Real Estate Taxation: Critical Considerations

RET4/21/V1

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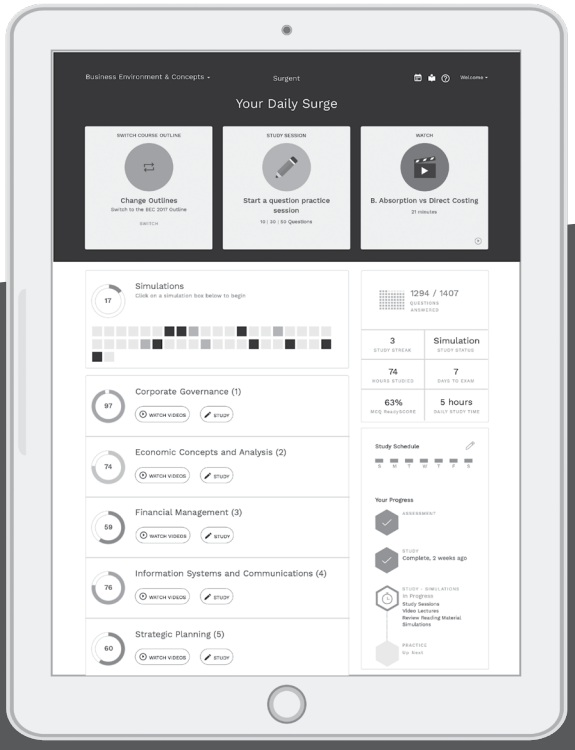

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Revised March 2021

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The Tax Cuts and Jobs Act and Its Impact on the Real Estate Industry

The Tax Cuts and Jobs Act and Its Impact on the Real Estate Industry

Learning objectives

Upon reviewing this material, the reader will be able to:

- Learn how the Act impacts commercial real estate; and
- Learn how the Act impacts homeowners.

In December of 2017, Congress passed and President Trump signed into law "The Tax Cuts and Jobs Act" resulting in the largest and most significant overhaul to the Internal Revenue Code (IRC) since the 1980s. In this chapter, we will discuss how this new tax Act impacts the real estate industry. We will summarize the major changes in this chapter while discussing them in more detail in later chapters. We will divide our discussion to first commercial real estate and then homeowners.

I. Commercial real estate

Anytime there are changes made to the IRC there are always "winners" and "losers." There appears to be very little question that one of the biggest "winners" under the Act will be investors in commercial real estate. The following are the major changes impacting this industry.

A. Pass-through entities

Possibly the most significant change brought about from the Act involves taxation of income from pass-through entities under IRC §199A. Pass-through entities include S corporations, partnerships, and limited liability companies. Also note that it also includes sole proprietorships and qualified real estate investment trusts. And since most real estate investments utilize these pass-through entities or sole proprietorships and REITs, the new Act will have a significant impact on the real estate industry.

Up through and including tax years 2017, 100 percent of pass-thru income was taxed at the taxpayer's ordinary income tax rate. However, beginning in 2018, most taxpayers will be able to deduct 20 percent of their Qualified Business Income ("QBI"). What makes this provision so lucrative is that it will not be necessary for the taxpayer to itemize their deductions in order to utilize this deduction.

There are however some restrictions on the use of this deduction:

- The deduction cannot be greater than 20 percent of taxable income, excluding capital gains and the pass-through deduction itself.
- If the taxpayer's taxable income is less than $157,500 when filing single and $315,000 for married filing jointly, the first bullet point is the only issue that must be considered when taking the deduction. However, if the taxpayer's taxable income exceeds those amounts, then there are other limitations that may apply based on the taxpayer's business. If the taxpayer operates in what is defined as a "specified trade or business," his or her deduction will be phased out if their taxable income is between $157,500 and $207,500 when filing single, and between $315,000 $415,000 when filing married filing jointly. If the taxpayers' taxable income exceeds $207,500 when filing single and $415,000 when married filing jointly, the deduction is completely lost. Specified service professions include:

- Health,
- Law,
- Accounting,
- Actuarial science,
- Performing arts,
- Consulting,
- Athletics,
- Financial or brokerage services, or
- Any business where the principle asset is "the reputation or skill" of one or more employees.

Accordingly, based on the above definition, the deduction limitation would apply to a real estate agent, but would not apply to real estate investors since their principal asset is their property, not their skill.

- If the taxpayer is not a service professional (as previously defined), and his or her taxable income exceeds $157,000 filing single and $315,000 when married filing jointly, then the pass-through deduction may be limited by the following computation. The pass-through deduction cannot exceed the greater of either:
  - 50 percent of W-2 wages, or
  - 25 percent of W-2 wages plus 2.5 percent of the "unadjusted basis" of depreciable assets, which is generally defined as what the taxpayer paid for the assets, excluding land.
- Finally, it should be noted that in order for the taxpayer to utilize this deduction, he or she must have net income from a property. This may result in many taxpayers losing out on this particular deduction due to the depreciation deduction causing a property to reflect current year losses.

In January of 2019, Notice 2019-07 was issued by the IRS. The most important provision of this Notice provides a safe-harbor requirement for rental real property to qualify as a trade or business under IRC §199A (thereby making it eligible for the QBI deduction). In order to qualify for the safe harbor:

- The real property must be owned directly or through a disregarded entity.

Note:

A disregarded entity refers to a business entity with one owner that is not recognized for tax purposes as an entity separate from its owner. An example of this would be a single-member LLC. For federal and state tax purposes, the sole-member of a single-member LLC disregards the separate status of the LLC otherwise in force under state law. Accordingly, this entity does not file a separate tax return. Rather its income and loss are reported on the tax return filed by the single member.

- Separate books are maintained for each real estate entity.
- On an annual basis, at least 250 hours of rental services are provided by the owner, agent, or contractor.
- Contemporaneous records (including time reports, logs, or similar documents) are maintained that demonstrate:
  - The hours worked,
  - A description of the service,

- The date the services are performed, and
- Who performed the service.

Notice 2019-07 also states that if a rental real estate does not meet the safe-harbor provisions noted above, they still may be eligible for the §199A deduction if they meet the definition of a trade or business under IRC §162 other than the trade or business of performing services as an employee. The two most significant exclusions from this eligibility are:

- Residences used by the taxpayer during the year, and
- Triple-net leases.

Note:

A triple net lease is a lease agreement where the lessee agrees to pay all real estate taxes, building insurance, and maintenance on the property.

The safe-harbor rules are effective for tax years ending after December 31, 2017.

If the rental activity does not meet the safe-harbor requirements previously detailed, the taxpayer will then have to determine if the activity is a trade-or-business (making it eligible for the IRC §199A deduction) or an investment activity (not eligible for the deduction). The IRC does not provide a specific definition of a trade-or-business; however, there have been a number of Tax Court rulings where they have ruled that a trade or business is an activity that has:

- A profit motive, and
- There is continuous and regular involvement by the taxpayer.

Each property owned by the taxpayer will have to be analyzed to determine compliance. Of particular concern will be vacation homes due to the profit motive noted above.

1. Capitalization vs. expensing

Under Notice 2015-82, expenditures for tangible property that would otherwise require capitalization can be currently expensed if:

- The item costs $2,500 or less, and
- The taxpayer makes the appropriate election

Note:

If the taxpayer has an applicable financial statement the amount is increased to $5,000.

The taxpayer makes the election annually by including a statement with the tax return citing: “Section 1.263(a)-1(f) de minimus safe harbor election.”

Lessors with average annual gross receipts for the three preceding of $10 million or less and for units of property with an adjusted basis of $1 million or less can elect to write-off repairs, maintenance, and improvements if the total of these expenditures does not exceed the lesser of 2 percent of the unadjusted basis of the property or $10,000 during a given year. The taxpayer makes the annual election by including a statement citing: “Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers,” along with the taxpayer’s name, address, EIN, and a description of each property for which the election is being made.

B. Section 179

One of the most significant impacts the Act has on commercial real estate is expansion of the use of IRC §179 and the ability to currently deduct more items than under previous law. In particular:

- The amount of qualified property eligible for a current deduction increases from $510,000 (the amount allowable up through 2017) to $1 million. The phase-out limitations ate increased from $2 million to $2.5 million.
- The Act expands the definition of qualified real property eligible for §179 current expensing to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service:
  - Roofs,
  - Heating,
  - Ventilation,
  - Air conditioning property,
  - Fire protection,
  - Alarm systems, and
  - Security systems.
- In addition, all leasehold improvement, provided they are made to the interior portion of nonresidential rental property after the building has been placed in service, will be eligible for immediate expensing under §179.

C. Depreciation

The following changes were made in the Act regarding depreciation:

- The Act retains the recovery periods for residential real property (27.5 years) and nonresidential real property (39 years), and qualified improvements (15 years) that were used though 2017.
- The Act replaces separate definitions for qualified restaurant, leasehold, and retail improvements with one definition, “Qualified Improvement Property,” and
- Since many real estate entities own vehicles, we will also mention that the amount of first-year depreciation that may be claimed on passenger automobiles used in business was increased to $10,000 under the Act for the year in which the vehicle was placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period.

Note:

There is one potential significant change involving depreciation. This may apply if a business’s average gross receipts are in excess of $25 million. If that should occur, the entity may have its deduction for “net interest expense” limited and may require the entity to depreciate its real property using the “Alternative Depreciation System” (ADS). This may have a significant impact on the real estate industry which could prevent the use of “100 percent expensing” of assets placed in service after September 27, 2017. This will be discussed in more detail in Chapter 6.

D. Provisions impacting the real estate industry that were not changed under the Act

- It should be noted that under the House introduced bill, rental income would have been subject to self-employment (SE) taxes. However, the final bill did not include this provision.

- Both the House and Senate introduced bills that were considering the elimination of the rules regarding like-kind exchange which allowed the deferral of recognizing gain on the sale of real property under IRC §1031. However, the final bill did not include this provision thereby allowing real estate investors to continue to defer gain recognition.

Note:

The final bill did in fact repeal the utilization of IRC §1031 for personal property (i.e., rental vehicle fleets, heavy equipment & machinery, art work, etc.). The issue of like-kind exchanges will be discussed in more detail in Chapter 11.

- The Act retains the deductibility of qualified private activity bonds used in constructing affordable housing, local transportation, and infrastructure projects and for state and local mortgage bond programs.
- The Act retains the law that was effective through 2017 regarding low income housing tax credits. However, since the Act has instituted a lower corporate rate, there will be a negative impact in the value of the credits in the future, and will probably result in less low-income housing being developed.
- The Act for the most part retains the rehabilitation credit (historic tax credit). However, it repeals the 10 percent 2017 law for pre-1936 buildings, but retains the current 20 percent credit for certified historic structures.

Note:

This credit was modified so that it is allowable over a five-year period based on a ratable 20 percent each year.

- Even though the Act limits deductions for real estate taxes and mortgage interest on a taxpayer's residence (as will be discussed shortly), there is generally no restrictions on the deductibility of these items for investment in residential and nonresidential real property (with the exception of the issue of "net interest expense" noted above).

II. Homeowners

Whereas investors in commercial real estate were considered one of the "winners" under the new Act, homeowners appear to be one of the "losers." Many of the changes made under the Act may make home ownership (at least in the short term) less desirable.

A. Mortgage interest deduction

The Act made some significant changes regarding the amount of mortgage interest that can be deducted by the taxpayer:

- Through 2017, interest associated with mortgage loans up to $1 million was deductible. The Act reduces the limit to $750,000 for new loans taken out after December 14, 2017.

Note:

Loans that were in place before December 15, 2017, up to $1 million are "grandfathered" and are not subject to the $750,000 Act cap.

- A taxpayer may refinance mortgage debts existing as of December 14, 2017, up to $1 million and still deduct the interest as long as the new loan does not exceed the amount of the mortgage that is being refinanced.
- The Act repeals the deduction for interest paid on home equity debt through December 31, 2025. However, the interest paid on home equity loans where the proceeds are used to substantially improve the residence are still deductible.
- Interest remains deductible on a second home subject to the $750,000 limitation.

B. Real estate taxes

Up through 2017, an itemized deduction was allowed for all state and local taxes paid (which included real estate taxes). The Act allows an itemized deduction up to $10,000 for the total of all state and local taxes paid (including real estate taxes). The $10,000 limit applies for both single and married filers.

C. Standard deduction

The Act provides a significant increase in the standard deduction starting in 2018 where the amount will be $12,000 for single filers and $24,000 married filing jointly. These amounts will be adjusted in all future years for inflation.

By doubling the standard deduction from what was allowed in 2017 has greatly reduced the value of mortgage interest and property tax deductions as tax advantages for homeownership. Congressional estimates indicate that only 5 percent to 8 percent of filers will now be eligible to claim these deductions by itemizing resulting in virtually no tax differential between renting and owning their primary residences for more than 90 percent of taxpayers. Moody's Analytics has estimated that as many as 38 million taxpayers who would otherwise itemize will now choose to take the higher standard deduction.

D. Casualty losses

Until 2017, a taxpayer could deduct casualty losses (which included losses to their home) if the net loss exceeded 10 percent of the taxpayer's adjusted gross income (AGI). Under the Act, beginning in 2018, a deduction is allowed only it the loss is attributable to a presidentially declared disaster. It should be noted that this provision represented a compromise from the House proposed bill which would have completely (with limited exceptions) eliminated this deduction.

E. A provision that will not change under the Act

In regards to being able to exclude the gain on sale of a principal residence under IRC §121, the Act retains this provision. It should be noted that the Senate-passed bill would have changed the amount of time a homeowner would have had to live in their home to qualify for the capital gains exclusions from two of the past five years to five of the past eight years. In addition, the House bill would have made this same change as well as phased out the exclusion for taxpayers with incomes above $260,000 single and $500,000 married filing jointly.

III. In conclusion

The Act (at least in the short run) should provide significant incentives for taxpayers to invest in real property. This is the result of advantages involving lowered tax rates; the increased use of §179 some acceleration of depreciation, and the continued ability to defer gain recognition by way of like-kind exchanges under IRC §1031.

On the other hand, some homeowners may face a decrease in their property values. There is the potential for home values in high tax areas (such as California, New York, New Jersey, Massachusetts, and Maryland, (among other states) will be negatively affected the most by no longer having the full federal deduction available. A National Association of Realtors study determined there could be a reduction in home values up to 10 percent in these high state and local tax areas.

IV. The impact of COVID-19 on commercial real estate

COVID-19 has had a negative effect on the entire U.S. economy in general, but it has particularly impacted the real estate industry. And, of all the segments of the real estate industry, none have been hit harder than commercial real estate. This segment is facing both short-term and long-term problems.

Short-term – The pandemic has caused a negative impact on both the earnings and the cash flows of lessees. This, in turn, has resulted in many tenants not paying their rent or being evicted/skipping out before the end of the lease term, resulting in serious cash flow issues for the lessors. It is expected that when the pandemic lessens, this situation will approve.

Long-term – The more serious problem for commercial real estate involves the long-term shift in companies' approach to leasing space. Pushed to be innovative by the pandemic, many firms have found ways to allow employees to work at home. This may become a permanent situation for many entities, causing a permanent decrease in the demand to lease commercial real estate. In New York City, for example, it has been reported that during the period between April 2020 and January 2021 the vacancy rate increased from 11 percent to 15 percent.

Determining the Basis of Acquired Real Property

Determining the Basis of Acquired Real Property

Learning objectives

After reviewing the material, the reader will be able to:

- Understand the importance of determining a property's tax basis;
- Know how to compute the tax basis in real property;
- Know how to allocate the purchase price among various components; and
- Understand the HUD-1 Settlement Statement and how to use it to determine basis.

I. Introduction

The tax basis of the real estate asset is one of the most important components when discussing real property and income taxes. It is used in determining:

- The amount of depreciation that may be deducted while the property is in its operational phase; and
- The gain or loss upon the disposal of the property.

In general terms, the basis in real property (also known as "tax basis" or "cost basis") is the cost of investment in the real property when it is acquired. As we will discuss in this chapter, there are numerous items that add to that original cost basis; others that reduce the original cost basis; and finally, other costs incurred that are currently deducted. When real property is purchased, a distinction will need to be made as to whether it was acquired for investment or for sale. This is a critical determination since when the property is sold, it will impact whether the gain or loss would be characterized as capital or ordinary. Therefore, it is important for taxpayers to have solid documentation when the property is acquired concerning their stated intentions.

Note:

We will be discussing the issue of dealer vs. investor in detail in Chapter 5, when we cover this same issue regarding recognizing gain on sale of real property.

II. Determining tax basis

A property's **original** basis may be the cost or a carryover basis if the property was obtained by gift or in an exchange. Cost would include actual cash payments to purchase the property but could also include the following:

- Assumption of debt such as existing mortgages; and
- The value of other property or services exchanged for the property.

If property has a carryover basis, the transferee's basis is determined by reference to the basis in the hands of the transferor.

A property's **adjusted** basis is the original basis increased or decreased for various modifications, which will now be detailed.

A. Four-step process

Accordingly, to determine a property's tax basis, the following four-step process should be utilized.

1. Step One

Determine the original cost basis (as we just discussed).

