annual rental receipts for the next seven years.

As a calendar year taxpayer, payments will be received over eight taxable years. The arithmetic calculation is consistent so the recovery of cost will be equally divided over these eight years.

For the year of sale, Baker will report gain of $31,250 and a basis recovery of $8,750 ($70,000 ÷ 8 = $8,750 and $40,000 – $8,750 = $31,250).

A sale in which the maximum price is not determined and the payment period is not determined will be closely scrutinized by the IRS. A question that needs to be answered is whether the transaction is a sale or a lease arrangement.

- If the disposition does satisfy the requirements of a sale, the seller will recover his/her basis and selling expense equally over a 15-year period. [Temp. Reg. §15a.453-1(c)]
- If a payment is missed or if the payment is less than the allocable portion of basis, the excess basis will be carried to the following years. The unrecovered basis is then allocated equally over the number of years remaining in this 15-year period. If there is unrecovered basis in the final year of this 15-year period, the excess will be carried to the next year. This carryover will continue year to year or until the future payment obligation is determined to be worthless.
Example: Continuing with the prior example except that there is no seven-year term. The buyer will pay 5% of annual gross rental receipts for each year until the total of payments for all years equals the FMV of the business as determined in the year of payment.

Baker will recover his $70,000 basis over a 15-year period, in the amount of $4,667 per year. Any payment in excess of this basis recovery amount will be gain on the sale.

If in year 11, he only received $3,000 for the year, the full $3,000 will be basis recovery. The excess of the allocable portion over the amount received ($4,667 - $3,000 = $1,667) will be carried to future years. The remaining allocable portion unrecovered ($18,663) and the carryover amount ($1,667) will be recovered over the remaining four years. This results in $5,083 basis recovered per year ($18,663 + $1,667 = $20,330 and $20,330 ÷ 4 = $5,083).

The income forecast method can be used for the sale of mineral property, a motion picture film, a television film, or a taped television show. The IRS may designate other similar properties if appropriate.

- The first step is to calculate a fraction. The numerator is the payment received during the year and the denominator is a forecast or estimate of total payments to be received under the contract.
- This fraction is applied to the basis to determine how much is recovered each year. This fraction could change each year if estimated payments change. The new fraction would then be applied against the unrecovered basis to determine the current year basis recovery.

Wraparound Mortgages

In some cases, it is beneficial for the buyer and/or the seller to leave the seller liable for the original mortgage and pay it over time, while the buyer makes payments to the seller through the installment contract. The seller then uses those payments to pay the original mortgage. The buyer may not be able to secure a conventional mortgage.
The character of the interest to the seller may change as a result of the installment contract. The seller is treated as having received interest on the installment contract and having paid interest on the original mortgage. The interest received is income. The interest paid may be investment or personal interest depending on the terms of the contract. The interest on the original mortgage loses its character as home mortgage interest due to the sale, if it was home mortgage interest in the beginning. Depending on the terms of the contract, the interest paid may be treated as investment interest. If the qualifications are not met, the interest paid is treated as nondeductible personal interest.

In a wraparound mortgage the contract price is equal to the sale price which results in a lower gross profit percentage than would be the case if the mortgage were assumed by the buyer. This allows the seller to report a smaller amount of gain each year.

To prevent the wraparound mortgage from being ignored and treated as an assumed mortgage where the seller may have a larger amount of gain to recognize in the beginning, the structure of the wraparound mortgage is important.

■ Payment terms should not be set up to be substantially identical to those of the underlying mortgage. (Structuring the installment obligation to be profitable relative to the underlying mortgage will support the interest character as investment interest expense.)

■ Payments should not go directly from the buyer to the underlying mortgagee, thus avoiding the seller.

**Imputed Interest**

The IRS requires that a reasonable rate of interest needs to be included in installment contracts. The applicable federal rate (AFR) in effect at the time of sale (the lowest rate for the three months ending on the date of sale) is the minimum rate of interest.

If an installment contract does not include interest or has understated interest, an imputed interest calculation will be necessary. This will recharacterize a portion of the sales price into interest. After the calculation is complete, the Form 6252 can be used to determine the gain on the installment contract.
The original issue discount (OID) rules under §1274 or the unstated interest rules under §483 are used to determine imputed interest when the installment sale contract does not provide for adequate stated interest. In general, §1274 applies to debt instruments issued for the sale or exchange of property if any payment under the instrument is due more than six months after the date of the sale or exchange. In general, if §1274 does not apply, §483 applies.

IRC §1274 does not apply to the following transactions:
- The sales or exchange of a principal residence.
- A sale or exchange for which the total payments are $250,000 or less.
- The sale or exchange of a farm for $1,000,000 or less by an individual, an estate, a testamentary trust, small business corporation under §1244(c)(3), or a domestic partnership.
- Certain land transfers of $500,000 or less per year between family members.

IRC §483 does not apply to the following transactions:
- A sale or exchange for which no payments are due more than one year after the date of the sale or exchange.
- A sale or exchange for $3,000 or less.

IRC §1274 and §483 do not apply to the following:
- A transfer of property between spouses or incident to divorce under §1041.
- A below-market loan under §7872 (such as gift loans and corporation-shareholder loans).

**Interest on Deferred Tax**

A special interest is paid on the deferred tax related to any obligation that arises during a tax year from the disposition of property under the installment method if the following conditions exist:
- The property had a sales price over $150,000; and
- The aggregate balance of all nondealer installment obligations outstanding at the close of the tax year is more than $5,000,000.
This special interest does not apply to the disposition of personal use property by an individual or property used or produced in the trade or business of farming.

The interest is calculated in the following manner:

- The applicable percentage of the deferred tax liability allocable to the installment obligation, multiplied by,
- The underpayment rate in effect under §6621(a)(2) for the month the tax year ends. This rate may change each year of calculation.
- The applicable percentage is the face amount of the obligations at the end of the year minus the $5,000,000 threshold divided by the face amount of the obligation.

The interest calculated above is entered on the “Total Tax” line of Form 1040 with “Section 453A(c)” on the dotted line to the left for individuals. Corporations are also subject to the interest calculation.

**Alternative Minimum Tax (AMT) Implications**

AMT rules apply to items sold on the installment basis in the same manner as for regular tax purposes.


Installment sale reporting of gain can still require an adjustment for AMT purposes under the “Disposition of property” heading. If the basis of the asset sold on the installment method is different for regular tax purposes than for AMT purposes, generally due to depreciation, an adjustment needs to be made. Since the sale of personal property requires the immediate recognition of gain due to depreciation, the AMT adjustment will only apply when real property is sold.
**Example:** Work Plus is selling a commercial building on the installment basis. The sales price of the building is $250,000. The original cost of the building was $175,000. Depreciation in the amount of $65,000 has been taken. The depreciation for AMT purposes was only $50,000. For AMT purposes, the gain would be $15,000 less, creating a negative adjustment for disposition of property.

**Purchase Price Adjustments**

It may be necessary to renegotiate the sales contract at a later date. If the seller reduces the selling price and continues to receive payments, the installment agreement has not been disposed of.

On the seller’s side, the gross profit percentage is refigured for the remaining payments. The new percentage is used to calculate the gain on all future payments. The basis of the installment obligation is adjusted to reflect the payments that have already been made (Rev. Rul. 72-570).
Example: Yagotta Deel sold land to Igor Byer for $30,000 on October 10, 2003.

- Selling Price: $30,000
- Cost: $12,000
- Gain on the Sale: $18,000
- Gross Profit %: 60%

Igor paid $6,000 per year plus interest for two years. He was not able to continue to pay the $6,000 per year. To avoid repossession, Yagotta reduced the remaining debt on the land from $18,000 to $12,000 over the following 3 years.

Yagotta must recalculate the gross profit percentage on a new Form 6252 for 2005. The new Form 6252 would show only the new gross profit percentage but the calculations would be as follows:

- Reduced Selling Price: $24,000
- Cost: $12,000
- Recomputed Gain on the Sale: $12,000
- Less Gain Previously Reported: $7,200
- Total Gain Remaining: $4,800
- New Gross Profit % ($4,000 ÷ $12,000): 40%
  (remaining gain ÷ remaining payments)

All remaining payments will be subject to the new gross profit of 40%.

The buyer adjusts the basis of the asset acquired. If it is a depreciable asset, the basis for depreciation is reduced. The accumulated depreciation continues causing the asset to be depreciated sooner than its normal life.

Example: From the installment sale in the prior example, Igor’s new basis in the land would be reduced to $24,000.
Disposition of Installment Obligation

A disposition of an installment obligation includes a sale, exchange, cancellation, bequest, distribution, or transmission of an installment obligation or installment note.

If the taxpayer is using the installment method and disposes of the obligation, the taxpayer will usually have gain or loss to report. The character of the gain or loss retains the same character as the gain or loss on the original sale.

The basis of an installment obligation is:
- The unpaid balance in the obligation, less
- The unpaid balance multiplied by the gross profit percentage.

Gain or loss is determined using the following rules:
- If the taxpayer sells or exchanges the obligation, or if the taxpayer accepts less than face value in satisfaction of the obligation, the gain or loss is the difference between the basis in the obligation and the amount realized on the sale.

Example: In 2004, Vishnu VerHeer sold property for $50,000 and reported the sale on the installment method. The gross profit percent from the original sale was 70%. In June 2009, Vishnu sold the contract to a third party for $10,000. At that time, the unpaid balance of the contract was $20,000.