2. Step Two

Add the following *acquisition* costs (usually incurred at settlement when title transfers from the seller to the buyer):

a. Title charges;
b. Title insurance (purchased for the benefit of the acquirer of the real property rather than for the lending institution);
c. Option payments;
d. Appraisal costs (purchased for the benefit of the acquirer of the real property rather than for the lending institute);
e. Survey costs;
f. Attorney and other professional fees (if directly related to the acquisition of the property);
g. Sales taxes;
h. Freight;
i. Installation and testing;
j. Excise taxes;
k. Transfer taxes, recording fees, revenue stamps, and other government costs;
l. Real estate taxes if assumed by the seller;
m. Abstract fees;
n. Charges to install utility services;
o. Costs of obtaining existing leases;
p. Costs of acquiring zoning changes;
q. Surveys; and
r. Any amounts owed by the seller the buyer agrees to pay.

It should be noted that the following costs generally incurred when purchasing real property would **not** be added to the tax basis:

- Any amounts paid into escrow at settlement for future payments of insurance and real estate taxes; and
- Any costs incurred related to obtaining financing.

3. Step Three

The original tax basis would be increased for the following items incurred after purchase of the property:

a. Capital improvements to the property;
b. The cost of extending utility services to the property, and local improvements such as water connections, sidewalks, roads, etc.;
c. Impact fees (defined as a fee imposed by a local government on a new or proposed development project to pay for all or a portion of the costs of providing public services to the new development);
d. Attorney and other professional fees, such as the cost of defending and perfecting title to the property;

e. Zoning costs; and
f. The capitalized value of a redeemable ground rent.

4. Step Four

The original tax basis would be reduced for the following items:

a. Depreciation, amortization, and depletion allowed or allowable (once the property is placed in service);
b. Any tax credits taken;
c. Casualty or theft losses and insurance reimbursements;
d. Certain cancelled debt that is not included in income;
e. Rebates from a manufacturer or seller; and
f. Easements treated as a sale of an interest in real property.

B. Uses and methods

Steps One through Four should all be netted together to determine the adjusted tax basis, which is utilized for both:

- Determining the amount of depreciation expense to be taken (to be discussed in Chapter 4); and
- Determining the gain or loss to be recognized upon the disposal of the property (to be discussed in Chapter 5).

1. Other methods for acquiring real property

Keep in mind that our discussion until now has worked under the assumption that the real property was acquired by purchase. However, there are a couple of other methods for acquiring real property, which we will now briefly discuss:

a. Real property acquired by gift – if the taxpayer acquires real property by gift, his or her basis is the same as the donor's basis at the time of the gift.
b. Personal-use property converted to real property – if the taxpayer converts personal-use property into business property, the basis will be the lower of:
   (i) The fair market value at the time of the conversion; or
   (ii) The cost plus any additions or improvements, minus any deducted casualty losses, up to the time of the conversion.

III. Allocating the tax basis

In most instances, once a piece of real property is purchased, it is usually necessary to allocate the tax basis between various components. Typically, this involves:

- Nondepreciable assets – land; and
- Depreciable assets – building, related improvements, and personal property.

For tax reporting purposes, it is to the taxpayer's obvious advantage to generally allocate as much of the tax basis to the depreciable assets and as little to the nondepreciable assets in order to maximize current deductions.

The issues of allocation may also apply when:

- A portion of the acquired real property is used in a trade or business while a portion is not (i.e., personal use); or
- When more than one property has been acquired in one transaction.

These allocations should be made based on the fair market value of the various assets at the time of their purchase.

Generally, upon examination, the IRS will accept a taxpayer's allocation as long as it is considered "reasonable." Some CPAs may advise their clients to allocate the tax basis simply using either "90/10" or "80/20" between the building and the land. However, this is not always an appropriate rule of thumb. For instance, in large urban cities, the value of land in proportion to the total property may be significantly greater as compared to rural areas where land is generally less expensive.

Accordingly, if the IRS takes the position that the allocation is not reasonable (i.e., too much is allocated to depreciable assets and not enough allocated to the land), the IRS may simply ignore the taxpayer's representation and come up with its own allocation (usually resulting in more of the basis allocated to the land and less to the depreciable assets).

Accordingly, when allocating the tax basis, the taxpayer may want to look to three outside sources for proper substantiation:

1. An independent appraisal (however, this option could be costly to the taxpayer);
2. Values set forth in the settlement statement (or sales contract); or
3. Local tax assessments.

In addition to allocation considerations between depreciable and nondepreciable assets, there is often a similar consideration between depreciable assets with long depreciation lives and those with shorter depreciable lives. The best example of this concept would be a situation in which personal property (i.e., machinery and equipment) was included in the purchase price, the difference being a much shorter depreciable life (seven years for the personal property vs. 27.5 or 39 years for the real property) or land (nondepreciable) and allowable land improvements (which can be depreciated over 15 years).

Similar to our discussion in allocating the purchase price between depreciable and nondepreciable assets, keep in mind that in the event of an IRS audit, it may not be acceptable if the taxpayer randomly assigns an amount of the tax basis to the personal property based on nothing more than an educated guess. Accordingly, at the time of purchase, the taxpayer may want to consider outside substantiation from:

- An engineering firm;
- Information provided by the architect or builder; or
- Amounts detailed in the settlement statement (or sales contract) as long as they were determined in an arm's-length negotiation between the buyer and seller.

The bottom line is that the taxpayer should have some sort of documentation of how the various allocations were made.

IV. The Settlement Statement

One of the most important documents used in the real estate industry is the Settlement Statement (a.k.a. the Settlement Sheet or the Closing Statement). This document summarizes the exchange of funds between the buyer and the seller and also details various costs involved in transferring real estate from one party to another.

Although there are many documents used in these transactions, for purposes of our discussion, we will be focusing on investment in residential real estate which involves one particular document: HUD-1, the Settlement Statement.

It has been the experience of the author that far too many CPAs do not understand the details or the flow of this document, and therefore are not recording the purchase and sale of real estate appropriately. This results in errors on tax returns and related financial statements alike.

For reference, we will now display the three pages of the HUD-1 Settlement Statement:

OMB Approval No. 2502-0265

A. Settlement Statement (HUD-1)

B. Type of Loan

1. ☐ FHA 2. ☐ RHS 3. ☒ Conv. Unins. 4. ☐ VA 5. ☐ Conv. Ins.	6. File Number:	7. Loan Number:	8. Mortgage Insurance Case Number:

C. Note: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.

D. Name & Address of Borrower:	E. Name & Address of Seller:	F. Name & Address of Lender:
G. Property Location:	H. Settlement Agent: Place of Settlement:	I. Settlement Date:

J. Summary of Borrower's Transaction

100. Gross Amount Due from Borrower	
101. Contract sales price	
102. Personal property	
103. Settlement charges to borrower (line 1400)	
104.	
105.	
Adjustment for items paid by seller in advance	
106. City/town taxes to	
107. County taxes to	
108. Assessments to	
109.	
110.	
111.	
112.	
120. Gross Amount Due from Borrower	
200. Amount Paid by or in Behalf of Borrower	
201. Deposit or earnest money	
202. Principal amount of new loan(s)	
203. Existing loan(s) taken subject to	
204.	
205.	
206.	
207.	
208.	
209.	
Adjustments for items unpaid by seller	
210. City/town taxes to	
211. County taxes to	
212. Assessments to	
213.	
214.	
215.	
216.	
217.	
218.	
219.	
220. Total Paid by/for Borrower	
300. Cash at Settlement from/to Borrower	
301. Gross amount due from borrower (line 120)	
302. Less amounts paid by/for borrower (line 220)	( )
303. Cash ☒ **From** ☐ **To Borrower**	

K. Summary of Seller's Transaction

400. Gross Amount Due to Seller	
401. Contract sales price	
402. Personal property	
403.	
404.	
405.	
Adjustment for items paid by seller in advance	
406. City/town taxes to	
407. County taxes to	
408. Assessments to	
409.	
410.	
411.	
412.	
420. Gross Amount Due to Seller	
500. Reductions In Amount Due to seller	
501. Excess deposit (see instructions)	
502. Settlement charges to seller (line 1400)	
503. Existing loan(s) taken subject to	
504. Payoff of first mortgage loan	
505. Payoff of second mortgage loan	
506.	
507.	
508.	
509.	
Adjustments for items unpaid by seller	
510. City/town taxes to	
511. County taxes to	
512. Assessments to	
513.	
514.	
515.	
516.	
517.	
518.	
519.	
520. Total Reduction Amount Due Seller	
600. Cash at Settlement to/from Seller	
601. Gross amount due to seller (line 420)	
602. Less reductions in amounts due seller (line 520)	( )
603. Cash ☒ **To** ☐ **From Seller**	

The Public Reporting Burden for this collection of information is estimated at 35 minutes per response for collecting, reviewing, and reporting the data. This agency may not collect this information, and you are not required to complete this form, unless it displays a currently valid OMB control number. No confidentiality is assured; this disclosure is mandatory. This is designed to provide the parties to a RESPA covered transaction with information during the settlement process.

L. Settlement Charges

700. Total Real Estate Broker Fees	Paid From Borrower's Funds at Settlement	Paid From Seller's Funds at Settlement
Division of commission (line 700) as follows :		
701. $ to		
702. $ to		
703. Commission paid at settlement		
704.		

800. Items Payable in Connection with Loan				
801. Our origination charge	$	(from GFE #1)		
802. Your credit or charge (points) for the specific interest rate chosen	$	(from GFE #2)		
803. Your adjusted origination charges		(from GFE #A)		
804. Appraisal fee to		(from GFE #3)		
805. Credit report to		(from GFE #3)		
806. Tax service to		(from GFE #3)		
807. Flood certification to		(from GFE #3)		
808.				
809.				
810.				
811.				

900. Items Required by Lender to be Paid in Advance				
901. Daily interest charges from to @ $ /day		(from GFE #10)		
902. Mortgage insurance premium for months to		(from GFE #3)		
903. Homeowner's insurance for years to		(from GFE #11)		
904.				

1000. Reserves Deposited with Lender				
1001. Initial deposit for your escrow account		(from GFE #9)		
1002. Homeowner's insurance	months @ $	per month $		
1003. Mortgage insurance	months @ $	per month $		
1004. Property Taxes	months @ $	per month $		
1005.	months @ $	per month $		
1006.	months @ $	per month $		
1007. Aggregate Adjustment		-$		

1100. Title Charges				
1101. Title services and lender's title insurance		(from GFE #4)		
1102. Settlement or closing fee	$			
1103. Owner's title insurance		(from GFE #5)		
1104. Lender's title insurance	$			
1105. Lender's title policy limit $				
1106. Owner's title policy limit $				
1107. Agent's portion of the total title insurance premium to	$			
1108. Underwriter's portion of the total title insurance premium to	$			
1109.				
1110.				
1111.				

1200. Government Recording and Transfer Charges				
1201. Government recording charges		(from GFE #7)		
1202. Deed $	Mortgage $	Release $		
1203. Transfer taxes		(from GFE #8)		
1204. City/County tax/stamps	Deed $	Mortgage $		
1205. State tax/stamps	Deed $	Mortgage $		
1206.				

1300. Additional Settlement Charges				
1301. Required services that you can shop for		(from GFE #6)		
1302.	$			
1303.	$			
1304.				
1305.				

1400. Total Settlement Charges (enter on lines 103, Section J and 502, Section K)		

Comparison of Good Faith Estimate (GFE) and HUD-1 Charrges		Good Faith Estimate	HUD-1
Charges That Cannot Increase	**HUD-1 Line Number**		
Our origination charge	# 801		
Your credit or charge (points) for the specific interest rate chosen	# 802		
Your adjusted origination charges	# 803		
Transfer taxes	# 1203		

Charges That In Total Cannot Increase More Than 10%		Good Faith Estimate	HUD-1
Government recording charges	# 1201		
	#		
	#		
	#		
	#		
	#		
	#		
	#		
Total			
Increase between GFE and HUD-1 Charges		$ or %	

Charges That Can Change		Good Faith Estimate	HUD-1
Initial deposit for your escrow account	# 1001		
Daily interest charges $ /day	# 901		
Homeowner's insurance	# 903		
	#		
	#		
	#		

Loan Terms

Your initial loan amount is	$
Your loan term is	years
Your initial interest rate is	%
Your initial monthly amount owed for principal, interest, and any mortgage insurance is	$ includes ☐ Principal ☐ Interest ☐ Mortgage Insurance
Can your interest rate rise?	☐ No ☐ Yes, it can rise to a maximum of %. The first change will be on and can change again every after . Every change date, your interest rate can increase or decrease by %. Over the life of the loan, your interest rate is guaranteed to never be **lower** than % or **higher** than %.
Even if you make payments on time, can your loan balance rise?	☐ No ☐ Yes, it can rise to a maximum of $
Even if you make payments on time, can your monthly amount owed for principal, interest, and mortgage insurance rise?	☐ No ☐ Yes, the first increase can be on and the monthly amount owed can rise to $. The maximum it can ever rise to is $.
Does your loan have a prepayment penalty?	☐ No ☐ Yes, your maximum prepayment penalty is $
Does your loan have a balloon payment?	☐ No ☐ Yes, you have a balloon payment of $ due in years on .
Total monthly amount owed including escrow account payments	☐ You do not have a monthly escrow payment for items, such as property taxes and homeowner's insurance. You must pay these items directly yourself. ☐ You have an additional monthly escrow payment of $ that results in a total initial monthly amount owed of $. This includes principal, interest, any mortgage insurance and any items checked below: ☐ Property taxes ☐ Homeowner's insurance ☐ Flood insurance ☐ ☐ ☐

Note: If you have any questions about the Settlement Charges and Loan Terms listed on this form, please contact your lender.

A. The three pages of the Settlement Statement

There are three pages (sections) to the HUD-1 Settlement Statement. The Statement covers the basic information of the involved parties, consisting of:

- The buyer and seller;
- The lender;
- Property details; and
- The settlement agent.

In addition, the Settlement Statement details numerous transactions between a variety of different parties.

1. Page One

Page One lists many numbers in a dual column format, listing buyer details in the left column and the seller details in the right column. Some of those numbers include:

a. The gross amount due from the buyer to the seller. This includes:
   (i) The contract sales price;
   (ii) Value of personal property (if any); and
   (iii) The total amount of the settlement charges and fees from the final total on Page Two (line 1400).
b. Adjustments for items paid in advance by the seller (i.e., real estate taxes).
c. Amounts paid for by and on behalf of the borrower and reductions in the amount due to the seller.
d. Adjustments for items unpaid by the seller.
e. Cash at settlement due from or to the buyer and seller.

2. Page Two

Page Two details the associated fees and charges associated with the settlement. And similar to Page One, the left column represents fees and charges to the buyer while the right column represents those associated with the seller. Some of these fees and charges include:

a. Broker fees (commissions);
b. Loan fees;
c. Items required to be paid in advance by the lender;
d. Deposits required by the lender;
e. Title fees and other related charges;
f. Transfer taxes and other government fees; and
g. Additional settlement charge.

3. Page Three

Page Three deals with the Good Faith Estimate (GFE) and the details of the various loan terms. The GFE amounts will have been supplied to the settlement agent by the bank upon application of the loan; the HUD figures will be listed side by side by the GFE figures in order to easily spot any discrepancies or wide variations in amounts. The loan terms include the originating loan amount, interest rate, interest rate details, and other payment details.

Note:

For purposes of our discussion concerning the accounting profession, preparation of the applicable tax returns, and the HUD-1 Settlement Statement, we will be limiting our discussion to Pages One and Two.

B. Various definitions

We will now define various costs and other items that appear on the HUD-1 Settlement Statement.

1. Bank charges

Bank charges: Fees paid to the bank for processing the loan. These fees are typically an origination fee or a processing fee. The fee may be either fixed or based on a percentage of the loan amount (referred to as points). Examples of these bank charges, which are all detailed on the HUD-1 Settlement Statement, include:

a. Appraisal fees;
b. Credit report fees;
c. Tax service fees; and
d. Flood certification fees.

2. Title insurance

Title insurance is a form of indemnity (guarantee) insurance predominantly found in the United States, which insures against financial loss from defects in title to real property and from the invalidity or unenforceability of mortgage loans. Title insurance is principally a product developed and sold in the United States as a result of alleged comparative deficiency of land records. It is meant to protect an owner's and/or a lender's financial interest in real property against loss due to title defects, liens, or other matters. It will defend against a lawsuit attacking the title or reimburse the insured for the actual monetary loss incurred, up to the dollar amount of insurance provided by the policy.

Typically, the categories of real property interest insured are fee simple ownership (the highest form of ownership available) or a mortgage. However, title insurance can be purchased to insure any interest in real property, including an easement, lease, or life estate.

Note:

"Fee simple" is defined as the greatest possible estate in land wherein the owner has the right to use it and exclusively possess it, commit waste upon it, dispose it by deed or will, and take its fruits. It represents an absolute ownership of land, and therefore, the owner may do whatever he or she chooses with the land. If an owner of a fee simple dies intestate (no legal will), the land will descend to the heirs.

There are two types of title insurance policies: owner and lender. Just as lenders require fire and other types of insurance coverage to protect their investment, nearly all institutional lenders require title insurance (referred to as a loan policy) to protect their interest in the collateral of loans secured by real estate. Buyers purchasing property with either cash or with a mortgage lender will almost always want title insurance (referred to as an owner policy) as well. It should be noted that a loan policy provides absolutely no protection or coverage to the buyer/owner and accordingly the decision to purchase an owner policy is always independent of the lender's decision to require a loan policy.

3. Real estate transfer taxes

Real estate transfer taxes are taxes imposed by states, counties, and municipalities on the transfer of the title of real property within the jurisdiction.

4. POC

POC stands for "Paid Outside of Closing" and refers to any fee that is not being disbursed at the closing. The two most common POC charges are the appraisal fee (often it is paid by the borrower prior to closing) and the yield spread premium (the rebate that the lender pays the mortgage broker).

When POC is listed on a Settlement Statement, the letters are often followed by the words Borrower, Seller, Broker, or Lender. This refers to who paid the fee. For example, if the borrower paid for the appraisal prior to closing, the fee would be marked "POC Borrower" on the Settlement Statement.

If a fee is marked POC, it is not included in the bottom line on the Settlement Statement because someone else has already paid it (in the case of a paid appraisal) or the borrower does not owe it (in the case of a yield spread premium; to be discussed next).

5. Yield Spread Premium (YSP)

YSP refers to the money or rebate paid to a mortgage broker for giving a borrower a higher interest rate on a loan in exchange for lower up-front costs generally paid in origination fees, broker fees, or discount points. The YSP may be used to eliminate or offset other loan costs.

V. Comprehensive example

We will now present a comprehensive example summarizing the major points discussed in this chapter, including the determination of the tax basis of real property purchased and analysis of the related Settlement Statement.

Note:

> In Chapter 5, we will be utilizing the same Settlement Statement to determine the gain or loss recognized by the seller.

A. Facts and Settlement Statement

On December 31, 2020, Jay Robin, LLC purchased residential property located in Philadelphia, PA. Below is the Settlement Statement associated with this purchase. It should be noted that there were no POC amounts (see the definition above).

OMB Approval No. 2502-0265

A. Settlement Statement (HUD-1)

B. Type of Loan

1. [X] FHA 2. [ ] RHS 3. [ ] Conv. Unins. 4. [ ] VA 5. [ ] Conv. Ins.	6. File Number: 1613	7. Loan Number: 7956	8. Mortgage Insurance Case Number: N/A

C. Note: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.

D. Name & Address of Borrower:	E. Name & Address of Seller:	F. Name & Address of Lender:
JAY ROBIN, LLC 6719 41 STREET MIAMI BEACH, FLORIDA	2200 GRIFFITH STREET ASSOCIATES 2200 GRIFFITH STREET PHILADELPHIA, PA 19111	GREAT BANK 11111 BUSTLETON AVENUE PHILADELPHIA, PA 19152
G. Property Location: 2200 GRIFFITH STREET PHILADELPHIA, PA 19111	H. Settlement Agent: HERBERT ROSENBERG Place of Settlement: 8500 CASTOR AVENUE PHILADELPHIA PA	I. Settlement Date: 12/31/20

J. Summary of Borrower's Transaction

100. Gross Amount Due from Borrower	
101. Contract sales price	$280,000.00
102. Personal property	$20,000.00
103. Settlement charges to borrower (line 1400)	$13,900.00
104.	
105.	
Adjustment for items paid by seller in advance	
106. City/town taxes 7/1/20 to 12/31/20	$1,000.00
107. County taxes to	
108. Assessments to	
109.	
110.	
111.	
112.	
120. Gross Amount Due from Borrower	$314,900.00
200. Amount Paid by or in Behalf of Borrower	
201. Deposit or earnest money	$10,000.00
202. Principal amount of new loan(s)	$200,000.00
203. Existing loan(s) taken subject to	
204.	
205.	
206.	
207.	
208.	
209.	
Adjustments for items unpaid by seller	
210. City/town taxes to	
211. County taxes to	
212. Assessments to	
213.	
214.	
215.	
216.	
217.	
218.	
219.	
220. Total Paid by/for Borrower	$210,000.00
300. Cash at Settlement from/to Borrower	
301. Gross amount due from borrower (line 120)	$314,900.00
302. Less amounts paid by/for borrower (line 220)	($210,000.00)
303. Cash [X] **From** [ ] **To Borrower**	$104,900.00

K. Summary of Seller's Transaction

400. Gross Amount Due to Seller	
401. Contract sales price	$280,000.00
402. Personal property	$20,000.00
403.	
404.	
405.	
Adjustment for items paid by seller in advance	
406. City/town taxes 7/1/20 to 12/31/20	$1,000.00
407. County taxes to	
408. Assessments to	
409.	
410.	
411.	
412.	
420. Gross Amount Due to Seller	$301,000.00
500. Reductions In Amount Due to seller	
501. Excess deposit (see instructions)	
502. Settlement charges to seller (line 1400)	$21,000.00
503. Existing loan(s) taken subject to	
504. Payoff of first mortgage loan	$125,000.00
505. Payoff of second mortgage loan	$45,000.00
506.	
507.	
508.	
509.	
Adjustments for items unpaid by seller	
510. City/town taxes to	
511. County taxes to	
512. Assessments to	
513.	
514.	
515.	
516.	
517.	
518.	
519.	
520. Total Reduction Amount Due Seller	$191,000.00
600. Cash at Settlement to/from Seller	
601. Gross amount due to seller (line 420)	$301,000.00
602. Less reductions in amounts due seller (line 520)	($191,000.00)
603. Cash [X] **To** [ ] **From Seller**	$110,000.00

L. Settlement Charges

700. Total Real Estate Broker Fees	Paid From Borrower's Funds at Settlement	Paid From Seller's Funds at Settlement
Division of commission (line 700) as follows :		
701. $ 18,000.00 to GEORGE REALTY (6% OF $300,000)		
702. $ to		
703. Commission paid at settlement		$18,000.00
704.		

800. Items Payable in Connection with Loan				
801. Our origination charge	$	(from GFE #1)		
802. Your credit or charge (points) for the specific interest rate chosen 2% OF $200,000	$	(from GFE #2)		
803. Your adjusted origination charges		(from GFE #A)	$4,000.00	
804. Appraisal fee to XYZ APPRAISERS		(from GFE #3)	$500.00	
805. Credit report to ABC CREDIT COMPANY		(from GFE #3)	$100.00	
806. Tax service to DEF TAX SERVICE COMPANY		(from GFE #3)	$100.00	
807. Flood certification to		(from GFE #3)		
808.				
809.				
810.				
811.				

900. Items Required by Lender to be Paid in Advance				
901. Daily interest charges from to @ $ /day		(from GFE #10)		
902. Mortgage insurance premium for months to		(from GFE #3)		
903. Homeowner's insurance for years to		(from GFE #11)		
904.				

1000. Reserves Deposited with Lender				
1001. Initial deposit for your escrow account		(from GFE #9)	$2,200.00	
1002. Homeowner's insurance 10 months @ $ 100.00 per month	$ 1,000.00			
1003. Mortgage insurance months @ $ per month	$			
1004. Property Taxes 6 months @ $ 100.00 per month	$ 1,200.00			
1005. months @ $ per month	$			
1006. months @ $ per month	$			
1007. Aggregate Adjustment	-$			

1100. Title Charges				
1101. Title services and lender's title insurance		(from GFE #4)	$3,000.00	
1102. Settlement or closing fee	$			$1,000.00
1103. Owner's title insurance		(from GFE #5)	$2,000.00	
1104. Lender's title insurance	$			
1105. Lender's title policy limit $				
1106. Owner's title policy limit $				
1107. Agent's portion of the total title insurance premium to	$			
1108. Underwriter's portion of the total title insurance premium to	$			
1109.				
1110.				
1111.				

1200. Government Recording and Transfer Charges				
1201. Government recording charges		(from GFE #7)		
1202. Deed $ Mortgage $ Release $				
1203. Transfer taxes		(from GFE #8)	$2,000.00	
1204. City/County tax/stamps Deed $ Mortgage $				$2,000.00
1205. State tax/stamps Deed $ Mortgage $				
1206.				

1300. Additional Settlement Charges				
1301. Required services that you can shop for		(from GFE #6)		
1302.	$			
1303.	$			
1304.				
1305.				
1400. Total Settlement Charges (enter on lines 103, Section J and 502, Section K)			$13,900.00	$21,000.00

B. Analysis

Based on this information, the following can be determined.

Jay Robin's total tax basis in the property is computed as follows:

Contract sales price	$ 280,000
Personal property	20,000
Title services	3,000
Owner's title insurance	2,000
Transfer taxes	2,000
Total	$ 307,000

Note that the following incurred costs detailed on the settlement statement would not be included in the tax basis:

Items incurred in connection with obtaining the mortgage:	
Bank origination charge	$ 4,000
Appraisal fee	500
Credit report	100
Tax service	100
Total	$ 4,700
Real estate taxes (currently deductible)	$ 1,000

Since it was detailed on the Settlement Statement, Jay Robin determined that the allocation between real property and personal property should be:

	Stated amount per settlement statement	Allocated amount
Real property	$ 280,000	$ 285,510
Personal property	20,000	21,490
Total	$ 300,000	$ 307,000

In regard to the real property, per discussions Jay Robin had with the appraiser of the property used for settlement purposes, it was determined that a reasonable allocation between land (nondepreciable real property) and building (depreciable real property) should be 15 percent and 85 percent. Accordingly, the allocation between these two assets would be:

Land	$ 42,826
Building	242,684
Total	$ 285,510

Rental Operations

Rental Operations

Learning objectives

After reviewing the material, the reader will be able to:

- Learn the proper tax treatment of lease acquisition costs for both the lessor and the lessee;
- Learn the appropriate tax treatment of recognizing various types of rental income, prepaid rent, and security deposits;
- Learn the deductibility of expenses related to real property;
- Understand the tax implications of a sales-leaseback transaction;
- Understand the differences between various types of leases for tax reporting purposes; and
- Learn the impact of the Tax Cuts and Jobs Act had on the deductibility of interest expense.

I. Lease acquisition costs

The costs of obtaining a lease are required to be capitalized by both the lessor and the lessee regardless of the method of accounting used. Some of these costs include:

- For the lessor:
  - Commissions;
  - Professional fees; and
  - Tenant incentives.
- For the lessee:
  - The cost of purchasing a leasehold estate; and
  - Professional fees.

In accordance with IRC §178, these costs are required to be amortized over the life of the original lease. This would also apply even if there may be expectations of renewals beyond the original lease term. The only exception to this rule occurs if less than 75 percent of the costs are allocable to the original term. If that should be the case, the lessee would then be required to include any explicit or implicit renewal option periods in the amortization period.[1] The rationale behind the capitalization requirement is that these costs incurred in one particular tax period also benefit future periods as the result of the receipt of rental income.

If a lessor decides to cancel a lease in the middle of a lease term, costs associated with the cancellation are required to be capitalized and amortized over the remaining term of the cancelled lease by the lessor.

II. Transactions between the lessor and the lessee

A. Rental income

Once the lease has been finalized by both parties, it is time for the lessee to pay the rent to the lessor. According to IRC §561(a), rents are taxable income to the lessor and per IRC §61(a)(5), they are legitimate deductions for the lessee. When each recognizes the income or deduction depends on whether

[1] See IRC §178(a).

they report on the cash method or the accrual method. For the lessor, rental income is taxable when the following circumstances are in effect:

- When all events have occurred to fix the right to receive the rent; and
- When the amounts can be determined with a reasonable degree of accuracy (in other words, when they are due under the terms of the related lease).

It should be noted that the term "rent" is not restricted to rent payments due; the term may also include various types of expense reimbursement (real estate taxes, common area maintenance, insurance, etc.). Payments by the lessee of any expense of the lessor are deductible by the lessee and rental income to the lessor.

It should also be noted that despite the normal accounting methods used by the lessor and lessee, IRC §467 may require earlier income recognition by the lessor when total rents exceed $250,000. This is intended to avoid abusive mismatches, such as equal rents payable under a master lease with a sublease providing the low rents in early years and higher rents in later years. IRC §467 applies to leases with rents back-end-loaded beyond one year following the calendar year in which the use occurs or where there are increases in rents during the term. Rent is recognized on an accrual basis with an imputed interest factor for the deferred rent. The reason for this provision is to prevent tax avoidance on behalf of the lessor. Accordingly, if the lessor can demonstrate that the purpose of the long-term leases was not for the purpose of tax avoidance, the lessor may be able to skirt the IRC §467 provisions.

B. Other transactions

In addition to monthly rent payments made by the lessee to the lessor, there are a number of other transactions that need to be discussed in order to understand the proper treatment according to the IRC.

1. Prepaid rents

Rents prepaid by a lessee reporting on the accrual basis are not deductible until they are considered due to the lessor according to the terms of the lease. In regard to the lessor, the IRS has ruled that accrual basis taxpayers (and, obviously, also cash basis taxpayers) must recognize rental income when received; even though it has not been earned according to the terms of the lease.[2] It should be noted that the issue of "taxable when received" includes amounts actually received in addition to amounts constructively received. Constructive receipts may apply when a related tenant has the ability to pay but does not.

Example: Justin, LLC (an accrual-basis lessor) has entered into a rental agreement with Sarah, LLC (an accrual-basis lessee). Sarah pays her rent due for January 2021 (and it is received by Justin) on December 31, 2020. For tax reporting purposes, Sarah would show the rent paid as a prepaid asset on Schedule L and may deduct this amount in 2021. However, Justin must recognize the rent received in 2020 as income in 2020.

2. Security deposits

When a lessee pays a security deposit to the lessor according to the terms of the lease, it is not deductible by the lessee, nor included into income by the lessor, unless the security deposit is used for non-compliance of the terms of the lease. In that situation, both the lessee and the lessor would bring the security deposit into their perspective income.

---

[2] See Reg. 1.61-8(b).

Note:

It is important to understand the terms of the lease to determine if the "extra" rent paid at the commencement of the lease is a security deposit (and treated as we just detailed), or if it is in actuality "last month paid in advance," which would then be treated as a prepaid asset by the lessee and income as received by the lessor.

3. Contingent rents

In commercial leases, it is not uncommon for lessees to pay, in addition to their base rent, a percentage of their recognized sales as additional rent. This is referred to in the real estate industry as "percentage rents." The Tax Courts have ruled that this type of rent is subject to accrual and income tax recognition by the lessor at the time the sales were made, even if not payable by the lessee until the following year. In other words, once the lessee hits the target sale number, the lessor (who reports on the accrual basis) is required to recognize the additional taxable income.

Example: Walrite, a pharmacy, leases space from Sherry Investors, Inc. The lease calls for monthly payments of $10,000 plus 2 percent of all sales recognized by Walrite in excess of $1 million annually. The additional amount based on Walrite's sales would be considered percentage rent. Once Walrite reaches the target amount of $1 million of sales, even though it has not been actually billed for the additional rent, Sherry will need to recognize the additional taxable income.

4. Cancellation payments

Payments made by the lessee to the lessor to cancel a lease may create rental income for the lessor in the year received by the lessor (or in which the liability to pay is certain).[3]

5. Lease incentives

Lease incentives are negotiated into many leases as an incentive for the potential lessee to sign a lease. They generally include:

a. A rent-free period;
b. A reduced rent period; or
c. Cash payments from the lessor to cover various, specific costs. These cash payments are generally provided in one of two ways:
    (i) The lessor pays directly for various tenant improvement to the property at an agreed-upon amount, or
    (ii) The lessor pays the lessee an agreed-upon amount and the lessee will then purchase the improvements (furniture, equipment, etc.).

We will now discuss the treatment of these lease incentives in accordance with the IRC.

Cash or tangible benefits are considered income to the lessee (see IRC §61). Capital items received (i.e., in lieu of cash) are taxable. However, under certain circumstances, they might be deducted (e.g., through depreciation) in later years by the lessee.

[3] See Regs. 1.61-8(b).

III. Expenses

Switching over to the other side, we need to discuss the deductibility of expenses incurred involving real property.

- Cash basis taxpayer -- expenses may be deducted by the lessor when actually paid.
- Accrual basis taxpayer -- as per IRC §462(h), expenses may be deduced by the lessor when the expense is fixed, reasonably determinable, and upon economic performance.

Note:

Depreciation expense will be discussed in detail in Chapter 4.

One particular expense that needs more discussion is real estate taxes. In accordance with Reg. 461-4(g), accrual basis lessors cannot deduct this item until economic performance has occurred -- not when the tax was assessed.

A. Deductibility of interest expenses

Another area that needs further discussion is the deductibility of interest expense under IRC §163. Generally, interest expense used in the ordinary course of business is currently deductible; for cash basis taxpayers it is deductible when paid, and for accrual basis taxpayers it is deductible when the expense is fixed, reasonably determinable, and upon economic performance. However, there are numerous types of interest that are not currently deductible. Those that relate to the real estate industry include the following.

1. Notes on non-deductible types

a. Interest paid relating to debt to finance the purchase of obligations that pay tax-exempt interest income is not deductible.[4]
b. A taxpayer can make an election to capitalize otherwise deductible carrying charges (including interest).[5]
c. Interest on debt to a related taxpayer cannot be deducted until it is included in the income of the related taxpayer.[6]
d. The deduction for interest on corporate acquisition debt may be limited.[7]
e. The deduction for interest expense incurred in passive activities may be limited, but only if the taxpayer is subject to the passive activity rules.[8]
f. The deduction for interest expense incurred on at-risk activities may be limited, but only if the taxpayer is subject to the at-risk rules.[9]
g. The deduction by cash basis taxpayers for prepaid interest is deferred.[10]
h. The uniform capitalization rules generally require the capitalization of interest allocated to the production period of real property that is being built for sale or self-use.[11]

There is another potential limitation to the deductibility of interest expense resulting from the passage of the Tax Cuts and Jobs Act in December of 2017. The purpose of this particular provision of the Act is to discourage entities from becoming too highly debt laden. Businesses (including real estate entities) have

4 See IRC §265(a)(2).
5 See IRC §266.
6 See IRC §267(a)(2).
7 See IRC §279.
8 See IRC §469.
9 See IRC §465.
10 See IRC §461(g).
11 See IC §263A(f).

long been incentivized to borrow, not only by the low current interest rates but also by the knowledge that the interest will be fully deductible.