Vishnu’s basis in the obligation is $6,000. This is determined by multiplying the unpaid balance by the gross profit percent ($20,000 x 70%) and subtracting the result from the unpaid balance ($20,000 – $14,000).

The obligation was sold for $10,000, so Vishnu has a gain on this sale of $4,000 ($10,000 – $6,000).

- If the obligation is disposed of in any other manner, the gain or loss is the difference between the basis in the obligation and its FMV at the time of disposition. This includes the following transactions:
A gift of an installment obligation, excluding gifts between spouses or former spouses incident to divorce.
- The installment obligation is canceled or becomes unenforceable.

If the taxpayer accepts part payment on the balance and forgives the rest, the settlement is a disposition with gain or loss being the difference between the basis in the obligation and the amount received.

No gain or loss is recognized on the transfer of an obligation between spouses or a former spouse if incident to divorce. The basis of the obligation carries over from the transferor spouse to the transferee spouse.

The following situations are not treated as a disposition of an obligation:
- The taxpayer agrees to reduce the selling price, but does not cancel the rest of the buyer’s debt. The gross profit percentage is refigured for that year and applied to future payments. Prior year returns are not amended.
- If the buyer sells the property and the original seller agrees to let the new buyer assume the obligation, no disposition has occurred.

A transfer due to the seller’s death is not a disposition. The beneficiary of the obligation will report the payments as the seller would have. On the other hand, if the obligation is canceled or transferred to the buyer, it is considered a disposition and the estate must determine its gain or loss.

OPTIONS, DOWN PAYMENTS AND EARNEST MONEY

The common law principles applicable to option contracts are well settled. An option contract has two elements: (1) A continuing offer to do something, or to forbear, which does not become a contract until accepted; and (2) an agreement to leave an offer open for a specified or reasonable period of time.

An option or earnest money deposit, received on the execution of a sales contract, is not income to the seller until the seller acquires an unconditional right to retain the payment.
If the sale is consummated, it fixes the seller’s right to retain the deposit, and the earnest money is included as part of the sales proceeds and taxed in the same manner (i.e. to the extent the payments exceed the seller’s basis, as capital gain or ordinary income).

If the sale is not consummated, the sales contract determines whether the seller has the right to retain the deposit, and the deposit is included in the seller’s income at the time that the contract fixes the seller’s right to retain the deposit. Because earnest money is in the nature of a payment for an option, it is included in the seller’s ordinary income when it is forfeited to him (Nam Sik Kang, TC Memo 1993-601).

In some cases down payments must be returned if the seller cannot provide clear title, the seller is unable to deliver possession, or other conditions of the sale are not satisfied. If the sale is never closed, and the down payment is returned to the buyer, it is never included in the income of the seller (Ferydoun Ahadpour, et ux., TC Memo 1999-9).

If a sale is delayed until contract conditions are satisfied, down payments are income to the seller not in the year in which received, but in the later year when the sale is closed, or when the payments are irrevocably forfeited by the buyer.

The tax treatment of a loss sustained by the buyer of an option which he allows to lapse depends on the character of the optioned property.

**Example:** Lotta Cash, a dealer in industrial property, acquires an option to buy an industrial site and fails to exercise the option. The loss is an ordinary loss since she would have held the property for sale to customers in the ordinary course of her trade or business if she had acquired it.

If the would-be buyer sells his option to another, the nature of his gain or loss likewise depends on the nature of the property subject to the option.
**Example:** Ben Wavering is considering buying a new house for his residence and acquires an option to buy a certain house at a fixed price. Although the property goes up in value, Ben decides he does not want the house for his residence and sells the option for more than he paid for it. The gain which taxpayer realized is a capital gain since the property, if acquired, would have been a capital asset in his hands.

If the property goes down in value, Ben decides not to purchase the house and sells the option at a loss, he would have a capital loss under §1234. However, it would be a nondeductible personal loss.

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**LEASE WITH OPTION TO PURCHASE**

If a lease gives the renter an option to buy the leased property from the landlord (sometimes referred to for accounting purposes as a “capital lease,” “finance lease,” or “financing lease”), it can be hard to tell whether the renter’s payments are rent or purchase payments. Rent is deductible but installment payments of the purchase price must be capitalized by the buyer.

In determining whether a transaction is a purchase/sale or a rental agreement, the IRS may consider the following factors (Rev. Rul. 55-540):

- Portions of the periodic payments are made specifically applicable to equity to be acquired by the lessee.
- The lessee will acquire title upon the payment of a stated amount of “rentals” which under the contract he is required to make.
- The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title.
- The agreed “rental” payments materially exceed the current fair rental value, indicating that the payments include an element other than compensation for the use of property.
- The property may be acquired for a price which is nominal in relation to the FMV of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made.
Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

If a lease with an option to purchase is actually a sale, the landlord must, under the installment sale rules, recognize part of each payment as profit and must treat the rest as recovery of its basis.

**Example:** Tyrone rents real estate to Ahmad for five years, giving Ahmad the option to purchase the property at the end of that time. Ahmad’s monthly payments are more than the FMV rent, but no allocation is made in the lease or option agreements between rent and other payments, and if Ahmad does not exercise the option before the lease expires, he gets no refund.

Tyrone reports the payments as rent until the option is exercise, after which they are treated as part of the purchase price. No recharacterization of payments from prior years is required, and Tyrone does not have to file amended returns for those years.

If at the end of the lease the option is not exercised by the renter, the landlord was reporting income on the installment method, and the landlord reacquires the property, the landlord treats the reacquisition in the same manner as a sale and repossession (see below).

**Repossessions**

Repossession requires a determination of gain or loss by both the seller and the buyer on repossession and a redetermination of the basis in the repossessed property.

The repossession of real property restores the seller to approximately the same position as prior to the sale. The seller’s basis in the property is the original basis. The total payments received from the buyer on the original sale must be considered income. The seller reports, as gain on repossession, any part of the payments that were not included in income (amounts previously treated as a return of basis). These rules concerning basis and gain on repossessed real property are
mandatory, and applies whether or not the sale was reported using the installment method.

Example: On January 1, 2008, Kim sold business land for $300,000 on installment, with $60,000 down and a $1,000 payment per month plus interest until paid off. Kim’s adjusted basis in the property was $200,000, resulting in a net profit from the sale of $100,000. For 2005, Kim’s gross profit percentage is 33.33%.

Tim, the buyer, paid $60,000 down and paid nine monthly payments of $1,000 each before defaulting. $23,000 (33.33% of the $69,000 principal) was taxed to Kim. The remaining $46,000 was untaxed as of the date of the repossession. Kim paid $5,000 in repossession costs.

The $46,000 untaxed portion of the principal payment is less than the $72,000 untaxed profit on the original sale ($100,000 original profit minus $23,000 taxed principal, minus $5,000 repossession costs). The taxable gain on repossession is the smaller of the two. Therefore, $46,000 will be taxed to Kim in 2008 as repossession gain.

Kim’s basis in the repossessed property is figured as follows: The original basis ($200,000) less payments received prior to repossession ($69,000) plus the gain previously reported ($23,000) plus the repossession costs ($5,000) plus the repossession gain recognized ($46,000) equals Kim’s new basis of $205,000.

The seller’s holding period for the later sale of repossessed property includes the period the property was held before the original sale and the period after the repossession.

The debtor/borrower treats a foreclosure or repossession as a sale or exchange from which the debtor may realize a gain or loss. The transaction is reported the same as other sales with the gain or loss being the difference between the adjusted basis in the property and the amount realized. The taxpayer may also realize ordinary income from the cancellation of debt if the loan balance was greater than the FMV.
If the debtor is not personally liable for repaying the debt (a nonrecourse loan), the amount realized includes the full debt canceled by the transfer.

If the debtor is personally liable for the debt (a recourse loan), the amount realized does not include the canceled debt. However, if the FMV of the transferred property is less than the canceled debt, the amount realized includes the canceled debt up to the FMV of the property. The canceled debt amount reported as ordinary income is separate from any gain or loss realized on the foreclosure or repossession.

**Qualified Principal Residence Debt**

Effective for discharges of indebtedness after December 31, 2006 and before January 1, 2010, a discharge of up to $2 million of acquisition debt on taxpayer’s main home in is excludable from income.

“Qualified principal residence indebtedness” means acquisition indebtedness, as defined by Code §163(h)(3)(B) for purposes of the interest deduction rules, with respect to the taxpayer’s principal residence, but not more than $2 million ($1 million for married individuals filing separately). Acquisition indebtedness with respect to an individual’s principal residence generally means debt that is incurred to acquire, construct, or substantially improve, and is secured by, that residence.

**Example:** Petunia Dursley, who isn’t in bankruptcy and isn’t insolvent, owns a principal residence subject to a $200,000 mortgage debt for which she has personal liability. Her lender forecloses and the home is sold for $180,000 in satisfaction of the debt. Under pre-2007 Mortgage Relief Act law, she would have had $20,000 of debt discharge income. Under the 2007 Mortgage Relief Act, Petunia has no debt discharge income when her lender forecloses with the result that the $200,000 debt is satisfied for $180,000. The result is the same if the loan is restructured and the principal amount is reduced to $180,000.
The exclusion doesn’t apply to second homes, vacation homes, business property, or investment property, since these properties aren’t the taxpayer’s principal residence.

The exclusion rule also doesn’t apply to discharges of second mortgages or home equity loans, unless the loan proceeds were used to acquire, construct, or substantially improve the taxpayer’s principal residence.