However, beginning in 2018, a real estate entity can only deduct its "net interest expense" (defined as interest expense paid/incurred net of recognized interest income) up to 30 percent of its "EBITDA." EBIDTA is defined as an entity's earnings before interest, taxes, depreciation, and amortization. Any amount of interest the real estate entity pays/incurs in excess of this 30 percent limitation cannot be currently deducted but may be carried forward to future tax years. The rules we have just discussed are effective for tax years from 2018 to 2021. Beginning in 2022, they become even more restrictive when the deductibility of interest expense will be capped at 30 percent of earnings before interest and taxes but *after depreciation and amortization expenses*. This will usually result in a significantly lower allowable amount of currently deductible interest.

A few rules concerning the applicability of this interest deduction limitation:

- It only impacts entities whose average gross receipts are in excess of $25 million. It will have no impact for entities with average gross receipts less than this threshold.
- A real estate entity can avoid this limitation, even if their average gross receipts exceed the $25 million threshold if they are engaged in what is defined as a "real property trade or business" under the meaning of IRC §469(c)(7). Accordingly, it a real estate entity is engaged in the following lines of business, they have an opportunity to avoid the limitation:
    - Leasing,
    - Construction,
    - Development,
    - Acquisition,
    - Management, or
    - Brokerage.
- If the real estate entity is not involved in 'the above-detailed activities, it can make an election to avoid the imposition of the 30 percent rule. However, by making that election, they will be required to depreciate their residential and nonresidential real property in addition to their qualified improvement property utilizing longer depreciation lives known as the Alternative Depreciation System (ADS). We will be discussing these potential changes to depreciation in Chapter 4.

B. Sales-leaseback transactions

When a real estate entity is in need of capital, an option available is for the owner of the property to sell it and immediately lease the property from the acquirer of the property. This transaction is referred to as a "sales-leaseback transaction." The most common reason for this transaction would be when a company needs to use the cash it has invested in a property for other investments, but the asset is still needed in order to operate. In addition, if properly structured, such a transaction can provide the seller-lessee with additional tax deductions. At the same time, it can provide the buyer-lessor in the transaction with a lease with stable payments for a specified period of time.

The first issue that has to be determined is whether the transaction should be characterized as a "true" sale or whether the transaction is in actuality something else, such as a financing arrangement (or maybe even a like-kind exchange under IRC §1031). If the transaction is characterized as a true sale with a true lease between the seller and the buyer, the seller-lessee will be subject to capital gains for the recognized

gain on the transaction (in addition to depreciation recapture, when applicable). In addition, the seller would be considered a lessee and subject to the lessee rules discussed throughout this chapter. The benefit of this transaction is the ability to extract cash from the property without the restrictions generally associated with bank loans using the property as collateral. Another benefit to the seller-lessee is that the rent payments are currently deductible. The disadvantage of this transaction is that any appreciation of the real property will benefit the buyer-lessor, not the seller-lessee.

However, if the sales-leaseback is not characterized as a true sale with an associated true lease, it would then generally be considered a refinancing resulting in loan treatment. “Rent” payments would need to be allocated between principal and interest with the interest portion a taxable event to both parties of the transaction (while the principal portion of the payment would not). However, it should be noted that in accordance with a number of revenue rulings, if the buyer-lessor ends up with ownership at the end of the transaction, there will be sale treatment at that time.

So now we have to ask, and attempt to answer, the question of whether a sales-leaseback should be recognized as a sale or a financing arrangement. There is no clear-cut answer; rather, it depends on facts and circumstances surrounding the transaction. Some of the key items to consider include:

- Is there an option for the seller-lessee to repurchase the property?
- Is the option price considered too low (which may be an indication of a financing arrangement)?
- Is the option price only equal to the present value of future rents?
- How are risks allocated regarding condemnation or casualty?
- Is the rent set at fair-market rates?
- Has the opportunity or risk for appreciation or depreciation in the value of the property moved from the seller-lessee to the buyer-lessor?

In summary, much thought and due diligence needs to be performed to provide assurance that the sales-leaseback transaction will be recorded as desired by both parties.

IV. Leases

Those members of the CPA profession involved with the preparation of financial statements in accordance with U.S. GAAP are surely aware that in 2016, the FASB issued ASU No. 2016-02 (codified as ASC No. 842), which would revolutionize how entities report and disclose their leasing activities. This Codification became effective for financial statement periods beginning on or after December 15, 2018 (calendar year 2019), for publicly traded entities; and beginning on or after December 15, 2021 (calendar year 2022), for all other entities. Prior to its issuance, lessees would report their leases (based on pertinent facts or circumstances) as either operating leases (where all payments go directly to the income statement) or capital leases (where the lease is reported similarly to fixed assets). Once the ASC becomes effective, virtually every lease will have to be reported similarly to a capital lease, virtually eliminating the operating lease classification.

Under today’s GAAP, a lease would be classified as a capital lease by the lessee if any of the following four conditions are met:

1. There is a transfer of ownership from the lessor to the lessee at the end of the lease term;
2. The lease contains a “bargain-purchase” option at the end of the lease term;

3. The lease passes an economic life test; or
4. The lease passes a present value test.

If any of the above conditions are not met, the lease would be classified as an operating lease by the lessee.

In regard to the lessors, they have two additional criteria to consider:

1. Collectability of the payments is reasonably assured; and
2. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

If any of the four criteria detailed above for the lessee and the two criteria detailed for the lessor are satisfied, the lessor would account for the lease either as a direct financing lease or a sales-type lease.

However, as we will now discuss, it is a whole different ball game regarding leases for tax reporting purposes.

According to the IRC, a lease would be considered a capital lease under a similar, but different, set of criteria as compared to GAAP. If it does not meet the criteria, which we will now detail, it is considered a financing lease (similar to an operating lease as defined by GAAP) in which payments are currently deductible. For tax purposes, a lease is considered a capital lease (also known as a conditional sales contract) based upon the intent of the lessor and the lessee. When we mention intent, we are referring to the provisions of the agreement and the facts and circumstances on the date of the agreement. According to a couple of Rev. Procs., there is no single test or special combination of tests that always applies. However, generally, a lease agreement may be considered a capital lease (conditional sales contract) instead of an operating (financing) lease if any of the following apply:

- The agreement applies part of each payment toward an equity interest;
- Title to the property will be transferred after making a stated amount of required payments;
- The payments to use the property for a short time are a large part of the amount that would be required to get title of the property;
- Payments are much more than the current fair rental value of the property;
- There is an option to purchase the property at a nominal price compared to the value of the property at the option date, and is made when the agreement is signed;
- There is an option to purchase the property at a nominal price compared to the total amount to be paid under the agreement; and/or
- The agreement designates part of the payments as interest, or that part is easy to recognize as interest.

It is obviously the obligation of the taxpayers to demonstrate how they determined the proper recognition of their various leases.

V. Points

Since we previously discussed the issue of interest expense, it now makes sense to discuss in detail one issue associated with the obtaining of financing and the incurring of interest known as “points.”

When a taxpayer obtains a mortgage, he or she will often be charged numerous fees by the lending institute. One example of these fees is known as “points.” IRS Topic 504, *Home Mortgage Points*, provides guidance on how those points should be treated for income tax reporting purposes.

Per IRS Topic 504, the term “points” is used to describe charges paid to obtain a home mortgage. The IRS considers these points to be “prepaid interest,” so accordingly, under certain circumstances, the taxpayer may be able to currently deduct these items as interest expense on Schedule A.

However, it should be noted that:

- If the taxpayer is able to deduct all of the interest on their mortgage, the taxpayer may be able to deduct all of the points paid on the mortgage;
- If the acquisition debt exceeds $1 million or home equity exceeds $100,000, the taxpayer cannot deduct all interest paid on the mortgage and cannot deduct all the points paid;
- The amount of the deductibility of the points may be reduced by the amount of the taxpayer’s adjusted gross income (AGI).

A. Requirements

Taxpayers who pay points related to their home mortgage can deduct the points in the year they are paid if they meet **all** nine of the following requirements:

1. The primary residence secures the loan.
2. Paying points is an established business practice in the taxpayer’s area.
3. The points paid were not more than the amount generally paid in the area where the taxpayer resides.
4. The taxpayer uses the cash method of accounting.
5. The points paid were not for items that are usually listed separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, or property taxes.
6. The funds provided by the taxpayer at or near closing, including any points paid by the seller, were at least as much as the points charged. The taxpayer cannot have borrowed the funds to pay the points from the lender or mortgage broker.
7. The taxpayer must use the proceeds of the loan to buy or build the taxpayer’s primary residence.
8. The points were computed as a percentage of the principal amount of the mortgage.
9. The amount shows clearly as points on the settlement statement.

The taxpayer can also fully deduct points in the year they were paid on a loan to improve the taxpayer’s primary residence if requirements 1 through 6 have been met.

The following points are generally deducted (amortized) over the life of the related loan:

- If the above-mentioned criteria have not been met.
- Those for financing of a second home (not the taxpayer’s primary residence).
- Those for refinancing a mortgage on the taxpayer’s primary residence. However, if a portion of the refinancing proceeds was used to improve the taxpayer’s primary residence and conditions 1 through 6 detailed above have been met, the taxpayer can currently deduct that portion of the points related to the improvements while the balance of the points paid must be deducted over the life of the related loan.

Points charged for specific services, such as preparation costs for a mortgage note, appraisal fees, or notary fees, are not considered interest and accordingly cannot be deducted.

Points paid by the seller of a home cannot be deducted as interest on the seller's tax return, but they can be deducted as a selling expense.

Points paid in relation to investment in real property (both residential and nonresidential) cannot be currently deducted but must be capitalized as part of the total deferred financing costs and amortized over the life of the related loan.

VI. Homeowner's deductibility of mortgage interest

In addition to the potential limitation on entities deducting excessive interest (discussed earlier in this chapter), The Tax Cuts and Jobs Act ("The Act") made some significant changes regarding the amount of mortgage interest that can be deducted by the taxpayer:

- Through 2017, interest associated with mortgage loans up to $1 million was deductible. The Act reduces the limit to $750,000 for new loans taken out after December 14, 2017. Note that loans that are in place before December 15, 2017, up to $1 million are "grandfathered" and are not subject to the $750,000 Act cap.
- A taxpayer may refinance mortgage debts existing as of December 14, 2017, up to $1 million and still deduct the interest as long as the new loan does not exceed the amount of the mortgage that is being refinanced.
- The Act repeals the deduction for interest paid on home equity debt through December 31, 2025. However, the interest paid on home equity loans where the proceeds are used to substantially improve the residence are still deductible.
- Interest remains deductible on second home subject to the $750,000 limitation.

Depreciation

Depreciation

Learning objectives

After reviewing the material, the reader will be able to:

- Understand the mechanics of depreciation and its importance in determining current year income or loss as well as gain or loss upon disposal of the property;
- Know which real property is depreciable and which is not;
- Understand how bonus depreciation and §179 apply to real property;
- Understand the concept of "allowed vs. allowable" regarding depreciation;
- Understand MACRS as it applies to real property;
- Know the rules concerning land and land improvements;
- Realize the impact the Tax Cut and Jobs Act has on depreciation of real property; and
- Understand the impact of the CARES Act on the real estate industry.

I. Introduction

The IRS describes depreciation as an income tax deduction that allows a taxpayer to recover the cost or other basis of certain property. It represents an annual allowance for the wear and tear, deterioration, or obsolescence of the property.

Depreciation is a critical component when discussing taxation of real estate from two different perspectives:

1. Determining the amount of current year taxable income (loss) to be recognized regarding the property; and
2. Determining the tax basis of the property (previously discussed), which is then used to determine the amount of gain or loss to be recognized upon disposal of the property (to be discussed later in this chapter).

A. GAAP financial reporting vs. income tax reporting

One of the major differences between financial reporting under Generally Accepted Accounting Principles (GAAP) and income tax reporting (shortened throughout this section to "Tax") under the Internal Revenue Code (IRC) is in the area of depreciation.

- **GAAP** – assets are depreciated over their estimated useful lives.
- **Tax** – assets are depreciated over lives prescribed by the IRC.

- **GAAP** – assets are depreciated generally using the straight-line method.
- **Tax** – assets are depreciated according to the IRC, generally using MACRS.

- **GAAP** – the asset may have its basis reduced for salvage value.
- **Tax** – the concept of salvage value does not exist.

- **Tax** – §179 expensing of personal property is allowed in addition to additional bonus depreciation (subject to numerous limitations).
- **GAAP** – the concepts of §179 and bonus depreciation do not exist.

Bottom line: Generally, Tax will allow greater amounts of depreciation than GAAP in the first year that the asset is placed in service, with the amount of GAAP depreciation "catching up" to Tax depreciation in later years.

When preparing financial statements for real estate in accordance with GAAP, it is critical for the accountant to understand the differences in depreciation between GAAP and Tax. Not properly utilizing GAAP methods (and instead using IRC guidelines, such as depreciating a residential property over its IRC prescribed life rather than its estimated useful life, and using MACRS depreciation rather than using the straight-line method) will result in errors in the recognition of gain or loss upon the sale of the asset if the asset was sold before it becomes fully depreciated for financial reporting purposes.

II. General rules concerning depreciation

Virtually all types of real property are depreciable. The only exceptions are:

- Land; and
- Property placed in service and disposed in the same year.

In order for a taxpayer to be allowed a depreciation deduction for real property, the property must meet the following requirements:

- The taxpayer must own the property. (There is an exception for any capital improvements regarding property the taxpayer leases.)
- The taxpayer must use the property in either a trade or business or in an income-producing activity.
- The property must have a determinable useful life of more than one year.

Depreciation begins when the taxpayer places the property in service for use in a trade or business or for the production of income. The property ceases to be depreciable when the taxpayer has fully recovered the property's cost (or other basis) or when the taxpayer retires it from service, whichever occurs first.

A. Allowed or allowable

One of the key concepts when discussing depreciation of real estate is that of "allowed or allowable." According to IRC §1016(a), the tax basis of the property should be reduced by the greater of the following:

(i) *The amount of depreciation deduction in computing taxable income (to the extent a tax benefit was derived from the deduction)*. **Allowed** depreciation is the depreciation deduction claimed on an income taxed return accepted by the IRS; or

(ii) *The amount of depreciation allowable.* **Allowable** depreciation is the amount a taxpayer may deduct from gross income using the methods, conventions, and recovery periods provided in the current tax law.

An example of this concept will now be provided.

Example: Alicia, LLC purchased residential property on January 1, 2018, for $300,000. The property was subsequently sold on December 31, 2020. Alicia claimed on its applicable tax returns the following amounts for depreciation:

2018	$ 2,000
2019	$ 2,000
2020	$0
TOTAL	$ 4,000

Under MACRS (to be discussed shortly), Alicia should have taken the following amounts of depreciation:

2018	$ 1,046
2019	$ 1,091
2020	$ 1,091
TOTAL	$ 3,228

Alicia must determine its adjusted tax basis by reducing the cost by the greater of the allowed or allowable depreciation. Alicia's **allowed** depreciation is $4,000; the actual depreciation deductions taken on its 2018-2020 tax returns for which a tax benefit was derived. Alicia's **allowable** depreciation is $3,228; the total amount of depreciation it should have claimed on the property. Therefore, Alicia's adjusted tax basis in the property is $296,000 ($300,000 - $4,000).

B. Depreciating real property

For any real property placed in service after December 31, 1986, the IRC requires the use of MACRS (Modified Accelerated Cost Recovery System) for depreciating the asset. When discussing using MACRS depreciation for real property, there are four items that must be considered:

1. The type of depreciable property;
2. The recovery period of the asset;
3. The applicable convention; and
4. The method used to depreciate the asset.

1. The type of depreciable property

Through 2017, there were five types of real property identified for depreciation purposes:

a. **Residential real property** – Any building or structure if 80 percent or more of the gross rental income for the taxable year is rental income from dwelling units.

b. **Nonresidential property** – Depreciable real property which is not residential property.

c. **Qualified leasehold improvement property** – Any improvement to an interior portion of a building that is nonresidential property and placed in service more than three years after the date the building was first placed in service. The landlord and tenant cannot be related parties and enlargements, elevators and escalators, common area work, and internal structural framework are excluded. The improvement may be made by the lessee or by the lessor but must be made pursuant to a lease.

d. **Qualified restaurant property** – Any §1250 property (to be described later in this chapter) that is a building or an improvement to a building if more than 50 percent of the building's square footage is devoted to the preparation of and seating for on-premises consumption of prepared meals.

e. **Qualified retail improvement property** – Any improvement to an interior portion of a building which is nonresidential real property and placed in service more than three years after the date the building was placed in service. Retail establishments that qualify include those open to the public and primarily in the business of the sale of goods (tangible personal property) to the general public but not services. Examples of these establishments include:

   (i) Grocery stores;
   (ii) Clothing stores;
   (iii) Hardware stores; and
   (iv) Convenience stores.

Enlargements, elevators/escalators, common area work, and internal structural framework are excluded from this definition of qualifying retail improvements.

However, the Tax Cuts and Jobs Act made significant changes to existing law concerning depreciation of real property beginning in 2018. It retained the first two categories (residential real property and nonresidential real property), but combined the other three categories (qualified leasehold improvement property, qualified restaurant property, and qualified retail property) into one category known as "qualified improvement property."