Sometimes a taxpayer will have gain or loss from the sale or exchange of the property instead of, or in addition to, income from discharge of indebtedness.

**Example:** Petunia’s lender foreclosed on her home recourse mortgage. At the time of the foreclosure, her basis in the home was $170,000, the home’s FMV was $200,000, and the unpaid mortgage on the home was $220,000. The foreclosure results in taxable gain of $30,000 and discharge of indebtedness income of $20,000, computed as follows:

\[
\text{Gain from deemed sale:} \quad 200,000 \text{ (FMV)} - 170,000 \text{ (basis)} = 30,000
\]

This gain is not eligible for the exclusion rule described above or for the bankruptcy or insolvency exclusions. However, all or part of the gain may be excludible from gross income under the Code §121 home-sale rules.

\[
\text{Discharge of indebtedness income:} \quad 220,000 \text{ (total debt)} - 200,000 \text{ (FMV)} = 20,000
\]

A taxpayer who has had a debt discharge of $600 or more during the year should receive a Form 1099-C, *Cancellation of Debt*, from the lender by the following February 28. The form doesn’t include enough information for the taxpayer to determine whether the discharge qualifies for the exclusion described above, e.g., whether the discharge relates to the taxpayer’s principal residence. The taxpayer and the taxpayer’s advisers must determine whether the exclusion applies.
The basis of the taxpayer’s principal residence is reduced (but not below zero) by the amount excluded from income under the principal residence exclusion.

As a result of this basis reduction rule, the discharged debt is potentially taxed when the taxpayer later sells the principal residence. However, in many cases there will not be any additional tax, because any gain on that sale or exchange will qualify for the §121 home-sale exclusion.

The principal residence exclusion doesn’t apply to:

■ A discharge of a loan that was on account of services performed for the lender (for example as an employee of the lender), or any other factor not directly related to a decline in the residence’s value or to the taxpayer’s financial condition, or

■ A taxpayer in a Title 11 case. Instead, the Title 11 bankruptcy exclusion applies.

The principal residence exclusion applies to an insolvent taxpayer not in bankruptcy unless the taxpayer elects to have the insolvency exclusion apply instead.

**Note:** Many taxpayers in foreclosure will be insolvent, but this isn’t always the case. To be considered “insolvent,” a taxpayer’s total liabilities must exceed the FMV of all of his assets, determined immediately before the discharge. All assets are included, even those such as retirement accounts, that are taken into account in determining insolvency but aren’t accessible without a penalty. The amount of discharge of indebtedness income that is excluded from income by reason of a debtor’s insolvency is limited to the amount by which the debtor is insolvent.

IRS Pub. 4681 has a worksheet to help determine whether a taxpayer is insolvent, and if so by how much.
The principal residence exclusion doesn’t apply if the discharge of the loan was on account of services performed for the lender or any other factor not directly related to a decline in the residence’s value or to the taxpayer’s financial condition.

**Gifts**

**General Considerations**

A gift tax return, Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, is the responsibility of the donor of the gift. It is required when the donor has made a taxable gift, which includes gifts of a present interest that exceed the $13,000 annual exclusion (for 2009) and/or gifts of a future interest.

A donor’s total gifts for the year are reduced by a $13,000 (for 2009) per donee annual exclusion, provided the gifts are present and not future interests in property.

Every donor also has a $345,800 credit (formerly the unified credit, now called the applicable credit amount) which is allowed against gift taxes imposed on lifetime transfers. This amount will offset the tax on the first $1 million of lifetime transfers. This exemption will not increase like the applicable exclusion amount for estates.

Gifts between spouses are eligible for the unlimited marital deduction. To qualify for the deduction, the spouses must be married, the spouse receiving the gift must be a U.S. citizen, and the interest transferred cannot be a nondeductible terminable interest. Gifts between spouses are generally not reported on Form 709, Schedule A, unless the gift is a terminable interest, a future interest in property, the donee spouse is not a U.S. citizen, or there is a question of the availability of the marital deduction.

When calculating a taxpayer’s gifts made to one individual during the year, it is necessary to look at all gifts made to that individual, such as birthday gifts, anniversary gifts, etc.
Example: Bill’s single daughter, Ellen, is buying a house. Bill made a gift of $13,000 to Ellen in 2009 to help her with the down payment. Bill also gave his daughter the usual birthday and Christmas gifts throughout the year totaling $500. Even though the gift of the down payment did not exceed $13,000, all of the gifts to Ellen during the year must be totaled when deciding whether a gift tax return needs to be filed. Since the gifts to Ellen totaled $13,500, Bill needs to file a gift tax return for the year.

Only individuals file gift tax returns. A married couple cannot file a joint gift tax return. However, they can elect to split the gift and include half of the value on their separate Form 709 returns.

However, gifts of community property are not eligible for the gift-splitting election. This is because the community property is already considered owned half by each spouse. Each spouse must file a separate return for taxable gifts, but there is no need to have the other spouse sign the consent on Form 709.

Trusts, estates, partnerships, or corporations cannot be donors. The individual beneficiaries, partners, or stockholders are considered the donor and would be responsible for the gift tax return and the tax liability.

A gift tax return needs to be filed when a gift to a non-U.S. citizen spouse is in excess of $133,000 in 2009. This amount is indexed for inflation every year.

If the donor is neither a citizen nor resident of the United States, the gift tax applies only to transfers of real and tangible property located in the United States. The gift of intangible property such as stock would not be subject to gift tax requirements.

Example: Juan is a resident of Mexico. He purchased property in Southern California many years ago. His son, Pedro, became a citizen of the United States and lives in California. Juan gave the property in Southern California to Pedro. Juan is required to file a gift tax return.
Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, is due on the date the donee’s income tax return is due, including extensions. Send Form 3520 to the Internal Revenue Service Center, Philadelphia, PA 19255.

**Noncitizen Nonresident Donor**

A noncitizen, nonresident donor who gives money or property located outside of the United States is not required to file Form 709. However, a foreign gift may have another reporting requirement.

A foreign gift is any amount that the recipient treats as a gift or bequest received from a person other than a United States citizen, but does not include any qualified transfer within the meaning of §2503(e)(2) relating to certain transfers for educational or medical expenses, or any distribution from a foreign trust properly reported under §6048(c) [§6039F(b)]. Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, is used to report the gift.

The code requires reporting foreign gifts of $14,139 or more for 2009, indexed for inflation. This is misleading in that the foreign person referred to for this purpose is a corporation or partnership (Form 3520, Question 55).

Gifts from foreign individuals are subject to a reporting requirement when the gift exceeds $100,000. If related parties give gifts, the amount must be aggregated to determine the $100,000 requirement (Form 3520, Question 54).

**Example:** Franco, a nonresident alien, gifted his daughter, a U.S. citizen, $75,000 in cash. Franco’s wife gave the same daughter a Villa in Rome valued at $95,000. Separately, each gift does not exceed $100,000. However, since related parties gave the gifts, the gifts for filing purposes exceeded $100,000.

The federal gift tax return is due on the same date as the donor’s federal income tax return, which is normally April 15. The liability for
filing a gift tax return rests with the donor. If the donor should die before the gift tax return is filed, the executor of the will is responsible for the filing of the return. The responsibility for the payment of any tax associated with a gift tax return also belongs to the donor or the donor’s estate in the case of death.

**Gifts Involving a Joint Interest**

The transfer of property into the names of the donor and another person is generally deemed to be a gift of one-half of the property’s value to the other person; to the extent the other person does not provide any consideration.

**Example:** Joe purchases a vacant lot for $50,000 with his own money and puts the title in his name and his daughter Janice’s name as joint tenants with the right of survivorship. Joe is considered to have made a $25,000 gift of land to his daughter. Meeting all of the qualifications, this is a completed gift.

**Part Sale – Part Gift**

A sale of property for less than its FMV is a gift of the difference between the property’s value and the sales price, as of the time of the sale.

- If an individual sets a price for the sale of the property, no matter how far or how close to the FMV, the difference is considered a gift.

**Example:** Paul sold real estate for $1 to Charles. The real estate has a FMV of $150,000. Paul has made a gift of $149,999 to Charles. If Paul had sold the real estate for $100,000 to Charles, the gift would be $50,000.
If a property subject to a loan is gifted and the loan is assumed by the donee, the sale price of the gifted property is the amount due on the loan. The FMV of the property, less the assumed loan, is the amount of the gift.

**Example:** Sara gave her daughter, Wendy, rental property. The FMV of the property was $120,000. The balance of the mortgage on the rental property was $30,000, which Wendy assumed. Therefore, Sara would report the sale of $30,000 on her personal income tax return and a gift of $90,000 on Form 709.

If the sales price is a reflection of a business agreement without gift intent, the difference may not be a gift.

**Example:** If, due to a need for quick cash and without gift intent, Paul sold real estate with a FMV of $150,000, for $130,000 to Charles, a gift did not take place.

**Note:** Reg. §1.1001-1(e) gives four examples calculating the taxable gain for income tax purposes of transfers that are in part a sale and in part a gift. Reg. §1.1015-4(b) gives the purchaser’s basis for these same four examples. The following example is Example (2) from Reg. §1.1001-1(e). The basis issues of this example will be covered later in this text.

**Example:** Allen transfers property to his son for $30,000. Such property in Allen’s hands has an adjusted basis of $60,000 (and a FMV of $90,000). Allen has no gain or loss, and has made a gift of $60,000, the excess of $90,000 over the amount realized, $30,000.
Transfers of Property With a Retained Life Estate

Transfers of property with a retained life estate are deemed to be completed gifts of the remainder interest if the transfer is “in trust,” which is a transfer with the title showing a life estate retained by donor [§2702(c)(1)].

There is some disagreement about the requirement to actually set up a formal “trust.” Some states, like New York, go with the informal definition of trust. Other states require an actual trust to be used in order for this to be a completed transfer. If an actual trust is not used in these states, the life estate interest will be considered 0%; therefore, the remainder interest will be considered 100% of the property’s FMV.

The valuation of the remainder interest involves the use of §7520 rates, Table S (for single remainder) and Table R2 (for joint lives). The §7520 rate is equal to 120% of the mid-term annual Applicable Federal Rate (AFR), rounded to the nearest .2%. For example, if 120% of the mid-term annual AFR is 5.58%, then the §7520 rate is 5.6%.

The age used for the valuation is the donor’s age at his or her nearest birthday either before or after the date of the gift.

Example: On April 15, 2003, William, age 63 at his closest birthday, transferred his residence to his cousin, Ruth, retaining a life estate interest for himself. The property had a value of $100,000 at the time of the transfer. The §7520 rate was 3.6% for the month of the transfer.

Table S (3.6% rate, at age 63), shows a remainder interest valuation of .54533. Therefore, William’s gift is $54,533 ($100,000 x .54533).

If William does not use a trust, but is in a state that requires a trust to be established to hold the property, he will be deemed to have made a gift of the entire $100,000.

Note: Table S was revised for gifts, etc., made after April 30, 1999. It can normally be found in the IRS regulations under §7520 and IRS Publication 1457.
Transfers with retained life estate can be made jointly. The gift tax implication is the same for the joint gift as it is for the single gift. A complication arises because the tables for calculating a joint gift are not readily available. The Table S is based on a single life. Table R(2) is used for the joint life calculation. To arrive at the correct factor from the joint life table, the ages of both donors will be necessary.

**Example:** To illustrate the difference between a joint gift and a single gift, the scenario of William will be used with the addition of a wife who will join in the gift. William and his wife, Wilma, both age 63, gave the gift of a remainder interest in the property on April 15, 2003. The remainder interest will pass to the donee when both William and Wilma have died.

Table R(2) using 3.6% interest rate at the ages of 63 for each of the donors, shows the remainder interest factor for the joint life as .44335. This would result in a taxable gift of $44,335 ($100,000 x .44335). This compares to the single taxable gift from the previous example of $54,533.

From a planning standpoint, the donor may want to structure the gift as a joint gift rather than a single gift to reduce the amount of the applicable exemption amount being used up prior to death.

The valuation of property gifted to a member of the family under this method is governed by §2702. The value of the retained interest is deemed to be zero resulting in the reporting of the full FMV of the property on the gift tax return even though it is a gift of a future or remainder interest.

This treatment applies unless the gift is the gift of a qualified interest. A qualified interest means any of the following [§2702(b)]:

- Any interest which consists of the right to receive fixed amounts payable not less frequently than annually.
- Any interest that consists of the right to receive amounts that are payable not less frequently than annually and are a fixed percentage of the FMV of the property in the trust (determined annually).
Any noncontingent remainder interest if all of the other interests in the trust consist of interests described in paragraph (1) or (2). It is important to define family members for this purpose. “Applicable family members” include those defined in §2701(e)(2) as the transferor’s spouse, an ancestor of the transferor or the transferor’s spouse, and the spouse of any such ancestor. These are the persons who are deemed to retain an interest in the property.

Family members as recipients of the remainder interest are defined in §2704(c)(2) with respect to an individual as the following:

- Such individual’s spouse.
- Any ancestor or lineal descendant of such individual.
- Any brother or sister of the individual.
- Any spouse of the individuals described above.

Example: Grandma Jamie gifts her grandson a remainder interest in a rental property. Grandma retains the right to collect the income from the rental property for her lifetime. The value of the gift for purposes of Form 709 will be the FMV of the property. No allocation will be made under §7520 for the remainder interest.

One exception must be noted as defined in §2702(a)(3). If the entire transfer to a qualified trust consists of a residence, which is the personal residence of the individual who holds the term interest, the valuation will be made under §7520 and this section will not apply.

Planning Technique: A revocable living trust may achieve the same goals as a retained life estate.

Basis Issues of a Gift

The basis of property received by gift is the same basis as that of the donor (§1015).
If the basis, as adjusted, is more than the FMV of the gift:
- The basis for computing gain is the adjusted basis.
- The basis for computing loss is the FMV of the property.

**Example:** John bought a rental property for $200,000 in 1999. By 2008, the FMV of the land had fallen to $150,000. John gave the property to his son, Frank, in hopes Frank would become self-supporting and move out of his parents’ home. However, Frank likes his mother’s cooking. If Frank sells the property, his basis for determining loss is $150,000.

Had John sold the rental property and given the money to Frank instead of the property, John would have reported a loss of $50,000.

If using the donor’s adjusted basis to compute gain results in a loss and using the FMV to determine loss results in a gain, there is no gain or loss on the disposition of the property.

**Example:** Since Frank’s basis is $200,000 for gain purposes, but $150,000 for loss, if the rental sold at a price between $150,000 and $200,000, Frank would have no gain or loss to report.

The basis of property is increased by all or a portion of the gift taxes paid. For gifts made after December 31, 1976, the basis will be increased by the portion of the gift tax attributable to the net appreciation of the gift. The net appreciation is the amount by which the FMV of the gift exceeds the donor’s adjusted basis immediately prior to the gift [§1015(d)(6)].

The basis of property received in a transaction that is in part a gift and in part a sale is the sum of:
- The greater of the amount paid for the property or the transferor’s adjusted basis of the property at the time of the transfer; and
- The amount of increase, if any, allowed due to the gift tax paid.
**Example:** Roger decided to sell his mansion to his daughter, Polly. The mansion was worth $1,000,000, but she could only afford to pay $550,000. Roger’s basis in the property was $300,000.

<table>
<thead>
<tr>
<th>Sale</th>
<th>Gift</th>
<th>Donee’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>$550,000</td>
<td>$450,000</td>
<td>$550,000 + a portion of gift tax</td>
</tr>
</tbody>
</table>

If Roger’s basis in the property had been $750,000, the following would apply.

<table>
<thead>
<tr>
<th>Sale</th>
<th>Gift</th>
<th>Donee’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>$550,000</td>
<td>$450,000</td>
<td>$750,000 + a portion of gift tax</td>
</tr>
</tbody>
</table>

The basis of a life interest and a remainder interest are calculated with reference to the “uniform basis” and the age of the donor. The uniform basis is the basis of the donor at the time of the gift. The life interest and the remainder interest factors change with time. As the donor gets older, the remainder factor increases while the life interest factor decreases. (Life interest factor + remainder factor = 1)

The depreciable basis of a gift is the donor’s adjusted basis. The donee not only receives the gift, but also the depreciation method, life, and accumulated depreciation. Any improvements or additional cost associated with acquiring the gift will be depreciated as if it were a new asset (§1016).

**Example:** Jane was gifted a rental condo her uncle had purchased on January 2, 1988. The property was being depreciated under MACRS 27.5 years. Her uncle paid $85,000 for it and had taken $46,236 of accumulated depreciation. Jane’s basis for depreciation is the $85,000. The accumulated depreciation belongs to her as well. She will continue depreciating the property where her uncle left off. If Jane renovates the property, the cost will be treated as an improvement with a new depreciable life.

In dealing with a gift that is a part sale/part gift, the donee’s basis is the greater of the amount paid by the donee or the donors adjusted
basis at the time of the transfer. If the donor’s basis is greater than the sales price, the basis is allocated first to the sales price, resulting in no gain or loss. Any remaining basis is allocated to the gift.

Example: If Allen transfers property to his son for $30,000, and such property at the time of transfer had an adjusted basis in Allen’s hands of $60,000 (and a FMV of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Allen’s basis for the sale would be the $30,000 resulting in no gain or loss. The remaining $30,000 would be allocated to the gift. Therefore, the son’s basis would be Allen’s adjusted basis of $60,000 ($30,000 + $30,000).

**Transfers at Death**

Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, is used to report the transfer of assets from a decedent at the time of death.

The federal estate tax is imposed on the decedent’s entire estate. It is an excise tax on the right to pass property at death. The gross estate is composed of all property that was owned by the decedent and is transferred either by will or by intestacy laws. It may include property interests that the decedent did not own at death, such as certain transfers that took place before death, and in which the decedent kept possession or enjoyment of, or received certain rights or interests. The value of gifts reported on Form 709 must be included in the estate as well.

The gross estate is based on the FMV of all of a decedent’s assets on the date of death (or the alternate valuation date, if applicable). The value of the gross estate of the decedent is determined by including the value at the time of death of all property, real or personal, tangible or intangible, wherever situated [§2031(a)].

For deaths after 1976, the unified credit and exemption equivalent were implemented in calculating the tax of the estate. The *Tax Relief Act of 2001* revised the unified credit and exemption amount to an
applicable credit amount. In addition, this Act also reduced the tax rates applicable before 2010 for estate tax purposes.