Throughout this section, we will provide a comparison of the depreciation rules, first presenting what is applicable through 2017 and what will be required under the Act.

2. The recovery period of the asset

a. Residential real property – the recovery period is 27.5 years.
b. Nonresidential real property – the recovery period is 39 years.
c. Qualified improvement property – the recovery period is 15 years.

It should be noted that any improvement or betterment made to residential or nonresidential real property would be treated in the same manner for depreciation purposes as the original property. In other words, if an improvement or betterment is made to nonresidential real property, it would also have a recovery period of 39 years.

It should be noted that the recovery period for the 15-year property is not elective. Failure to properly depreciate qualified improvement property over the required 15 years could potentially put other property at risk for reclassification to a longer recovery period.

3. The applicable convention

For residential and nonresidential real property, the mid-month convention should be utilized for both when the asset is placed in service and when the asset is disposed of. Under the mid-month convention, no matter what day of the month the property is placed in service or disposed of, it is treated as occurring in the middle of that particular month for depreciation calculation purposes.

For qualified improvement property, the half-year convention should generally be used whereby no matter what date the asset is placed in service or disposed of, half-year depreciation should be taken. The only exception to this rule is if more than 40 percent of these assets were placed in service during the final quarter of the entity's accounting year, then a mid-quarter convention would be used.

4. The method used to depreciate the asset

Under the IRC, MACRS depreciation must be used in determining the amount of depreciation to be taken for real property. The IRS provides tables for computing the annual depreciation deduction.

A provision of the regulations that were in place through 2017 under PATH (Protecting Americans from Tax Hikes) was that it extended bonus depreciation for qualified property placed in service during 2015 through 2017. This is referred to as "bonus depreciation." The bonus depreciation percentages were:

a. 2015 – 50 percent.
b. 2016 – 50 percent.
c. 2017 – 50 percent.

After 2015, the provision allows additional first-year depreciation for qualified improvement property without regard to whether the improvements are property subject to a lease and also removes the requirement that the improvements must be placed in service more than three years after the date the building was first placed in service.

Some of the provisions of bonus depreciation included:

- Eligible property for bonus depreciation included newly constructed or original use property with a recovery period of 20 years or less (which included both real and personal property).
- Regarding real property, qualified leasehold improvements were eligible for taking this bonus depreciation.
- Only new property was eligible for bonus depreciation; used property was not eligible.
- Unlike in §179 expensing, taxpayers did not need to recognize net income in order to take the bonus depreciation deduction.
- Bonus depreciation is not limited to smaller businesses or capped at a certain dollar level. However, it was not available for:
    - Used property;
    - Property used outside of the United States;
    - Tax-exempt use property; or
    - Tax-exempt financed property.

And finally, it should be noted that qualified restaurant and qualified retail improvement property were not eligible for bonus depreciation unless the property also satisfied the definition of qualified leasehold improvement property. However, beginning in 2016, PATH substituted for qualified leasehold improvement property a new category of assets, referred to as “qualified improvement property.” These are defined as any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the building was first placed in service.

Similar to qualified leasehold improvement property, qualified improvement property does not include the following:

- Any improvement attributable to the enlargement of the building;
- Any elevator or escalator; or
- The building’s internal structure.

However, qualified improvement property does have a number of obvious advantages over-qualified leasehold improvement property:

- It does not require that the improvement be subject to a lease; accordingly, interior improvements made by the owners of an owner-occupied building that meet the other requirement for qualified improvement property may now qualify for bonus depreciation.
- There is no longer a three-year waiting period. Under previous law, bonus depreciation could not be taken on improvements made to a building within three years from when it was originally placed in service. PATH has removed this requirement. Accordingly, tenant improvements made in a less-than-three-year-old building are now eligible for bonus depreciation.
- PATH has removed the restriction (applicable under previous law) that forbade taking bonus depreciation on common areas. Accordingly, common area improvements in an owner-occupied building are now eligible for bonus depreciation.

However, beginning in 2018 under the Tax Cuts and Jobs Act, significant changes were made regarding bonus depreciation. IRC §168(k) was amended to provide that beginning with assets placed in service after September 27, 2017, the bonus depreciation becomes 100 percent. However, there are a few conditions related to the ability to utilize this provision:

- The 100 percent deduction will now be available for a "qualified film or television production" as well as "live theatrical production."
- It will not be available to any business that has floor-plan financing (i.e., automobile dealers), if the floor-plan financing interest is deducted in full.
- It will not be available for assets acquired in the trade or business of the furnishing or sale of:
    - Electrical energy, water, or sewage services;
    - Gas or steam through a local distribution system; or
    - Transportation of gas or steam by pipeline.
- And finally, a provision that will have a direct effect on the real estate industry, the asset will no longer be required to be new in order to be eligible for 100 percent expensing. Used property will now qualify as long as it is the taxpayer's first use of the property.
- Similar to the rules through 2017, bonus depreciation will not be permitted on any asset that is required to use the Alternative Depreciation System (ADS). We will be discussing the use of the ADS under the Act later in this chapter.
- It should be noted that under IRC §168(k)(6), bonus depreciation will not remain at 100 percent expensing indefinitely. Rather, the provision will phase it out as follows:
    - 100 percent for any qualifying asset placed in service after September 27, 2017 and before December 31, 2022;
    - 80 percent for any qualifying asset placed in service in 2023;
    - 60 percent for any qualifying asset placed in service in 2024;
    - 40 percent for any qualifying asset placed in service in 2025;
    - 20 percent for any qualifying asset placed in service in 2026; and
    - After 2026, no bonus depreciation will be permitted.
- And finally, similar to the regulation through 2017, the Act allows the taxpayer to elect out of the use of bonus depreciation.

5. Alternative Depreciation System

Through 2017, under IRC §168(g), certain assets were required to be depreciated using the Alternative Depreciation System (ADS). Under the ADS, the asset is depreciated using the straight-line method using a longer life than that used under regular depreciation. For example:

- Residential real property – regular depreciation 27.5 years; ADS 40 years.
- Nonresidential real property – regular depreciation 39 years; ADS 40 years.
- Qualified leasehold, restaurant, and retail improvement property – regular depreciation 15 years; ADS 39 years.

In addition, it should be noted that any asset required to be depreciated under the ADS was not eligible for bonus deprecation.

However, that all changed starting in 2018. In Chapter 3, we discussed the provision under the Tax Cut and Jobs Act concerning the deductibility of interest expense by an entity. To summarize that provision, any business with average gross receipts in excess of $25 million may be limited in its deduction for "net interest expense." The deduction will be limited to up to 30 percent of adjusted taxable income. However,

for certain lines of business (which includes most lines involving real estate as we discussed in Chapter 3); the taxpayer may make an election to avoid the 30 percent interest expense limitation. What is the downside of making this election? The taxpayer will be required to depreciate their residential, nonresidential, and qualified leasehold improvement property using the ADS.

We will now present a summary of the ADS for the real estate industry:

- Residential real property – regular depreciation 27.5 years; ADS will now be 30 years.
- Nonresidential real property – regular depreciation 39 years; ADS 40 years.
- Qualified leasehold, restaurant, and retail improvement property – regular depreciation 15 years; ADS 20 years.

So in conclusion, a real estate entity with excessive debt and related interest will need to determine if it would be beneficial to limit their interest deduction or allowing the full deduction of the interest but decreasing the amount of current year depreciation due to utilizing the longer ADS lives.

C. Section 179 and real property

Through 2017, a taxpayer was able to elect to treat certain qualified real property placed in service during the year as §179 property allowing (if the other §179 limitations were met) immediate expensing of the cost of the property. Qualified real property included (all of which we have previously discussed):

- Qualified leasehold improvements;
- Qualified restaurant property; and
- Qualified retail improvement property.

It should be noted that the PATH Act has provided the taxpayer with more opportunity to use §179. Prior to PATH, the aggregate cost of the qualified real property that the taxpayer could elect to expense was subject to an annual limit of $250,000. Now that PATH has kicked in, the $250,000 limit was removed (for tax years beginning after December 31, 2015). However, the overall dollar-for-dollar phase out of $2,030,000 for 2017 still applied.

In addition, prior to PATH, §179 expenses attributable to qualified real property could not be carried forward to later years. Qualified real property expenses in excess of the allowable $250,000 amount were treated as if no §179 election had been made. Now that we have PATH, amounts disallowed because of the taxable income limitation attributable to qualified real property placed in service beginning in 2016 may be carried forward to later tax years.

However, beginning in 2018, the Tax Cut and Jobs Act made some significant changes to utilizing IRC §179 which we will now detail:

- The IRC §179 limitation is increased to $1,000,000.
- The phase-out will now begin at $2,500,000 for qualifying assets placed in service.
- Whereas through 2017, IRC §179 was allowed regarding qualified leasehold, qualified restaurant, and qualified retails, beginning in 2018 those terms have been replaced whereby IRC §179 is allowed for “qualified improvement property” (previously discussed in this chapter).
- Accordingly, all improvements made to the interior portion of nonresidential property (provided they are made after the building has been placed in service) are eligible for immediate IRC §179 expensing.

- The following improvements made to the structural component of a building are eligible for immediate expensing under IRC §179:
    - Roofs;
    - Heating, ventilation, and air-conditioning property;
    - Fire prevention and alarm systems; and
    - Security systems.

D. Cost segregation

As we previously noted, depreciation recovery period of non-residential property is 39 years (for property placed in service after May 13, 1994). This results in a very long period between the time when the taxpayer incurred the cost related to the construction or development of the asset and when he or she receives a full tax benefit from that asset. One manner in which a taxpayer may be able to alleviate this situation is through a concept known as "cost segregation."

Under cost segregation, if the taxpayer can identify certain components of the construction or development work that are considered not to be structural components of the building, then the taxpayer may be able to depreciate them over a shorter recovery period (i.e., seven years as personal property). Examples of such components may include:

- Moveable room partitions;
- Removable wall coverings;
- Removable floor finishes;
- Cabinets and counters;
- Decorative lighting;
- Emergency equipment;
- Signs and graphics;
- Certain electrical and plumbing systems; and
- Air conditioning units.

Since most CPAs are not engineers or architects, it would be virtually impossible for us to determine how much of the construction/development cost could be allocated to personal property. Accordingly, should a taxpayer want to cost segregate, the taxpayer would probably need the services of a qualified person to perform this.

Example: Jerry purchased a shopping center near Dallas, Texas. The total cost of the purchase was $10,000,000. It was determined that 10 percent of the purchase price should be allocated to the land ($1,000,000) and 90 percent should be allocated to the building ($9,000,000). The building was placed in service July 15, 2020. Without cost segregation, Jerry's allowable depreciation for 2019 would be:

Land (not depreciable)	$ -
Building (39-year recovery)	105,930
Total allowable depreciation	$ 105,930

However, if Jerry performed a proper cost segregation and determined that 20% of the building cost related to the various personal property, then the allocation would be 10% to the land ($1,000,000), 72% (80% of 90%) to the building ($7,200,000), and 18% (20% of 90%) to the personal property ($1,800,000). With a proper cost segregation, Jerry's allowable depreciation for 2019 would be:

Land (not depreciable)	$ -
Building (39-year recovery)	84,744
Personal property (7-year recovery)	257,220
Total allowable depreciation	$ 344,964

By performing a proper cost segregation, Jerry was able to increase his depreciation deduction by $239,034!

E. Land and land improvements

We noted earlier that land is not a depreciable asset. This is the result of the IRS considering land to have an indefinite life, and, accordingly, to be non-depreciable.

Note:

> The only exception to this rule when depreciation of land is allowed is when the value of the land is being depleted through the removal of natural resources.

However, improvements to the land are a different ball game and may result in allowable depreciation (something, in this author's experience, of which many CPAs may not be aware). The reason for the ability to depreciate land improvements is that they gradually wear out, resulting in a definite life, resulting in allowable depreciation. This brings us back to the concept of cost segregation.

Land improvements are defined as enhancements to a plot of land to make the land useable. If the taxpayer is incurring costs to prepare land for its intended use, then these costs generally should not be depreciated. Examples of this include:

- Demolishing an existing building; and
- Cleaning and leveling the land.

However, if the taxpayer is adding functionality to the land and the expenditures have a useful life, they can be considered depreciable land improvements. In other words, improvements that help the land serve other purposes are probably depreciable assets. Examples of this include:

- Drainage and irrigation systems;
- Fencing;
- Roads;
- Bridges;
- Shrubbery;
- Parking lots; and
- Walkways.

The reasoning is that the land itself does not require these improvements, but buildings erected on it do; accordingly, the land improvements are considered depreciable assets to the extent they support the building.

If the taxpayer determines that the land improvement is in fact depreciable, it would be depreciated over 15 years. However, such land improvements are not eligible for §179 expensing.

We will now provide an example illustrating the concept of eligible and ineligible land improvements:

Example: Bruce is converting raw land into a golf course. Most of the work Bruce performs is not depreciable since it relates to laying out or landscaping the land. However,

highly specialized parts of the golf course like greens, sand traps, or an underground drainage system are depreciable. In addition, the costs to prepare the land for installation of those systems are also depreciable as land improvements.

F. The impact of the CARES Act on the real estate industry

There is no doubt that COVID-19 has had a tremendous impact on the economy in general and the real estate industry in particular. The government, in attempting to deal with the pandemic, has implemented various measures, many of which have impacted the real estate industry.

The most important of these measures involves the Coronavirus Aid, Relief, and Economic Security (CARES) Act. One provision of CARES that has directly impacted taxation of real property deals with bonus depreciation for qualified improvement property.

The Tax Cuts and Jobs Act permitted taxpayers to deduct the full cost of certain depreciable property placed in service by the taxpayer in a taxable year before January 1, 2027. This is known as "bonus depreciation." Property eligible for bonus depreciation included property with a depreciable life of 20 years or less. While these rules permitted immediate expensing for various types of personal property (furniture and fixtures, equipment, etc.), it was also intended to apply to structural improvements made to commercial properties. However, the general 39-year recovery period for these improvements prevented them from being eligible for immediate expensing. The CARES Act corrects this "error" by assigning a 15-year depreciable life to "qualified improvement property," thereby permitting such improvements to be eligible for bonus depreciation. This provision is effective retroactively for property placed in service in 2018 and later. This provision may allow taxpayers to file amended returns for 2018 and 2019 tax years if they placed qualified improvement property into service during those years; it may also encourage taxpayers to make needed improvements in the coming years as the economy continues to recover from the pandemic.

The CARES Act also revises the definition of "qualified improvement property" to limit that concept to "improvements made by the taxpayer," thereby eliminating the possibility of the taxpayer getting bonus depreciation for "used" property that was purchased by the taxpayer.

G. Form 4562

Depreciation should be reported on Form 4562, *Depreciation and Amortization*. In regards specifically to real property, the only time this form is required to be filed is when property was placed in service during the current year.

Note:

C corporations are always required to file this form, even if no property was placed in service during the current year.

Attached is Page 1 of Form 4562.

Form **4562**

Department of the Treasury
Internal Revenue Service (99)

Depreciation and Amortization

(Including Information on Listed Property)

▶ **Attach to your tax return.**

▶ **Go to *www.irs.gov/Form4562* for instructions and the latest information.**

OMB No. 1545-0172

2020

Attachment Sequence No. **179**

Name(s) shown on return	Business or activity to which this form relates	**Identifying number**

Part I Election To Expense Certain Property Under Section 179

Note: If you have any listed property, complete Part V before you complete Part I.

1	Maximum amount (see instructions)	1	
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	

6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	
10	Carryover of disallowed deduction from line 13 of your 2019 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5. See instructions	11	
12	Section 179 expense deduction. Add lines 9 and 10, but don't enter more than line 11	12	
13	Carryover of disallowed deduction to 2021. Add lines 9 and 10, less line 12 ▶	13	

Note: Don't use Part II or Part III below for listed property. Instead, use Part V.

Part II Special Depreciation Allowance and Other Depreciation (Don't include listed property. See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year. See instructions	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III MACRS Depreciation (Don't include listed property. See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2020	17	
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2020 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2020 Tax Year Using the Alternative Depreciation System

20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 30-year			30 yrs.	MM	S/L	
d 40-year			40 yrs.	MM	S/L	

Part IV Summary (See instructions.)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

Determining Gain or Loss on the Sale of Real Property

Determining Gain or Loss on the Sale of Real Property

Learning objectives

After reviewing the material, the reader will be able to:

- Know the five factors the accountant must consider when computing the taxable gain or loss on the sale of real property;
- Know the definition of §1231 property and the advantages associated with such property;
- Know about §1245 and §1250 recapture;
- Know about §291 recapture;
- Understand the mechanics of Form 4797; and
- Know how to report capital losses upon the sale of real estate.

I. Introduction

Similar to GAAP, computing the gain or loss upon sale of real property is a very complicated area, considered by some CPAs to be one of the most difficult and misunderstood provisions of the Internal Revenue Code (IRC). It should be noted that the Tax Cuts and Jobs Act kept the recognition of gain virtually unchanged from regulations that were in place through 2017.

A. Five general steps

In general, there are five steps the accountant must consider when computing the taxable gain or loss upon sale of real property.

1. The type of asset being sold;
2. The period for which the asset was held;
3. How the sales price is to be allocated among various components;
4. The manner in which the asset was disposed of (cash vs. like-kind exchange); and
5. Whether a gain or loss is realized.