<table>
<thead>
<tr>
<th>Year</th>
<th>Applicable Exclusion Amount</th>
<th>Top Marginal Rate for Estate and Gift Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$675,000</td>
<td>55%, plus 5% surtax on transfers over $10,000,000</td>
</tr>
<tr>
<td>2002</td>
<td>$1,000,000</td>
<td>50%</td>
</tr>
<tr>
<td>2003</td>
<td>$1,000,000</td>
<td>49%</td>
</tr>
<tr>
<td>2004</td>
<td>$1,500,000</td>
<td>48%</td>
</tr>
<tr>
<td>2005</td>
<td>$1,500,000</td>
<td>47%</td>
</tr>
<tr>
<td>2006</td>
<td>$2,000,000</td>
<td>46%</td>
</tr>
<tr>
<td>2007</td>
<td>$2,000,000</td>
<td>45%</td>
</tr>
<tr>
<td>2008</td>
<td>$2,000,000</td>
<td>45%</td>
</tr>
<tr>
<td>2009</td>
<td>$3,500,000</td>
<td>45%</td>
</tr>
<tr>
<td>2010</td>
<td>Repeal</td>
<td>Repeal for Estate Tax and Gift Tax will be at 35%</td>
</tr>
</tbody>
</table>

There is a sunset provision in this Act and it is scheduled for 2011. That means the estate taxes will be back unless Congress makes these changes permanent or enacts other changes.

The estate tax computation uses a progressive rate of tax from a minimum of 18% on values less than or equal to $10,000, up to a maximum rate of 45% (for deaths in 2007, 2008 and 2009) on estates in excess of $2,000,000. The tax is figured on the gross estate, including prior taxable gifts, less allowable deductions. The applicable credit amount and other deductions are then applied to arrive at the tax due.

IRC §2033 requires that the value of all property owned by the decedent at the time of death be included in the gross estate. This includes real or personal and intangible or tangible property, regardless of where it is located (Reg. §20.2033-1).

This category also includes the value of certain rights the decedent may have had including the following:

- The right to borrow against a life insurance policy.
- Legal ownership, even when the individual is not aware of the right.
Real property is included whether it came into the possession and control of the executor or administrator, or passed directly to heirs or devisees.

**Dower and Curtesy Interests**

The application of §2034 requires that the value of the gross estate shall include the value of a surviving spouse’s dower or curtesy interest in the decedent’s estate.

A **dower interest** is the part of a deceased husband’s real property allowed to his widow for her lifetime.

A **curtesy interest** is a deceased wife’s real property that passes upon her death to her husband for his lifetime, provided they have had children capable of inheriting — state law governs.

**Community Property**

Currently, nine states follow community property laws: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

In completing Form 706, it is important to know and follow local and state law. Community property rules are different than the rules for common law states. Even within in the nine community property states, community property laws differ.

Generally, the full value of community property is reported on each applicable schedule and then only the net is reported on the bottom line. Care must be taken in that some property is subject to federal law, which supersedes state or local law in determining ownership, i.e., *Employee Retirement Income Security Act* (ERISA).

States also differ on what expenses are chargeable against community income or only the decedent’s share of community income.

Conflict may also arise in other situations. Spouses in community property states may hold some assets separately. Also, some couples who move from a community property state may still have some assets that are considered community property.
Marital Bequests

All property passing to the surviving spouse that qualifies for the marital deduction (§2056) must be reported on Schedule M.

The marital deduction is a means of reducing the estate tax of the first spouse to die by transferring assets to the surviving spouse. This amount reduces the gross estate prior to the computation of the estate tax. There is an unlimited amount that may be transferred as long as certain conditions are met:

- The decedent spouse must be a U.S. citizen or resident alien.
- The surviving spouse must be a U.S. citizen, except in the case of a qualified domestic trust (QDOT).
- The property must be includible in the decedent spouse’s gross estate and pass to the surviving spouse.
- The property may not be nondeductible terminable interest property.

Any property transferred to the surviving spouse under the marital deduction will be included on that spouse’s Form 706 upon his or her death. Property not transferred under the marital deduction may still be transferred to the surviving spouse, but it is part of the taxable estate of the first to die. As such, it is not again included in the taxable estate of the second to die.

One objective of estate planning is to maximize the benefit of the decedent’s applicable exclusion amount. If the decedent’s taxable estate is below the applicable exclusion amount, the marital deduction is seldom used.

The marital deduction is based on the value of property passing to the surviving spouse. If the executor elects the alternate valuation date, it is this value that is used to determine the marital deduction.

Nondeductible terminable interest property is property that is given to the spouse for life with the remainder passing to a third person upon the death of the spouse or some other contingency. These are interests that terminate or fail after the passage of time or on the occurrence of an event or contingency. This includes patents, copyrights, life estates, annuities, etc.

The marital deduction is reduced to the extent federal estate taxes or other death taxes are paid out of any property included in the gross estate and passed to the spouse. Any administrative expenses paid out
of property passing to the surviving spouse also reduces the marital deduction.

A marital deduction for property passing to a spouse who is not a United States citizen can be accomplished if the property is passed to a QDOT [§2056(d)(2)].

A QDOT must meet the following requirements:

- At least one trustee is a U.S. citizen or a domestic corporation. There are some exceptions for estates of decedents who die after August 5, 1997.
- No distribution (other than an income distribution) may be made from the trust, unless a trustee who is an individual citizen of the United States or domestic corporation has the right to withhold tax from the distribution.
- An election to be treated as a QDOT must be made by the executor.

**Basis of Inherited Property**

**Before the Year 2010**

The basis of inherited property is determined at the date of death of the decedent. The basis of inherited property, other than income in respect of a decedent (IRD) items, is the FMV on that date (§1014). If the alternative valuation date is selected, the basis is the value used on that date.

If property is gifted with a retained life estate, the remainder interest will receive a basis equal to the property’s FMV on the date of death of the decedent, if the property is not disposed of prior to the death of the decedent.
Example: John gifted his son land valued at $125,000 at the time of the gift, but retained a life interest in it. John paid $100,000 (uniform basis) for the property. When John died, the property was worth $250,000.

If John and his son sold the life and remainder interest before John’s death, the basis of $100,000 would be apportioned between the two men based on the factors found in Table S.

Since the property was not sold until after John’s death, his son’s basis will be $250,000, the FMV on the date of John’s death.

The depreciation method and life is the same as that of a new asset. The decedent’s basis as well as the accumulated depreciation prior to death has no effect on the inherited property.

Example: Mattie inherited a fully depreciated rental property from her brother Mike. Mike purchased the property for $25,000 including the land. The depreciation on the property amounted to $20,000. When Mike died, the property was valued at $95,000 including $15,000 for land. Mattie will have a depreciable basis in the rental of $80,000. The $20,000 prior depreciation will have no effect on Mattie.

After the Year 2009

The basis as determined by FMV on the date of death, is repealed with respect to decedents dying after December 31, 2009 (§§1014 and 1022).

- Property acquired from a decedent will be treated the same as property acquired by gift. The recipient’s basis in property received will be a basis equal to the lesser of the decedent’s adjusted basis in the property or the FMV on the date of the decedent’s death.
- The decedent’s estate may then increase the basis for a limited amount of property on a property-by-property determination. This property is defined by what it is not. Some of the property that is not eligible for this increase includes:
Property acquired by the decedent by gift within three years of DOD, except if received by gift from a spouse.

Stock or securities in a foreign personal holding company.

Stock of a DISC (Domestic International Sales Corporation) or former DISC.

Stock in certain other foreign investment companies.

This increase is $1,300,000, adjusted for inflation after 2010, and increased by the decedent’s unused NOL, capital loss carryovers, and certain built-in losses that would have been allowable under §165 if inherited property had been sold at FMV immediately before the decedent’s death.

An additional increase of $3,000,000 is available for certain property transferred to a surviving spouse.

These increases cannot increase the basis of any property above its FMV on the DOD.

The basis increase available to a noncitizen, nonresident of the U.S. is up to $60,000 and no addition is allowed for the decedent’s unused capital losses, NOLs, or built-in losses.

FOREIGN INVESTORS

The following is an IRS article titled “Tax Information For Realtors, Rental Agents and Foreign Owners of U.S. Real Estate,” which can be found at

www.irs.gov/businesses/small/international/article/0,,id=129631,00.html:

“With the increasing globalization of trade and investments, foreign ownership of U.S. real estate continues to grow. Consequently, U.S. realtors and rental agents/property managers are encountering an increasing number of situations that involve foreign persons acquiring U.S. real estate as a part-time residence, for investment or in some cases to conduct a U.S. business. The U.S. tax rules that apply to ownership and dispositions of U.S. real estate by foreign persons are different in some important respects from the rules that apply to U.S. persons.”
Definition of Foreign Persons

Because a number of U.S. federal tax rules differ when a foreign person is involved or apply only to foreign persons, it is important for a U.S. real estate professional to understand when an individual or entity is considered foreign for U.S. federal income or estate tax purposes.

A nonresident alien is defined for federal income tax purposes as an individual who is neither a U.S. citizen nor a resident of the United States within the meaning of §7701(b) of the Internal Revenue Code (the “Code”). An alien individual is a resident of the U.S. for federal income tax purposes if he or she meets either of the two tests under section 7701(b):

- The first test is the “green card” test. If an alien has been admitted for U.S. permanent residence (i.e., has a green card) at any time during the calendar year, the alien is a resident of the United States and is taxed on his or her worldwide income, the same as a U.S. citizen. Otherwise, U.S. immigration status generally is not controlling or relevant for U.S. federal tax purposes. In this respect, the U.S. differs from many foreign countries, in which immigration and tax status are integrated, a difference that frequently causes confusion.

- The second test is the substantial presence test. Under the substantial presence test, an alien individual is a resident for U.S. federal tax purposes if the alien is physically present in the U.S. for 183 days or more during the current calendar year. Alternatively, if the alien is physically present for at least 31 days during the current year, the alien may be treated as a U.S. tax resident in the current year under a three-year look-back test in which each day of presence in the current year is counted as a full day, each day of presence in the first preceding year is counted as one-third of a day, and each day of presence in the second preceding year is counted as one-sixth of a day. If the total of such days is 183 days or more, the alien may be a U.S. tax resident for the current year unless certain exceptions apply and the alien files certain required information with the IRS to claim the benefit of any relevant exception. As with the green card test, if an alien is a U.S. tax resident under either version of the substantial presence test, the alien is taxed on his or her worldwide income, the same as a U.S. citizen.

If the alien is from a country that has an income tax treaty with the United States, the treaty may act to change these results, subject to
certain required filings with the IRS to claim the treaty benefit. Also, in the first year that an alien might be subject to the substantial presence rule, it may be difficult to tell if the alien actually will become treated as a U.S. tax resident for that year.

A foreign corporation is a corporation that is not incorporated in the United States. The rules for other types of entities are more complex. Also, if an eligible foreign entity has filed a “check-the-box” election for U.S. federal tax purposes, its U.S. federal income tax treatment will differ from the norm for that type of entity; for example, a foreign corporation with a single owner may (if eligible) elect to be disregarded for U.S. federal tax purposes, or to be treated as a partnership if it has more than one owner. In either case, the resulting U.S. taxpayer is the owner or owners, who themselves may be foreign or domestic for U.S. federal tax purposes. Similarly, a foreign unincorporated entity might elect to be taxed as a foreign corporation for U.S. federal tax purposes.

**Foreign Investment in Real Property Tax Act (FIRPTA)**

IRC §897 of the Code (enacted under the 1980 FIRPTA legislation) provides rules for the taxation of nonresident alien individuals and foreign corporations on sales or other dispositions of U.S. real property interests (including installment sales, exchanges, foreclosures, and deeds in lieu of foreclosure of a U.S. real property interest).

FIRPTA applies to what it defines as a U.S. real property interest, which includes not only interests in land, but interests in buildings, mines, wells, crops and timber as well. Because Congress was concerned that foreign persons would try to avoid FIRPTA by incorporating their U.S. real estate holdings, a U.S. real property interest is defined to also include any interest in a U.S. corporation if that U.S. corporation is a “U.S. real property holding company,” with the result that a disposition of its stock by a foreign investor may be subject to federal income tax under FIRPTA. A U.S. corporation is a U.S. real property holding company if the FMV of its U.S. real property interests equals 50% or more of the sum of the FMV of its U.S. real property interests, interests in real property located outside of the United States, and trade or business assets. A foreign corporation may also be classified as a U.S. real property holding company, but the sale of stock in a foreign corporation by a foreign person generally is not
subject to U.S. federal income tax (although other important U.S. federal income tax consequences may result).

Since 1985, a disposition of a U.S. real property interest by a foreign corporation or nonresident alien individual generally is subject to a withholding tax regime under §1445. Under the withholding tax regime, any purchaser of a U.S. real property interest from a foreign seller must withhold ten percent (10%) of the gross purchase price and remit such amount to the IRS within 20 days of the closing. The purchase price includes cash plus the FMV of any other property transferred to acquire the real estate. A purchaser failing to withhold is liable for any uncollected withholding tax, as well as penalties and interest charges.

There are several total or partial exceptions to the §1445 withholding requirement. The more commonly encountered are:

- **If the seller is not a foreign person.** Under §1445, there is a presumption that every seller is a foreign person subject to the withholding tax unless proof to the contrary is provided to the purchaser. Usually, this proof is furnished in the form of a “non-foreign certification,” signed by the (U.S. citizen, resident or entity) seller under penalties of perjury, certifying that the seller is not a foreign person and setting forth the seller’s name, address and taxpayer identification number. The purchaser can rely on the certificate unless the purchaser has actual knowledge that it is false or receives a notice from an agent involved in the transaction stating that the certification is false (and an agent involved in a closing who knows that a non-foreign certificate is false is subject to a penalty if he or she fails to give the purchaser a written notice that the certificate is false). In the case of multiple sellers, including spouses holding property jointly, the regulations contain rules for allocating the purchase price among the sellers for purposes of withholding and tax liability. Where multiple sellers include U.S. and foreign parties, withholding applies (subject to receiving the non-foreign certification from the U.S. parties) only to the amounts allocated to the foreign parties under rules set forth in the regulations under §1445. The purchaser should retain the non-foreign certification for at least five years.

- **If the seller or the purchaser obtains a qualifying statement** (a withholding certificate) from the IRS providing that the seller is entitled to a reduced (or zero) withholding amount or has provided adequate security or made other arrangements with the IRS for payment of the tax. The application for the withholding certificate has to be filed before closing, and (if the seller applies for the
certificate) the seller must give the purchaser a written notice at closing stating that the application has been filed with the IRS. The purchaser still must withhold the full 10% at closing, but the withheld amount may be held by the purchaser and not remitted to the IRS until the IRS sends the purchaser its determination on the amount required to be withheld and paid over. The purchaser has 20 days from receipt of the notice from the IRS to pay over the amount required by the IRS.

- **If the purchaser intends to use the real property as a residence** and the purchase price is not more than $300,000. In order to qualify for this residential use exception, at the time of sale the purchaser (or any member of his immediate family) must have definite plans to reside at the property for at least 50% of the number of days that the property is to be used during each of the first two twelve-month periods following the date of sale. So long as the foregoing requirement is met, the property does not need to be the purchaser’s primary or principal residence. However, purchasers are cautioned that they will be liable for the tax not withheld if their intention does not materialize in fact and they cannot prove that the failure to so use the property was due to a change of circumstances that they could not reasonably have anticipated at the time of the purchase. Also, this exemption is available to individual purchasers only, and is not allowed for purchases by corporations, partnerships or trusts, or if the seller is a foreign partnership. A purchase of raw land or of an existing dwelling that is to be demolished and replaced, does not qualify for the exemption even if the purchaser intends to construct an otherwise qualifying residence on the property.

A Form 8288, *U.S. Withholding Return for Disposition by Foreign Persons of U.S. Real Property Interests*, is required to be filed by the transferee (buyer or designated agent) of the U.S. real property interest. In addition, Form 8288-A, *U.S. Withholding Statement on Disposition by Foreign Persons of U.S. Real Property Interest*, must be attached to Form 8288 and submitted with the required withholding. The amount of tax required to be withheld and paid to the IRS by the transferee is ten percent of the amount realized on the disposition of the USRPI by the foreign transferor. Forms 8288, 8288-A and the withholding tax must be filed (mailed) to the IRS by the 20th day after the date of transfer unless the seller is waiting for a response from the IRS to an application for a withholding certificate (see next paragraph) filed before closing. In such case, upon receipt of an approved withholding certificate or rejection letter, the taxpayer has 20 days from the date on the certificate/letter to file Forms 8288 and 8288-A.
and remit the required amount. Penalties and interest will be charged on late filed Forms 8288 (filed after the 20th day from the date of transfer or the response from the IRS to the withholding certificate). There is a penalty of up to $10,000 over the tax for a willful failure to collect and pay.

In certain situations, such as when the tax due on the transferor’s gain from the sale is less than the withholding, the foreign transferor or the transferee can submit a Form 8288-B, Application for Withholding Certificate for Disposition by Foreign Persons of U.S. Real Property Interests, to request a reduction or elimination of withholding on a transfer of a USRPI. Refer to Reg. §1.1445-3 or -6 for the different categories of withholding certificates.

The IRS generally will act on a completed withholding certificate application within 90 days of the request. Alternatively, the regulations permit the transferor to request an early refund of amounts already withheld if the request for an early refund is combined with an application for a withholding certificate.

If the seller of a U.S. real property interest is a domestic partnership, trust, or estate with foreign partnerships or beneficiaries, withholding by the buyer is not required, but the domestic partnership, trust, or estate should withhold 35 percent of the gain allocable to the foreign partnership or beneficiary [§1445(e)].

Just because there has been withholding with regard to the sale by the foreign seller, or the transaction was exempt from withholding, does not mean the foreign seller is excused from filing a U.S. income tax return and reporting any gain with respect to the sale. The sale of a U.S. real property interest by a foreign investor is a taxable event calling for the filing of a U.S. federal income tax return for the year of the sale. The amount of tax withheld may be credited against the seller’s federal income tax liability, which will reduce the amount of tax owed or may entitle the seller to a refund.

According to a recently released Treasury Regulation, Forms 8288, 8288-A and 8288-B must contain the foreign seller’s U.S. taxpayer tax identification number (and the buyer’s tax identification number as well). The seller’s tax identification number also is required for reporting the transaction on Form 1099-MISC, as the sale generally is not eligible for the “no information” reporting exception for sale of a taxpayer’s principal residence. Nonresident aliens generally obtain an Individual Taxpayer Identification Number (ITIN) for this purpose, but ITINs are no longer issued unless the applicant is filing a U.S. federal
income tax return with the application or other specific exceptions apply. Under guidelines published by the IRS in February, 2004 (see "ITIN Guidance for Foreign Property Buyers/Sellers") the application for the ITIN (Form W-7) can be done at the time of closing the transaction, with the Form W-7, proper supporting documents, and the FIRPTA withholding documents (either Form 8288-B, or Form 8288, 8288-A and the remittance of the amount withheld) being filed with the IRS ITIN Unit rather than filed directly with the IRS FIRPTA Unit. The instructions for filing are on current Form W-7, as modified by the above ITIN Guidelines.