We will now discuss steps 1, 2, and 3 in more detail.

1. The type of asset being sold

The first issue that must be considered is whether the asset being sold is either:

a. A capital asset;
b. An IRC §1231 asset; or
c. Ordinary income property.

IRC §1221 defines a capital asset as any property, with a number of exceptions. One of those exceptions is "depreciable or real property used in a trade or business," which is IRC §1231 property. If a "non-capital asset" does not qualify as IRC §1231 property (which will be discussed later in this section), it is then considered ordinary income property.

2. The period for which the asset was held

In order for the disposed property to be considered IRC §1231 property, it must have been held for at least one year.

3. Allocating the sales price among various components

When real property is sold or exchanged, the total amount realized must be allocated among §1250 property and the non-§1250 (i.e., §1245) personal property or nondepreciable land. Accordingly, the sale of depreciable real property typically requires an allocation of the sale price between the land and building, and personal property.

II. Section 1231 property

Section 1231 property has the following characteristics:

- It is used in the entity's trade or business;
- The property has to be held for at least one year; and
- It is not a capital asset (as defined by the IRC).

By the way, speaking of holding the asset for at least one year, the rules in particular are the following (according to Rev. Rul. 66-7):

- The measurement of a property's holding period generally commences on the day after acquisition; and…
- Ends on the date of disposition.
- Accordingly, the day of purchase is excluded from the determination, but the day of disposal is included.
- A holiday falling on the beginning or ending date of a holding date has no effect on measuring the period.
- Therefore, in practicality, in order to be able to be considered §1231 property, the entity must hold the property for one year and one day from the date of acquisition.

If a property does not meet the above-detailed criteria, it is not considered §1231 property and any gain must be recognized as a short-term capital gain (ordinary income).

The advantages of having an asset classified as §1231 property are:

- Gains are classified as long-term capital gains (subject to a number of limitations which we will shortly discuss); and
- Losses are recognized as ordinary.

Therefore, it is said that §1231 assets have what is considered "the best of both worlds."

III. Sections 1245 and 1250 recapture

In order to understand this section, it is first necessary to define the term "recapture" in regard to recognizing gain on the sale of §1231 property.

Several provisions of the IRC convert a §1231 gain (e.g., a capital gain) into ordinary income when business property is sold. One of these provisions is the recharacterization ("recapture") of depreciation under IRC §§1245 and 1250.

In discussing recognizing gain on the sale of an asset, one must differentiate between §1245 property and §1250 property.

A. Section 1245 property

Section 1245 property is depreciable and is included under numerous categories. Those categories applicable to the real estate industry include:

- Tangible or intangible personal property (e.g., machinery, furniture and fixtures, and office equipment);
- Elevators and escalators placed in service after 1987; and
- Real property (other than buildings and their structural components) on which depreciation or amortization deductions were taken when the property was used.

When §1245 property is disposed of, the amount of gain that should be treated as ordinary income is the lesser of the following:

(i) The sum of all allowable depreciation deductions related to the property; and

(ii) The gain realized on the disposition.

When §1245 property is disposed of for a loss, the entire loss would be recognized as ordinary under §1231. The recapture rules only apply to gains, not losses.

Example: Alan & Stanley, LLC, purchased furniture used in a real estate operation for $50,000 on January 1, 2019. Alan & Stanley deducted $20,000 of depreciation during 2019 and 2020 and sold the furniture on December 31, 2020, for $40,000. Alan & Stanley's gain calculation is as follows:

Sales price:		$ 40,000
Basis		
Cost	50,000	
Depreciation	(20,000)	30,000
Realized gain		$ 10,000

This property qualifies as §1231 property since it was used in a trade or business and was held for at least one year. It is considered §1245 (personal) property. Accordingly, since the amount of gain is less than the amount of depreciation taken, under the recapture rules, the entire gain must be reported as ordinary.

B. Section 1250 property

Section 1250 property includes any depreciable real property not classified as §1245 property. Section 1250 property includes:

- Buildings;
- Their structural components;
- Leasehold improvements;
- Leaseholds of real property; and
- Other structures permanently attached to the land.

If real property is classified as §1245 property at any time during its use, it retains this classification even if its use changes and it no longer meets the definition of §1245 property. However, §1250 property can become §1245 property.

When §1250 property is disposed of, any recognized gain is treated as ordinary to the extent of the lesser of the following two items.

1. Additional depreciation taken on the property

Additional depreciation for §1250 property held one year or less is all depreciation on such property. This same definition also applies to nonresidential real property placed in service after 1980 and depreciated under an accelerated depreciation method (ACRS property). For residential property acquired after 1975 and held for more than one year, and nonresidential real property acquired before 1981. Additional depreciation is the excess of the depreciation taken over what depreciation would have been if the straight-line method had been used. Residential rental property purchased prior to 1976 is subject to special rules, as is other real property used to provide low-income housing.

Note:

The IRC defines low-income housing as follows:

- Federally assisted housing projects if the mortgage is insured under §221(d)(3) or §236 of the National Housing Act or housing financed or associated by direct loan or tax abatement under similar provisions of state or local laws;
- Low-income retail housing for which a depreciation deduction for rehabilitation expenses was allowed;
- Low-income housing held for occupancy by families or individuals eligible to receive subsidies under the United States Housing Act of 1937, or under provisions of state or local laws that authorize similar subsidies to low-income families; or
- Housing financed or assisted by direct loan or insured under Title V of the Housing Act of 1949.

2. Gain realized on the disposition

Another provision the taxpayer needs to consider in relation to recapture regards unrecaptured §1250 gain on the sale of real property. Unrecaptured §1250 gain is gain to the extent of depreciation claimed on the property, other than gain treated as ordinary income because of §1250 recapture, or nonrecaptured §1231 loss carryovers. A maximum 25-percent tax rate applies to unrecaptured §1250 gain if the real property will be held for at least one year.

C. IRC §291 recapture

One final provision the taxpayer needs to consider when discussing recapture is IRC §291(a)(1). The good news for most taxpayers is that this provision only impacts corporations. Generally, corporations must recognize as ordinary income an additional portion of any gain from the disposition of §1250 real property beyond the amount required to be recognized as ordinary income under §1250. IRC §291(a)(1) treats 20 percent of the excess gain as income computed as if the property were §1245 property, over the amount actually treated as ordinary income under §1250. Since under current law corporate capital gain income is taxed at the same rate as corporate ordinary income, IRC §291 does not increase a corporation's tax liability directly. However, it does reduce the amount of capital gain that might otherwise be available to offset a capital loss or capital loss carryforward. An S corporation does not recognize any IRC §291 recapture amounts unless it was a C corporation in the last three years.

D. Example

To assist in understanding the concept of recognizing gain under §1231 and recapture under §1250, we will present a couple of examples.

Example 1: Kahn Brothers, LLC purchased a shopping center located on Mercer Island, Washington, on January 1, 1982, for $2,000,000. The purchase price was allocated 25% ($500,000) to the land and 75% ($1,500,000) to the building. The

shopping center was sold on December 15, 2020, for $4,000,000. The sales price was allocated $1,000,000 to the land and $3,000,000 to the building. While Kahn owned and operated the property, $1,200,000 of depreciation was deducted. Had the straight-line method been used, total depreciation deducted would have been $1,100,000 (accelerated depreciation in excess of straight line is $100,000; $1,200,000 - $1,100,000). The recognized amount and character of the gain would be reported as follows:

	Land	Building
Original cost of property	$ 500,000	$ 1,500,000
Depreciation taken 1982-2019	(1,200,000)	
Adjusted tax basis	$ 500,000	$ 300,000
Proceeds from sale of property	$ 1,000,000	$ 3,000,000
Adjusted tax basis	(500,000)	(300,000)
Amount of recognized gain	$ 500,000	$ 2,700,000
The gain would be characterized as follows:		
Section 1231 long-term capital gain	500,000	2,600,000
Ordinary gain under §1250 recapture rules		100,000

Example 2: Kahn Brothers, LLC purchased a shopping center located in Brooklyn, New York, on January 1, 1987, for $2,000,000. The purchase price was allocated 25% ($500,000) to the land and 75% ($1,500,000) to the building. The shopping center was sold on December 15, 2020, for $4,000,000. The sales price was allocated $1,000,000 to the land and $3,000,000 to the building. While Kahn owned and operated the property, $1,200,000 of depreciation was deducted. Had the straight-line method been used, total depreciation deducted would also have been $1,200,000 (since MACRS straight-line was used since the property was placed in service after 1986). The recognized amount and character of the gain would be reported as follows:

	Land	Building
Original cost of property	$ 500,000	$ 1,500,000
Depreciation taken 1987-2019	-	(1,200,000)
Adjusted tax basis	$ 500,000	$ 300,000
Proceeds from sale of property	$ 1,000,000	$ 3,000,000
Adjusted tax basis	(500,000)	(300,000)
Amount of recognized gain	$ 500,000	$ 2,700,000
The gain would be characterized as follows:		
Section 1231 long-term capital gain	500,000	2,700,000
Ordinary gain under §1250 recapture rules	-	100,000

We will now provide an example of reporting unrecaptured §1250 gains. Berry, LLC, purchased a property for $250,000 on January 1, 2016, and claimed depreciation of $130,000, leaving an adjusted basis of $120,000 as of December 31, 2020, when the property was sold for $285,000. Berry recognized an overall gain of $165,000. Since the property had been sold for more than the basis, the unrecaptured §1250 gain is based on the difference between the adjusted basis and the original price. This means the first $130,000 of gain is considered unrecaptured §1250 gain and would be taxed at 25 percent (resulting in a tax of $32,500), while the remaining amount of gain of $135,000 would be considered a long-term capital gain and taxed at 15 percent (resulting in a tax of $20,250).

IV. Completion of Form 4797

A. Form 4797

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

► Attach to your tax return.
► Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184
2020
Attachment Sequence No. **27**

Name(s) shown on return | **Identifying number**

1	Enter the gross proceeds from sales or exchanges reported to you for 2020 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1	

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2020)

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255 (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A		
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20				
21 Cost or other basis plus expense of sale	21				
22 Depreciation (or depletion) allowed or allowable	22				
23 Adjusted basis. Subtract line 22 from line 21	23				
24 Total gain. Subtract line 23 from line 20	24				
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975. See instructions	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 If section 1252 property: Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage. See instructions	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 If section 1254 property:					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b Enter the **smaller** of line 24 or 29a. See instructions	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation. See instructions	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

B. Overview

Gains and losses recognized upon the disposal of real estate are reported on IRS Form 4797, *Sales of Business Property*. However, this form can be confusing, and some accountants may be unaware of how it should be properly completed. We will now discuss this form focusing exclusively on real estate transactions.

We had noted earlier (and provided examples) that when real estate is sold, the sale price should be allocated between the land and building.

- If the land and building were held for less than one year, any recognized gain or loss would be considered short-term and would therefore be recognized as ordinary income and reported on Part II of Form 4797.
- If the land was held for more than one year and sold for either a gain or loss, it would be considered either a capital gain or loss under §1231 and reported on Part I of the Form 4797.
- If the building was held for more than one year and sold for a gain, it would be considered a capital gain and reported as §1231 property on Part III of the Form 4797 subject to the recapture rules under §1250. Note that the computed gain from Part III flows through to Part 1.
- If the building was held for more than one year and sold for a loss, it would be considered §1231 property and reported on Part I of the Form 4797 but classified as an ordinary loss.

1. Miscellaneous considerations

A few other Form 4797 considerations:

a. When considering §1231 gain, do not forget the concept (previously touched on) of nonrecaptured net §1231 losses from prior years. Individuals and pass-through entities would make this consideration on their own applicable returns; C corporations would make this consideration on Line 8 of Part I of the Form 4797.

b. Many times, when real estate is sold, a portion of the sale involves personal property.

(i) If the personal property was held for less than one year, the gain or loss would be considered short-term and would therefore be recognized as ordinary income and reported on Part II of Form 4797.

(ii) If the personal property was held for more than one year and sold for a gain, it would be considered a capital gain and reported as §1231 property on Part III of the Form 4797 subject to the recapture rules under §1245.

Note:

The computed gain from Part III flows through to Part I.

(iii) If the building was held for more than one year and sold for a loss, it would be considered §1231 property and reported on Part II of the Form 4797 but classified as an ordinary loss.

c. IRC §291(a)(1) recapture (previously discussed) should be reported on Part III of the Form 4797.

C. Example

We will now present a completed Form 4797 for Kahn Brothers, LLC, reflecting **Examples 1** and **2.**

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184
2020
Attachment Sequence No. **27**

Name(s) shown on return: KAHN BROTHERS, LLC

Identifying number: 11-1111111

1 Enter the gross proceeds from sales or exchanges reported to you for 2020 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions 1

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	6,300,000
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	6,300,000
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	100,000
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	100,000
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2020)

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A SHOPPING CENTER LOCATED IN MERCER ISLAND, WA	01/01/82	12/15/20
B SHOPPING CENTER LOCATED IN BROOKLYN, NY	01/01/87	12/15/20
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	4,000,000	4,000,000		
21 Cost or other basis plus expense of sale	21	2,000,000	2,000,000		
22 Depreciation (or depletion) allowed or allowable	22	1,200,000	1,200,000		
23 Adjusted basis. Subtract line 22 from line 21	23	800,000	800,000		
24 Total gain. Subtract line 23 from line 20	24	3,200,000	3,200,000		
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975. See instructions	26a	100,000			
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions	26b	100,000			
c Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c	3,100,000			
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e	0			
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g	100,000	0		
27 **If section 1252 property:** Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage. See instructions	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b Enter the **smaller** of line 24 or 29a. See instructions	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	6,400,000
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	100,000
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	6,300,000

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

			(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33		
34	Recomputed depreciation. See instructions	34		
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2020)

V. Real property sold for a loss

Our discussion has focused on real property sold for a gain. But what happens if real property is sold for a loss (i.e., the sales price is less than the cost basis)?

- Individual taxpayers can offset capital gains with capital losses, and to the extent there are excess capital losses, up to $3,000 ($1,500 when married filing separate returns) can be deducted against other types of income.[1] Remaining capital losses can be carried forward indefinitely, retaining their character as either short- or long-term.[2]
- A C corporation's capital losses are allowed only to the extent of capital gains.[3] Any net capital loss for the year is treated as a short-term capital loss carryback to the three tax years preceding the year of the loss. To the extent not fully used in the carryback period, the net loss is allowed as a short-term capital loss carryover to the five tax years following the year of the loss.[4]
- Pass-through entities (partnership, LLCs classified as partnerships, and S corporations) – capital losses of these entities are passed through to their partners, members, or stockholders.

VI. Investor vs. dealer

The CPA profession is aware of the advantage of classifying a gain as a capital gain rather than an ordinary gain due to the lower tax rates generally associated with capital gains. Therefore, taxpayers who own real property must be aware that certain actions they take when owning the property may result in requiring the gain to be reported as an ordinary gain. This then brings up the issue of "investor vs. dealer."

A. General guidelines

An investor:

- Treats sale expenses as a reduction of the proceeds;
- Treats gains or losses on the disposition of real property as capital gains and losses; and
- Is able to defer gain recognition by being able to use the installment method under IRC §453 (discussed in Chapter 7) and like-kind exchange treatment under IRC §1031.

A dealer:

- Treats sale expenses as ordinary business deductions;
- Treats gains and losses on the disposition of real property as ordinary gains and losses rather than capital gains and losses, which (in regard to gains) could result in significantly higher taxation; and
- Is precluded from deferring gain recognition by not being able to use the installment method and like-kind exchange treatment.

Accordingly, we now need to address the issue of who is an investor and who is a dealer.

The general rule is that sales of real estate that are an integral part of the taxpayer's business indicate a dealer, as opposed to real estate held for investment or speculation.

---

1 See IRC §1221(b).
2 See IRC §1212(b)(1).
3 See IRC §1211(a).
4 See IRC 1212(a)(1).

B. Making the determination

Various recent Tax Court rulings have determined that there are five factors that must be considered when making this determination.

1. Frequency and continuity of sales

Frequent and continual sales of real property may indicate that such sales are undertaken in the ordinary course of business; while infrequent sales, often for significant profits, are more indicative of real estate held for investment.

Note:

Many professionals are of the opinion that this is the most indicative of the various factors we are now detailing.

2. Nature and extent of improvements and development activities

The taxpayer may be deemed a dealer due to the nature of the development activity performed. For instance, if a taxpayer's activities regarding a tract of land include subdividing, grading, zoning, or installing roads and utilities, the taxpayer may be deemed a dealer.

3. Solicitation, advertising, and sales activities

The taxpayer may be deemed a dealer based on the extent of the taxpayer's sales and marketing effort related to the disposition of a particular parcel of real estate. If the taxpayer advertises, markets, solicits customers, or merely lists the property for sale, it is more likely that the taxpayer may be deemed a dealer.

4. Extent and substantiality of transactions

The overall level of the taxpayer's real estate activities, with a particular focus on the extent to which the taxpayer's main occupation is developing property for sales to customers in its ordinary line of business, also factors into the dealer vs. investor determination.

5. Nature and purpose for holding property

Courts have extensively analyzed the taxpayer intent of acquiring the property. In other words, what is the nature and purpose of the acquisition? The ultimate questions are:

a. Why did the taxpayer acquire the real property in the first place?
b. For what purpose was the property held at the time of sale?