Transferor’s Tax Return Responsibility Upon Sale

The individual transferor of the U.S. real property interest is required to file a Form 1040NR along with Schedule D, and if required, Form 4797, Sale of Business Property, and/or Form 6251, Alternative Minimum Tax, in order to meet its tax obligation. If the transferor is a corporation, then a Form 1120F with appropriate schedules will have to be filed. In order for a foreign individual or corporate transferor to claim a credit against its tax liability for the amount of tax withheld by the purchaser under §1445 or obtain a refund of excess withholding, the transferor should attach to its tax return the receipted copy of Form 8288-A that the IRS returns to the transferor.

Under U.S. tax law, a taxpayer can depreciate the property; there are different rates for residential and commercial properties. This annual depreciation is deducted from income as an expense on an income tax return. However, it will be recaptured when the property is sold.

The reporting of real property interests either on Form 8288, Form 1040NR or Form 1120-F may trigger an IRS inquiry regarding taxes for rental income in situations where the nonresident has failed to submit timely tax returns relating to the property.

U.S. Income Taxation of Foreign Persons

The U.S. federal income tax differentiates two principal types of U.S. source income of foreign persons: business income and investment income. If a foreign person conducts a business in the United States, the net income is taxed at the same graduated rates applicable to U.S. citizens and residents. For example, if a foreign person is an operator
of U.S. commercial real estate, the foreign person is conducting a business in the United States and must pay federal income tax at graduated rates. The foreign person will file either a Form 1120F (for foreign corporations) or a Form 1040NR (for nonresident aliens). If a foreign person receives investment income not connected with a U.S. business, the gross amount is taxed through withholding by the party paying the rent proceeds to the owner at a flat rate of 30% (without any deductions) unless a U.S. income tax treaty provides a lower rate or an exemption and proper documentation if provided. The policy behind withholding on investment income is that a foreign person earning only investment income in the United States typically does not have enough U.S. contacts for the IRS to collect tax due through the self-assessment process. Unlike the FIRPTA requirements, a foreign person whose entire U.S. tax liability for investment income is satisfied by withholding is not required to file a U.S. federal income tax return, although the party paying the income will have to file certain tax information returns in connection with the withholding, as discussed below.

**Tax Return Responsibility During Ownership and Rental**

Before agreeing to manage U.S. real property for a foreign taxpayer, a realtor or rental agent should discuss with the foreign client whether the rental income will be taxed as investment income through withholding, or on a net income basis as “effectively connected with a U.S. trade or business,” without withholding (although the owner may have to file estimated tax returns). Rental income from real property located in the United States and the gain from its sale will always be U.S. source income subject to tax in the United States regardless of the foreign investor’s personal tax status and regardless of whether the United States has an income treaty with the foreign investor’s home country.

The method by which rental income is taxed depends on whether or not the foreign person who owns the property is considered “engaged in the U.S. trade or business.” Ownership of real property is not considered a U.S. trade or business if it consists of merely passive activity such as a net lease in which the lessee pays rent, as well as all taxes, operating expenses, repairs, and interest in principal on existing mortgages and insurance in connection with the property. Such passive rental income is subject to a flat 30% withholding tax (unless reduced by an applicable income tax treaty) applied to the gross
income rather than the “net rent” received. Thus, the real estate
taxes, operating expenses, ground rent, repairs, interest and principal
on any existing mortgages, and insurance premiums paid by the lessee
on behalf of the foreign owner-lessor, must be included in gross
income subject to the 30% withholding tax. The gross income and
withheld taxes must be reported on Form 1042-S, Foreign Persons
U.S. Source Income Subject to Withholding, to the IRS and the payee
by March 15 of the following calendar year. The payor must also
submit Form 1042, Annual Withholding Tax Return for U.S. Source
Income of Foreign Persons, by March 15.

If, on the other hand, the foreign investor is engaged in a U.S. trade
or business such as the developing, managing and operating a major
shopping center, the rental income is not subject to withholding and
taxed at ordinary progressive rates. Expenses such as mortgage
interest, real property taxes, maintenance, repairs and depreciation
(accelerated cost recovery) may then be deducted in determining net
taxable income. The nonresident must make estimated tax payments
for the tax due on the net rental income, if any. The only way these
expenses can be deducted, however, is if an income tax return Form
1040NR for nonresident alien individuals and Form 1120-F for foreign
corporations is timely filed by the foreign investor.

Foreign individuals and foreign corporations may elect to have their
passive rental income taxed as if it were effectively connected with the
U.S. trade and business. Once such an election is made by attaching a
declaration to a timely filed income tax return, there is no obligation to
withhold even in a net-lease situation. Once made, the election may
not be revoked without the consent of the IRS. Unless the foreign
investor has properly informed the property manager that the rental
income is to be treated as “effectively connected income” by
submitting to the property manager with a fully completed Internal
Revenue Service Forms W-8ECI, Certificate of Foreign Person’s Claim
for Exemption From Withholding on Income Effectively Connected With
the Conduct of a Trade or Business in the United States, the property
manager should withhold 30% of the gross rental receipts so as to
avoid personal liability. A fully completed Form W-8ECI must include a
valid U.S. tax identification number for the foreign landlord (in other
words, the rental agent must withhold and remit the 30% tax to the
IRS until this requirement is satisfied). A real property manager who
collects rent on behalf of a foreign owner of real property is considered
a withholding agent and is personally and primarily liable for any tax
that must be withheld. The liability of the withholding agent includes
amounts that should have been paid plus interest, penalties, and
where applicable, criminal sanctions. Property managers who do not comply with these rules will be held liable (either individually or through their company) for 30% of gross rents, plus penalties and interest.

Also, property managers need to report annual rents collected on behalf of foreign landlords on Forms 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and 1042-S, *Foreign Person’s U.S. Source Income Subject to Withholding*. These are the equivalent of Forms 1096 and 1099-MISC but are for foreign owners.

To enforce the system of withholding, the Internal Revenue Code defines a “withholding agent” to be any person in whatever capacity (including lessees and managers of U.S. real property) having the control, receipt, custody, disposal or payment of income that is subject to withholding. Thus, a real property manager who collects rent on behalf of a foreign owner of real property is clearly considered a withholding agent. A withholding agent is personally and primarily liable for any tax that must be withheld. The liability of the withholding agent includes amounts that should have been paid plus interest, penalties and, where applicable, criminal sanctions. The statute of limitations does not start until a withholding return is filed by the withholding agent. Once the return has been filed, the statute of limitations begins to run at the later of two dates: the date of actual filing of the correct return or April 15 of the calendar year in which the return should have been filed. The withholding agent will remain liable if he actually knows that the foreign owner’s statements are false. The withholding agent’s duty of inquiry seems to be a “reasonably prudent test,” measured by all facts and circumstances.

A nonresident who fails to submit a timely filed income tax return loses the ability to claim deductions against the rental income, causing the gross rents to be subject to the 30% tax. Generally, the nonresident will need to retroactively file at least six years of delinquent income tax returns, or all prior year tax returns, if they have held the rental property for less than six years. However, the ability to elect to treat the rental income as effectively connected with a U.S. trade or business will be lost after 16 months from the original due date of the return, and the remaining back years may be subject to tax under the gross income method. Rental income from real property located in the United States and the gain from its sale will always be U.S. source income subject to tax in the United States regardless of the foreign
investor’s status and regardless of whether the United States has an income treaty with the foreign investor’s home country.”

**BROKER REPORTING REQUIREMENTS**

**Form 1099-S**

Generally, the IRS requires Form 1099-S reporting of transactions that consist in whole or in part of the sale or exchange for money, indebtedness, property, or services of any present or future ownership interest in any of the following:

- Improved or unimproved land, including air space.
- Inherently permanent structures, including any residential, commercial, or industrial building.
- A condominium unit and its appurtenant fixtures and common elements, including land.
- Stock in a cooperative housing corporation (as defined in §216).

If Form 1099-S is not filed timely, there is a graduated system of penalties of $15 to $50 per return (depending on how late the form is filed) to encourage filing, even after a deadline, and to correct erroneous returns. The person filing the Form 1099-S must also provide a copy or an acceptable substitute statement to each transferor.

Generally, the person responsible for closing the transaction is the one required to prepare and file the Form 1099-S. Thus, the person required to file Form 1099-S is (in order):

1. The person listed as the settlement agent on a Uniform Settlement Statement, prescribed under the *Real Estate Settlement Procedures Act of 1974* (RESPA).
2. If a Uniform Settlement Statement is not used, or no settlement agent is listed, the person who prepares the closing statement, including a settlement statement or other written document that identifies the transferor, transferee, and real estate transferred, and that describes how the proceeds are to be disbursed.