An investment purpose at acquisition does not guarantee investor (i.e., capital gains) treatment forever. A taxpayer may decide to develop and sell property that was initially purchased and held for investment. In such an event, upon disposal, the gain would not be eligible for capital gains treatment but would be taxed as ordinary income. At the same time, a development purpose at acquisition does not forever preclude investor status. A taxpayer may decide to hold investment property that was initially purchased for sale to customers in the ordinary course of business. A sale of this property would result in non-dealer (investor) status allowing the gain to be taxed as a capital gain.

6. Other considerations

Besides these five key factors, other considerations include:

a. The duration of ownership;
b. The extent of subdividing ad development to increase sales;

c. The use of a business office for the sale of the property; and
d. The character and degree of supervision or control over representation selling the property.

No one factor or combination of factors is determinative. Each situation must be individually considered in its entirety to determine if the property conveyed was held for sale in the ordinary course of business.

The burden of proof of non-dealer status obviously falls on the taxpayer. It is his or her responsibility to have proper documentation, not only when the property was purchased, but also throughout the entire period the property was held and eventually sold, proving his or her intent as well as any of the other considerations detailed above.

VII. Comprehensive example

We will now present a comprehensive example summarizing the major points discussed in this chapter, including the gain on the sale of real property purchased, an analysis of the related Settlement Statement, and completion of Form 4797.

Note:

In Chapter 2, the same Settlement Statement was utilized to determine the tax basis recognized by the buyer.

A. Facts

The property, located at 2200 Griffith Street in Philadelphia, Pennsylvania, was purchased by 2200 Griffith Street Associates on January 5, 2020, and sold to Jay Robin, LLC (an unrelated party), on December 31, 2020. 2200 Griffith's tax basis in the property (land, building, and personal property) was $260,000. Since the property was acquired and sold in the same year, no depreciation was taken. We will now present the settlement sheet related to the sale. It should be noted that there were no amounts paid outside of the settlement (POC).

OMB Approval No. 2502-0265

A. Settlement Statement (HUD-1)

B. Type of Loan

1. [X] FHA 2. [ ] RHS 3. [ ] Conv. Unins. 4. [ ] VA 5. [ ] Conv. Ins.	6. File Number: 1613	7. Loan Number: 7956	8. Mortgage Insurance Case Number: N/A

C. Note: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.

D. Name & Address of Borrower:	E. Name & Address of Seller:	F. Name & Address of Lender:
JAY ROBIN, LLC 6719 41 STREET MIAMI BEACH, FLORIDA	2200 GRIFFITH STREET ASSOCIATES 2200 GRIFFITH STREET PHILADELPHIA, PA 19111	GREAT BANK 11111 BUSTLETON AVENUE PHILADELPHIA, PA 19152
G. Property Location: 2200 GRIFFITH STREET PHILADELPHIA, PA 19111	H. Settlement Agent: HERBERT ROSENBERG Place of Settlement: 8500 CASTOR AVENUE PHILADELPHIA PA	I. Settlement Date: 12/31/20

J. Summary of Borrower's Transaction

100. Gross Amount Due from Borrower	
101. Contract sales price	$280,000.00
102. Personal property	$20,000.00
103. Settlement charges to borrower (line 1400)	$13,900.00
104.	
105.	
Adjustment for items paid by seller in advance	
106. City/town taxes 7/1/20 to 12/31/20	$1,000.00
107. County taxes to	
108. Assessments to	
109.	
110.	
111.	
112.	
120. Gross Amount Due from Borrower	$314,900.00
200. Amount Paid by or in Behalf of Borrower	
201. Deposit or earnest money	$10,000.00
202. Principal amount of new loan(s)	$200,000.00
203. Existing loan(s) taken subject to	
204.	
205.	
206.	
207.	
208.	
209.	
Adjustments for items unpaid by seller	
210. City/town taxes to	
211. County taxes to	
212. Assessments to	
213.	
214.	
215.	
216.	
217.	
218.	
219.	
220. Total Paid by/for Borrower	$210,000.00
300. Cash at Settlement from/to Borrower	
301. Gross amount due from borrower (line 120)	$314,900.00
302. Less amounts paid by/for borrower (line 220)	($210,000.00)
303. Cash [X] **From** [ ] **To Borrower**	$104,900.00

K. Summary of Seller's Transaction

400. Gross Amount Due to Seller	
401. Contract sales price	$280,000.00
402. Personal property	$20,000.00
403.	
404.	
405.	
Adjustment for items paid by seller in advance	
406. City/town taxes 7/1/20 to 12/31/20	$1,000.00
407. County taxes to	
408. Assessments to	
409.	
410.	
411.	
412.	
420. Gross Amount Due to Seller	$301,000.00
500. Reductions In Amount Due to seller	
501. Excess deposit (see instructions)	
502. Settlement charges to seller (line 1400)	$21,000.00
503. Existing loan(s) taken subject to	
504. Payoff of first mortgage loan	$125,000.00
505. Payoff of second mortgage loan	$45,000.00
506.	
507.	
508.	
509.	
Adjustments for items unpaid by seller	
510. City/town taxes to	
511. County taxes to	
512. Assessments to	
513.	
514.	
515.	
516.	
517.	
518.	
519.	
520. Total Reduction Amount Due Seller	$191,000.00
600. Cash at Settlement to/from Seller	
601. Gross amount due to seller (line 420)	$301,000.00
602. Less reductions in amounts due seller (line 520)	($191,000.00)
603. Cash [X] **To** [ ] **From Seller**	$110,000.00

L. Settlement Charges

				Paid From Borrower's Funds at Settlement	Paid From Seller's Funds at Settlement
700. Total Real Estate Broker Fees					
Division of commission (line 700) as follows :					
701. $ 18,000.00	to GEORGE REALTY (6% OF $300,000)				
702. $	to				
703. Commission paid at settlement					$18,000.00
704.					
800. Items Payable in Connection with Loan					
801. Our origination charge		$	(from GFE #1)		
802. Your credit or charge (points) for the specific interest rate chosen	2% OF $200,000	$	(from GFE #2)		
803. Your adjusted origination charges			(from GFE #A)	$4,000.00	
804. Appraisal fee to XYZ APPRAISERS			(from GFE #3)	$500.00	
805. Credit report to ABC CREDIT COMPANY			(from GFE #3)	$100.00	
806. Tax service to DEF TAX SERVICE COMPANY			(from GFE #3)	$100.00	
807. Flood certification to			(from GFE #3)		
808.					
809.					
810.					
811.					
900. Items Required by Lender to be Paid in Advance					
901. Daily interest charges from	to	@ $	/day (from GFE #10)		
902. Mortgage insurance premium for	months to		(from GFE #3)		
903. Homeowner's insurance for	years to		(from GFE #11)		
904.					
1000. Reserves Deposited with Lender					
1001. Initial deposit for your escrow account			(from GFE #9)	$2,200.00	
1002. Homeowner's insurance 10	months @ $ 100.00	per month	$ 1,000.00		
1003. Mortgage insurance	months @ $	per month	$		
1004. Property Taxes 6	months @ $ 100.00	per month	$ 1,200.00		
1005.	months @ $	per month	$		
1006.	months @ $	per month	$		
1007. Aggregate Adjustment			-$		
1100. Title Charges					
1101. Title services and lender's title insurance			(from GFE #4)	$3,000.00	
1102. Settlement or closing fee		$			$1,000.00
1103. Owner's title insurance			(from GFE #5)	$2,000.00	
1104. Lender's title insurance		$			
1105. Lender's title policy limit $					
1106. Owner's title policy limit $					
1107. Agent's portion of the total title insurance premium to		$			
1108. Underwriter's portion of the total title insurance premium to		$			
1109.					
1110.					
1111.					
1200. Government Recording and Transfer Charges					
1201. Government recording charges			(from GFE #7)		
1202. Deed $	Mortgage $	Release $			
1203. Transfer taxes			(from GFE #8)	$2,000.00	
1204. City/County tax/stamps	Deed $	Mortgage $			$2,000.00
1205. State tax/stamps	Deed $	Mortgage $			
1206.					
1300. Additional Settlement Charges					
1301. Required services that you can shop for			(from GFE #6)		
1302.		$			
1303.		$			
1304.					
1305.					
1400. Total Settlement Charges (enter on lines 103, Section J and 502, Section K)				$13,900.00	$21,000.00

B. Conclusion and analysis

The gain on the sale would be computed as follows:

Sales price		$ 300,000
Less: basis in property		(260,000)
Gross profit		40,000
Less: cost of sale		
Commission	18,000	
Settlement fee	1,000	
Transfer taxes	2,000	(21,000)
Recognized gain on sale		$ 19,000

The following incurred costs detailed on the settlement statement would not be included in the calculation of recognized gain:

Repayment of first mortgage	$ 125,000
Repayment of second mortgage	$ 45,000
Real estate tax credit (this would be shown as a reduction of real estate tax expense deduction in 2018)	$ 1.000

Note:

Since the property was not held for more than one year, it does not qualify as §1231 property. Accordingly, any gain would be recognized as ordinary; not qualified for capital gain treatment. Attached is Form 4797 reporting the gain.

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184

2020

Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
2200 GRIFFITH STREET ASSOCIATES	88-8888888

1	Enter the gross proceeds from sales or exchanges reported to you for 2020 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1	300,000

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):						
RESIDENTIAL REAL PROP						
IN PHILADELPHIA PA						19,000

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	19,000
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	

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It should be noted that:

- Since the property is not §1231 property, the gain is reported on Page 1 of the form as ordinary income (Page 2 of the Form 4797 is used to report capital gains).
- Since the entity recognizing the gain is a partnership, the recognized gain would flow to Schedule K of Form 1065 to be distributed to the partners.

Passive Activity Rules

Passive Activity Rules

Learning objectives

After reviewing the material, the reader will be able to:

- Understand the reason why the passive activity rules were established;
- Be aware of the passive activity rules in general, and in particular how they impact the real estate industry;
- Know the definition of "material participation" and how it interacts with the passive activity rules;
- Know how the passive activity rules impact rental real estate;
- Understand the special $25,000 allowance available in regard to real estate activities; and
- Understand the concept of grouping activities in regard to passive vs. active participation.

I. Introduction

For years, one of the most efficient means of sheltering taxable income was through real estate. A taxpayer could purchase (either individually or through a partnership arrangement) a rental property. This could then create the "best of both worlds" for the taxpayer:

- It could produce positive cash flow …
- … While at the same time, due to depreciation, creating a taxable loss which the taxpayer could offset against other forms of taxable income.

One of the ways Congress "righted" this alleged abuse was by passing the Tax Reform Act of 1986. One of the major provisions of this Act was codified in the Internal Revenue Code under IRC §469. Although IRC §469 was principally enacted in order to discourage abusive tax shelters, as we will discuss throughout this section, its provisions extend far beyond these shelters.

IRC §469 presents taxpayers with a number of new terms that must be considered before taxpayers can deduct a loss on their tax return. Those terms involving "participation" in an activity include:

- Active;
- Passive; and
- Material.

IRC §469 disallows a taxpayer from using losses generated from passive activities to offset income earned on activities which the taxpayer either materially or actively is involved with. In other words, losses from activities which are defined by the Code as passive can generally only be used to offset *passive income*. To the extent passive losses exceed passive income, they cannot be recognized as a current year loss, but generally are considered suspended and must be carried forward to be used to offset passive income generated in future years. These losses are considered *passive activity losses* (PALs).

Accordingly, we now have three areas of the IRC that can limit recognizing a current year loss (which must be considered in the following order):

1. Basis limitations (discussed in Chapter 2);
2. At-risk rules; and
3. Passive activities rules (to be discussed in this chapter).

The passive activity rules we will be discussing kick in only after consideration is made of the at-risk rules.

IRC §469 identifies two separate categories of passive activities:

1. A trade or business in which the taxpayer does not materially participate; and
2. Any rental activity even if the taxpayer materially participates in the activity (with an exception dealing with a real estate professional, which will be discussed later). This includes both personal property (equipment) as well as real estate (which will be the topic discussed in this presentation) even if the taxpayer materially participated in the activity.

Nonpassive activities would include a trade or business in which the taxpayer materially participates (and works at on a regular, continuous, and substantial basis). In addition, nonpassive income includes:

- Salaries and wages;
- IRS Form 1099 commission and other related income;
- Portfolio income (interest, dividends, etc.);
- Investment income;
- Royalties;
- Sole proprietorships in which the taxpayer materially participates;
- Pass-through entities in which the taxpayer materially participates; and
- Trusts in which the fiduciary materially participates.

Note:

The issue of passive vs. nonpassive activities generally does not apply to non-closely held C corporations.

Note:

It should be noted that no significant changes were made to the passive activity rules as a result of the Tax Cuts and Jobs Act which became effective in 2018.

II. Passive income and losses – In general

Before we begin our discussion of passive activities involving real estate, it would make sense to summarize the rules concerning passive activities in general in accordance with IRC §469.

- Income derived from passive activities is recognized as current year taxable income.
- Passive losses generally may only be offset against passive income. The taxpayer may generally not offset passive losses against nonpassive income.
- Income derived from passive activities can be used to offset current year passive losses in addition to prior year suspended passive losses that were carried forward to the current year.
- If a taxpayer does not materially participate in the activity that produces the passive loss, then those losses can only be used against passive income. If there is no passive income, the loss is considered suspended, and accordingly cannot be deducted in the current year but can be carried forward to be utilized in future years.
- These passive activity rules apply to the following types of entities:
  - Individuals;
  - Estates;
  - Trusts (except grantor trusts);

- Closely held C corporations; and
- Personal service corporations.

A. Material participation

Since we have already touched on the subject of material participation in this chapter, it now makes sense to discuss the issue in detail. Keep in mind that material participation applies both to **income** as well as **losses**. In addition, it should be noted that a taxpayer can have a significant financial interest in a business, and not materially participate in that business.

In regard to "tiered" entities, the look-through rule in Reg. 1-469-2T(e)(3)(ii)(D)(3) treats the taxpayer as holding an interest in a subsidiary entity. In other words, we should look to the lowest tier for participation by the individual taxpayer.

Example: Alex Huber, an individual taxpayer, invests in Thorndale Partnership, but does not materially participate in that entity. Thorndale flows losses to Vancouver, Inc., an S corporation in which Alex is a shareholder. According to the look-through rules we just noted, Alex's losses from Vancouver would be treated as passive.

In accordance with IRC §469(h)(1), a taxpayer materially participates in an activity if he or she works on a regular, continuous, and substantial basis in the activity's operations. The IRS has provided further guidance in this area. It defines participation as performing any work that an owner of a business would typically perform. If the work is not typically performed by an owner, and if the reason for doing the work was to avoid the passive loss rules, then the activity will not be deemed to be material participation.

For example, a taxpayer will generally not perform general secretarial work for the entity. Therefore, any such work being performed by an owner solely for the purpose of appearing to materially participate would probably not result in material participation.

The IRC has also stated that the following would indicate material participation:

- Making decisions in the operations or management of the activity;
- Hiring and firing employees; or
- Actually performing some the services required of the activity.

At the same time, the following would indicate nonmaterial (passive) participation:

- The taxpayer has no authority in operating the activity and may only have the authority to remove the manager but none of the employees; or
- The manager is an independent contractor.

1. Seven participation tests

The IRC has provided specific guidance to determine whether the taxpayer materially participates in an activity. The material participation requirement is met only if one of the following seven participation tests, as detailed in Reg. 1.469-5T(a), are met:

a. The taxpayer works 500 hours or more during the year in the activity. By the way, for purposes of determining 500 hours, participation of both the taxpayer and the taxpayer's spouse is counted, but **not** participation of the taxpayer's children or employees. This particular test will help to prevent most taxpayers from treating income from a passive activity as active income, since 500 hours would require a substantial amount of both

effort and time, which most taxpayers would be unable or unwilling to accomplish, especially if they were working at a full-time job or an active business.

b. The taxpayer does substantially all the work in the activity. This is defined as the taxpayer performing most of the work required by the entity. The involvement in the activity of an employee or non-owner could cause the taxpayer to fail this test. The theory behind this particular test is that if the taxpayer is doing most of the work for the activity, then it is an active business that may not require 500 hours, and accordingly, it should be classified as active income. On the flip side, if the taxpayer had non-owner employees doing most of the work, then the question would be raised as to whether the taxpayer's participation was necessary -- whether it was just a means to classify the passive activity as active.

c. The taxpayer works more than 100 hours in the activity during the year and no one else works more than the taxpayer. This would include work performed by the taxpayer's children, employees, and even non-employees. Although 100 hours is less than the 500 hours noted in the first test, it is reasonable that if the taxpayer participates at least as much as anyone else, then it was not just a means to classify the passive activity as active.

d. The activity is a significant participation activity (SPA), and the sum of SPAs in which the taxpayer works 100-500 exceeds 500 hours for the year. The IRS defines an SPA as one in which the taxpayer is active for more than 100 hours during the tax year. Therefore, in order to satisfy this particular test, the taxpayer must have a number of activities where he or she spends more than 100 hours actively participating in the activity and where the sums of those hours exceed 500. If the taxpayer spends 100 hours or fewer in a given activity, then the hours in that activity are not counted toward the 500-hour requirement.

e. The taxpayer materially participated in the activity in any five of the prior 10 years. If this happens to be true, then the activity is classified as active.

f. The activity is a personal service activity and the taxpayer materially participated in that activity in any three prior years, thereby classifying the activity as active.

g. Based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during such year. However, this test only applies if the taxpayer works at least 100 hours in the activity; no one else works more hours than the taxpayer in the activity; and no one else receives compensation for managing the activity. This rule is designed to prevent taxpayers from coming in for 101 hours to manage the business so that the activity can be classified as active, even though there is a full-time manager for the business.