If no closing statement is used, or if two or more statements are used, the person responsible for closing is, in the following order:

1. The transferee’s attorney if the attorney is present at the delivery of either the transferee’s note or a significant part of the cash proceeds to the transferor or if the attorney prepares or
reviews the preparation of the documents transferring legal or equitable ownership;
2. The transferor’s attorney if the attorney is present at the delivery of either the transferee’s note or a significant part of the cash proceeds to the transferor or if the attorney prepares or reviews the preparation of the documents transferring legal or equitable ownership; If there is more than one attorney described in (1) or (2), the one whose involvement is most significant is the person responsible for filing.
3. The disbursing title or escrow company that is most significant in disbursing gross proceeds.
4. The mortgage lender.
5. The transferor’s broker.
6. The transferee’s broker.
7. The transferee.

**Form 1099–MISC**

Form 1099–MISC, *Miscellaneous Income*, is used to report certain payments made in a trade or business. These payments include the following items.
- Payments of $600 or more for services performed for a business by people not treated as employees, such as subcontractors, attorneys, accountants, or directors.
- Rent payments of $600 or more, other than rents paid to real estate agents.

**Form 8300**

File Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*, when receiving more than $10,000 in cash in one transaction or two or more related business transactions. Cash includes U.S. and foreign coin and currency. It also includes certain monetary instruments such as cashier’s and traveler’s checks and money orders.
Recent Legislation

THE FIRST-TIME HOMEBUYER CREDIT

In order to encourage sales of residential homes, the Housing Assistance Tax Act of 2008 allowed eligible first-time homebuyers a tax credit of up to $7,500 for a purchase of a principal residence, as defined for purposes of the home sale capital gains exclusion, after April 8, 2008, and prior to January 1, 2009. For qualified homes purchased in 2008, the credit is the equivalent of an interest-free loan from the IRS of up to $7,500 of a home’s purchase price.

The American Recovery and Reinvestment Act of 2009 increased the credit to up to $8,000 for qualified homes purchased after December 31, 2008, and before December 1, 2009.

For qualified homes purchased in 2008, the maximum credit equals the lesser of:

- 10% of the purchase price of the principal residence, or
- $7,500 ($3,750 for married filing separate).

For qualified homes purchased in 2009, the maximum credit equals the lesser of:

- 10% of the purchase price of the principal residence, or
- $8,000 ($4,000 for married filing separate).

The credit for both years is refundable, which means it can be used to offset the taxpayer’s entire federal income tax liability (regular tax and AMT) with any remaining credit refunded.

Example: Adele, a first-time homebuyer, bought a principal residence in December, 2008, and claims the maximum $7,500 credit on her 2008 tax return. Before applying the credit, her tax liability for the year is $6,400. The credit reduces her tax liability to zero, and she will receive a $1,100 refund. She will have to pay back the $7,500 over 15 years. If she had purchased the home in 2009, she would have received a credit of up to $8,000 which she would not have to repay.
For qualified homes purchased in 2008, the taxpayer must repay the credit amount over a 15-year period, starting with the second year after the year the credit is claimed. The repayment requirement does not apply for qualified homes purchased after December 31, 2008, and before December 1, 2009.

The credit applies only to principal residence purchases occurring after April 8, 2008, and before December 1, 2009. The purchase date of a newly-constructed home is the date the taxpayer moves into the home.

When two or more taxpayers who are not married purchase a principal residence, the amount of the credit is allocated among the eligible individuals in any manner they desire. However, the total credit for all owners combined cannot be more than the lesser of 10% of the purchase price or $7,500 ($8,000 for homes bought in 2009).

Eligibility for the credit is limited to U.S. citizens or residents who are first-time homebuyers. A first-time homebuyer is someone who has not owned a principal residence in the U.S. during the three-year period that ends on the purchase date of the residence. In the case of a married couple, neither the taxpayer nor his or her spouse may have owned a principal residence in the preceding three-year period. To qualify, the residence cannot be purchased from a spouse, ancestor (parent, grandparent, etc.), lineal descendant (child, grandchild, etc.), or a corporation or partnership in which the taxpayer has (directly or indirectly) a more than 50% interest. The ownership interest cannot be acquired by gift or inheritance.

If a qualified home purchase is made in 2009 (before December 1, 2009), the taxpayer can claim the credit in 2009 or elect to treat the purchase as if made on December 31, 2008.

The credit is phased out ratably as the taxpayer’s modified adjusted gross income (MAGI) increases from $75,000 to $95,000 ($150,000 to $170,000 for joint filers). For this purpose, MAGI is defined as regular AGI plus income excluded under IRC §§911, 931, and 933 (all of which deal with income from foreign sources).

The credit is not available if the taxpayer disposes of the home, or stops using it as a principal residence before the end of the tax year in which it was purchased.
For qualified homes purchased in 2008, the first-time homebuyer credit must be recaptured ratably over 15 years (without interest) commencing with the second tax year after the tax year in which the credit is claimed. Each year’s repayment amount is in the form of an additional income tax equal to 6 2/3% of the total credit. This recapture provision does not apply for qualified homes purchased after December 31, 2008, and before December 1, 2009.

If a home purchased in 2008 is sold or the taxpayer discontinues use as a principal residence before the credit has been completely repaid, an accelerated recapture provision will apply. Any unpaid credit balance must be paid with the Form 1040 for the year in which the triggering event occurs. However, the amount due under the accelerated recapture rule cannot exceed the gain from sale of the home to an unrelated third party. For this purpose, the basis of the home is reduced by the unpaid credit balance.

Example: In July 2008 Harley Davison, a first-time homebuyer, purchases a home for $150,000. He is allowed a $7,500 credit on his 2008 tax return. Each year from 2010–2024, he must pay an additional income tax of $500 ($7,500 × 6 2/3%) to repay the credit. If he sells the home in 2012 for $170,000, on his 2012 return he must pay an additional tax of $6,500, which is the excess of the $7,500 credit allowed over the $1,000 previously repaid ($500 in 2010 and $500 in 2011).

For qualified homes purchased after December 31, 2008, and before December 1, 2009, the credit is recaptured only if the taxpayer disposes of the residence, or the residence ceases to be the taxpayer’s principal residence, during the 36-month period beginning on the date of purchase.

If a taxpayer dies, no amount is recaptured after a taxpayer’s death. In the case of a qualifying first-time homebuyer filing a joint return with a spouse who subsequently dies, the surviving spouse will be required to repay the remaining credit.

When a residence is forcibly or involuntarily converted (e.g., the home is destroyed in a hurricane) and the taxpayer acquires a new principal residence within the two-year period starting on the date of
disposition, the accelerated recapture rules will not apply. Instead, the standard recapture of 6 2/3% per year will continue as if the new residence were the converted residence.

A divorce-related transfer of the residence will not trigger the accelerated recapture rule. The transferee spouse will remain responsible for the credit recapture and any accelerated repayments that may be required in the future.

§121 AND NONQUALIFIED USE

Under prior law, a taxpayer could move into investment property, turn it into a primary residence, and as long as the taxpayer lived there for two out of the last five years, when it was sold, up to $250,000 ($500,000 if married filing jointly) of the profit was excluded from taxation by §121.

However, the Housing Assistance Act of 2008 excludes from the protection of §121 gain from the sale of a principal residence that is allocable to periods during which neither the taxpayer, the taxpayer’s spouse, nor the taxpayer’s former spouse used the property as a principal residence. The new law is effective for sales and exchanges after December 31, 2008.
Example: The Olsons buy a vacant lot on July 1, 1990, for $25,000. In 1995 they build a house on the lot for $100,000, and rent it out until March 1, 2010, when they move in and make it their principal residence. They live there until March 1, 2012, when they sell it for $450,000. While it was being rented they claimed depreciation of $65,000. They owned it a total of 260 months.

Only the 14 months it was being rented out after 2008 are considered nonqualified use. Under the Housing Act change, the $65,000 of gain attributable to the depreciation deductions is included in income (and taxed at 25%). Of the remaining $325,000 gain, $14/260 or $17,500 is recognized gain allocated to nonqualified use and not eligible for the exclusion (and taxed at maximum rate of 15%).

The remaining gain of $307,500 is excluded under §121, since it’s less than the maximum excludible gain of $500,000 (assuming they file a joint return).

In addition to excluding pre-2009 periods from the definition of nonqualified use, §121(b)(4)(C) lists several other periods which are not considered a period of nonqualified use:

- Any portion of the 5-year period ending on the date the property is sold which is after the last date that such property is used as the principal residence of the taxpayer or the taxpayer’s spouse;
- Any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer’s spouse is serving on qualified official extended duty (as a member of the armed forces, as a Foreign Service officer, or as an employee of the intelligence community); and
- Any other period of temporary absence (not to exceed an aggregate period of two years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the Secretary.
PROPERTY TAXES AND THE STANDARD DEDUCTION

The American Housing Rescue and Foreclosure Prevention Act of 2008 and the Tax Extenders and AMT Relief Act of 2008 provided an addition to the basic standard deduction for certain taxpayers in 2008 and 2009. Taxpayers filing single can add up to $500 of state and local real property taxes to their basic standard deduction amount. Married joint filers can add up to $1,000 to their basic standard deduction amount. However, the additional amount cannot exceed the amount of state and local property taxes actually paid.

In addition, the 2008 Tax Extenders and AMT Relief Act allows nonitemizers in 2008 and 2009 to add their disaster loss deduction to their basic standard deduction for both regular tax and AMT purposes. A taxpayer’s disaster loss deduction is the excess of their personal casualty loss attributable to a federally-declared disaster occurring before January 1, 2010, and occurring in a disaster area, over personal casualty gains.
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