If the taxpayer meets one of these seven tests, the activity is deemed to be nonpassive materially participating.

It should be noted that the rationale behind the seven tests is presented as follows:

- The first four tests look to set the number of hours of participation in that particular tax year. The IRS is trying to prevent the taxpayer from classifying passive activities as active.
- The next two tests look to material participation in prior tax years. The IRS is trying to prevent taxpayers from classifying active income as passive income so that passive losses can be deducted from it. The assumption seems to be that if the taxpayer materially participated in an activity in the past, then he or she will continue to do so in the future. Accordingly, the presumption is that if a taxpayer tries to change what was

once an active activity into a passive activity, then the taxpayer is probably trying to classify active income as passive income in order to be able to deduct passive losses against them.

- The final test looks to the facts and circumstances, but is obviously highly restrictive.

Note:

It is the taxpayer's responsibility and burden of proof to show documentation indicating how the taxpayer was in compliance with any of the seven above-detailed conditions in order to prove material participation in the activity in the event of an IRS examination.

How is this accomplished? To quote Temp. Regs. §1.469-5T(f)(4):

> The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required. The extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the appropriate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

To summarize, for a taxpayer who engages in any activity (including rental real estate), it would be prudent to prepare and maintain documentation to substantiate the time spent on and the services performed regarding the specific activity. This is especially applicable regarding taxpayers who are employed in non-real property trades or businesses and must establish that they are real estate professionals (which we will be discussing next) who devote more than 50 percent of their personal services during the year to real property trades or businesses.

By the way, material participation is a year-by-year determination. Consequently, it is conceivable that a taxpayer could be passive in one year and active (materially participating) in other years.

B. Grouping of activities

One method of complying with the material participation test is known as "grouping of activities." Related businesses that form an appropriate economic unit are treated as a single "activity" for the purpose of demonstrating material participation. Whether reported on a Form 1040, Schedule C; Form 1065 (partnerships and limited liability companies); Form 1120 (C corporation); or Form 1120S (S corporation), various endeavors the taxpayer is involved in may be grouped into one activity. In other words, as per IRC §§1.469-4(c) and 1.469-4(d)(4), an activity is not constrained solely by an entity line.

By grouping related businesses as a single activity, the taxpayer can more easily meet the 500-hour test for material participation. However, it is important that the taxpayer only group activities that are considered appropriate. Grouping of activities will be discussed in greater detail later in this chapter.

C. Suspended losses

As we have previously noted, passive losses are generally only deductible up to the amount of passive income. Any excess passive loss as defined by IRC §469 is deemed to be a "suspended loss." The taxpayer may carry the suspended losses forward indefinitely. These suspended losses will be able to be used if one of the following two conditions is met:

1. The taxpayer recognizes passive income in a subsequent year; or
2. The taxpayer fully disposes of the activity. Once the activity is disposed, any suspended losses can be utilized (deducted) in full.

D. Example

We will now provide an example of these concepts based on the following set of facts involving Howard Sanders, a real estate investor not defined as a real estate professional (real estate professional status will be discussed shortly):

1. Facts

For tax year 2019, Sanders had a passive loss of $8,000 and passive income of $3,000.

For tax year 2020, he had a passive loss of $4,000, but no passive income.

For tax year 2021, he had $1,000 of passive losses and $2,000 of passive income.

For tax year 2022, he had no passive income or losses, but made an entire disposition of the activity that was generating the passive losses.

2. Solution

The following table will demonstrate how the passive losses should be recognized.

Howard Sanders					
Year	**Balance Forward Suspended Losses**	**Current Year Passive Loss**	**Current Year Passive Income**	**Current Year Passive Loss Allowed**	**Suspended Current Year Passive Loss**
2019	–	(8,000)	3,000	3,000	(5,000)
2020	(5,000)	(4,000)	–	–	(9,000)
2021	(9,000)	(1,000)	2,000	2,000	(8,000)
2022	(8,000)	–	–	8,000	–
Note: Due to the entire disposition of the activity causing the suspended losses, the previously suspended loss is allowable in 2022.					

III. Real estate rental activities

So now that we have provided the general rules of passive activities and material participation, we can move to the main topic of this presentation: real estate rental activities.

Section 1.469-9(b)(3) provides the following definition:

> Rental real estate is any real property used by customers or held for use by customers in a rental activity within the meaning of 1.469-1T(e)(3).

Temp. Regs. §1.469-1T(e)(3)(i) provides that an activity is a rental activity if "during such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers."

A. Exceptions to the general rule

The following are six exceptions to the general rule and by definition are not considered to be rental activities as per Reg. 1.469-1T(e)(3)(ii):

1. The average period of customer use of the property is seven days or less (e.g., a hotel).
2. The average period of customer use of the property is 30 days or less, **and** significant personal services are provided by or on behalf of the property in connection with making the property available for use by customers.
3. Extraordinary personal services are provided by or on behalf of the owner of the property in connection with making such property available for use by customers, without regard to the average period of customer use (e.g., a patient in a hospital).
4. The rental of the property is treated as incidental to a nonrental activity of the taxpayer.
5. The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers.
6. The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity.

B. Exceptions to the passive activity rule

We previously noted that by definition in accordance with IRC §469, rental activities (including real estate) generally are passive by nature even if the taxpayer materially (as defined above) participates in the activity. However, as we will discuss in this section, there are special rules for some taxpayers. Losses from real estate rental activities are considered passive and are not currently deductible unless one of the following four situations applies:

1. Passive income exists (as we have previously noted, passive losses are allowed only to the extent of passive income).
2. The taxpayer actively participates in a rental real estate activity and qualifies for the $25,000 special allowance.

Note:

The special allowance is available only for real estate rentals. It is not available for the rental of equipment (personal property). Accordingly, equipment rentals are always considered passive activities whether or not the taxpayer materially participates in the activity.

3. There is an entire disposition of a passive activity [as per IRC §469(g)].
4. The taxpayer meets the requirements of a "real estate professional," as defined by IRC §469(c)(7).

We will now further discuss these four issues.

1. Situation #1 – Passive income exists

Since passive losses can generally only be offset against passive income, if a particular activity is anticipated to throw off passive income, it may make sense for the taxpayer to avoid material participation in the activity. This would be accomplished by not being in compliance with any of the seven conditions noted earlier in this chapter.

Example: Emilio is involved in a rental activity that is expected to generate passive income. Originally, Emilio had planned to work 10 hours per week for this activity, which would then satisfy the 500-annual-hours requirement (the first requirement detailed above). In order to be able to utilize passive losses, it may be advantageous for Emilio to work less than 10 hours per week, thereby allowing him to recognize the activity as passive (assuming he is in compliance with any of the other six passive activity requirements previously discussed).

2. Situation #2 – Special allowance

One of the most important "loopholes" to the passive activity rules involves a special rule allowing qualifying taxpayers (individuals and estates) to offset up to $25,000 of nonpassive income against losses generated from rental real estate activities in accordance with IRC §469(i)(B).

In order to qualify for this particular deduction, the following needs to occur:

a. The taxpayer must own at least 10 percent of the value of all interests in the activity at all times during the tax year. (When measuring an individual's ownership in a rental real estate activity, any spousal interest may also be included.)

b. The taxpayer must **actively** participate in the operations of the rental property in both the year the loss is incurred and the year recognition is sought if the years are different under the carryover provisions.

c. The taxpayer's modified adjusted gross income (MAGI) generally does not exceed $100,000 (although we will shortly discuss one exception to this rule).

d. If at any time during the tax year the taxpayer's interest falls below 10 percent of the value of all interests in the activity, the taxpayer is deemed not to be active.

e. A taxpayer who owns rental real estate through an interest in the following types of entities does not meet the standard of active participation:
   (i) A limited partnership.
   (ii) A trust or corporation (with the exception of a grantor trust owned by a natural person since it is not deemed a separate entity).
   (iii) A taxpayer whose rental activity consists of a net lease. (Under a net lease, the tenant pays most of the expenses.)

The rules of active participation are less stringent than the rules concerning material participation. The following is a summary of active participation rules:

- It does not require regular, continuous, and substantial involvement in the operations.
- Instead, the taxpayer must participate in a significant way.
- This participation could be demonstrated by:
  - Making management decisions;
  - Arranging for others to provide services;
  - Approving new tenants;
  - Setting rental policies and terms; and
  - Approving capital expenditures or major repairs.

To summarize, let us take a look at verbiage from an IRS training manual provided to its auditors:

> As long as a taxpayer participates in management decisions in a bona fide sense he (or she) actively participated in the real estate rental activity. There is no specific hour requirement. However, the taxpayer must be exercising independent judgment and not simply ratifying decisions made by a manager.

We will now provide a few examples of the concept of active participation.

Example 1: Earl, a resident of Seattle, Washington, together with his next-door neighbor, purchased a residential apartment complex in Spokane, Washington. Each owns 50 percent of the investment. It was agreed that the neighbor would be

responsible for managing the property. Earl's only function would be to cash the quarterly profit checks generated from the investment.

Even though Earl owns more than 10 percent of the investment (thereby satisfying the first requirement), since he does not participate in a significant way in the management of the property, his participation in the property would *not* be considered active and accordingly, any losses generated by the property would be considered by Earl to be passive.

Note:

The neighbor's participation would in fact be considered active.

Example 2: Dorothy, a resident of Portland, Oregon, decided to purchase a commercial property in San Diego, California, together with Shelly, a childhood friend. The understanding between the two participants was that Shelly would put up most of the capital (92 percent) while Dorothy, who only contributed 8 percent of the capital, would be responsible for the day-to-day management of the property.

Even though Dorothy meets the requirement of participating in a significant way in the management of the property, since her ownership is less than 10 percent, her participation in the property would **not** be considered active and accordingly, any losses generated by the property would be considered by Dorothy to be passive.

Note:

Shelly's participation would also not be considered active since she did not participate in a significant way in the management of the property.

Example 3: David, a resident of Columbus, Ohio, purchased an apartment complex in Scranton, Pennsylvania. David never visits the Scranton property, has all rents sent to him by way of mail, and hires contractors and consultants to handle problems related to the property. David also personally approves all new tenants and sets monthly rental rates.

Even though David never physically visits the property, the fact that he has more than a 10-percent interest in the property (the first condition), and makes all management decisions -- who to hire, approving new tenants, etc. (the second condition) -- his participation in this activity would be considered active and any passive losses generated by the property would be eligible for the special $25,000 rental real estate loss allowance.

Now that we have determined which taxpayers are eligible to take the special $25,000 offset, next we have to determine the taxable income limitation. According to §469(i)(3), the $25,000 maximum amount that can be used to reduce nonpassive income is reduced by 50 percent of the amount by which the taxpayer's modified adjusted gross income (MAGI) exceeds $100,000. Accordingly, for most filing statuses (single, married filing jointly, head of household, and qualifying widow), when the taxpayer's MAGI exceeds $150,000, the special $25,000 deduction is completely lost even if he or she actively participates in the rental activity.

Note:

For taxpayers who file married filing separately, the maximum deduction is reduced to $12,500 and phases out by 50 percent of the amount by which the taxpayer's MAGI exceeds $50,000. Accordingly, when the taxpayer's MAGI exceeds $75,000, the special $12,500 deduction is completely lost even if he or she actively participates in the rental activity.

MAGI is calculated as follows:

- Start with Adjusted Gross Income (AGI) (Line 37 from Form 1040)
- This amount is reduced by the following:
  - Individual Retirement Account (IRA) deductions (Form 1040 Schedule 1 Line 19);
  - Student loan interest deduction (Form 1040 Schedule 1 Line 20);
  - Taxable Social Security benefits (Form 1040 Line 5a); and
  - Any passive losses allowed under the exception for real estate professionals (to be discussed shortly)
- This amount is increased by the following:
  - Income excluded for U.S. savings bond interest used for higher education expenses; and
  - Employer provided adoption assistance program

To wrap up this section, the following are recommendations that should be considered in order to potentially maximize the use of the $25,000 special allowance by way of reducing the amount of AGI and ultimately MAGI:

a. Whenever feasible, avoid filing under the married filing separate status, since this results in the reduction in both the amount of the allowance ($12,500 vs. $25,000) and the amount of MAGI which would result in its disallowance ($75,000 vs. $150,000).

b. If a self-employed taxpayer (filing a Form 1040 Schedule C) has historically used the accrual method of accounting, the taxpayer should consider switching to the cash method if it does in fact result in a deferral in the recognition of taxable income.

c. Maximize contributions to retirement plans (SEP, Keogh, etc.).

Note:

This would not apply to contributions to an IRA. As we previously discussed, IRA contributions are added back to AGI when computing MAGI.

d. Rather than investing in taxable securities, consider investing in tax-exempt securities.

3. Situation #3 – Disposition of a passive activity

As we have previously discussed, if a taxpayer entirely disposes of a passive activity, then any suspended losses will be able to be deducted in the year of disposal. Accordingly, a prudent tax planning tool may be considered: If the opportunity presents itself to sell a property involving a passive activity prior to a taxpayer's year-end, and the taxpayer has suspended passive losses, then it may make sense for the taxpayer to settle the property prior to his or her year-end in order to utilize the suspended passive losses.

4. Situation #4 – Real estate professional

Finally, we need to discuss the issue of being classified as a "real estate professional." A major exception to the rule that generally all rental activities are deemed passive (including real estate rentals) applies if a taxpayer is deemed to be a real estate professional as defined by IRC §469(d)(2). Per the Code, if the taxpayer qualifies as a real estate professional, the taxpayer's rental real estate activity escapes the per se passive activity rule otherwise applicable to the rental activity.

A Congressional Committee report provided an explanation for this particular exception:

> The Committee considers it unfair that a person who performs personal services in a real estate trade or business in which he (or she) materially participates may not offset losses from rental real estate activities against income from nonrental real estate activities or against other types of income such as portfolio or investment income.

A taxpayer would be considered a real estate professional if he or she satisfies both of the following two conditions:

a. More than one-half of the total personal services the taxpayer performs in trades or businesses are performed in real property trades or businesses in which the taxpayer materially participates; and
b. The taxpayer performs more than 750 hours of services during the tax year in real property trades or business in which the taxpayer materially participates.

Although the IRC does not specifically refer to individuals meeting these two conditions as real estate professionals, various IRS regulations, publications, and Tax Court rulings refer to the taxpayers in real property businesses who meet the stipulated statutory requirements as real estate professionals.

In order to be classified as a real estate professional, an individual must spend the majority of his or her time in real property businesses, which include:

a. Development or redevelopment;
b. Construction or reconstructions;
c. Acquisition;
d. Rental;
e. Management or operation;
f. Leasing; and
g. Brokerage.

However, it should be noted that in addition to proving that they are real estate professionals, taxpayers must also prove that they materially participated (as previously discussed) in the rental real estate activity.

Taxpayers who engage in multiple rental real estate activities must treat each activity as a separate activity, unless he or she elects under IRC §469(c)(7) to treat all rental real estate activities as one activity (a concept known as “grouping,” introduced earlier in this chapter).

The issue of “real estate professional” must be taken very seriously by the CPA profession. The IRS has been very aggressive in pursuing what they consider abuse in this area whereby taxpayers are inappropriately ignoring the passive loss limitation rules and taking inappropriate deductions under the belief that they are what the IRC defines as a real estate professional.

An example of this involves a recent Tax Court ruling whereby it was held that a real estate broker was not considered a real estate professional. The taxpayer brokered real estate mortgages and other loans secured by real property. The taxpayer was a licensed real estate agent, but did not operate, develop, redevelop, construct, reconstruct, or rent real estate in brokering mortgages. He did however manage and maintain various properties owned by himself and family members. He received annual compensation of $6,000 for these services, but did not maintain the required records of the hours spent.
On his 2011 and 2012 tax returns, the taxpayer claimed rental real estate loss deductions for the properties. He argued to the Court that his mortgage brokerage services should be included for purposes

of satisfying the real estate professional test (that we detailed above). Additionally, the taxpayer prepared a non-contemporaneous calendar for each month reflecting time spent on property management and mortgage brokerage services.

The Tax Court held that the taxpayer's mortgage brokerage services did not constitute real property trades or businesses under IRC §469(c)(7)(C). While the brokered loans were secured by real property, the taxpayer's services did not involve operating the real properties. In addition, the Court held that while his mortgage brokerage services were a brokerage trade or business, they were not a real property brokerage trade or business, as he did not broker real estate, only loans.

C. Grouping real estate activities

Taxpayers who engage in multiple rental real estate activities may find it difficult to qualify as real estate professionals (as defined) if they do not make this particular election -- as we will now demonstrate.

> ***Example:*** Norman owns four rental properties in the Seattle metropolitan area: Buildings 1, 2, 3, and 4. Norman materially participates in Building 1, but does not materially participate in Buildings 2, 3, or 4. If Norman did not make the grouping election to treat the four buildings as one activity, he would need to satisfy the material participation requirements for each of the four buildings in order to avoid the passive activity limitations.

Keep in mind that as per Regs. §1.469-9(e)(3)(i), the taxpayer may not group rental real estate activities with non-rental real estate activities in determining his or her material participation in rental real estate activities unless either activity is insubstantial when compared to the other activity. This would include the grouping of real property and personal property.

The following entities can make this grouping election:

- Individuals;
- Closely held C corporations;
- Personal service C corporations;
- S corporations;
- Partnerships;
- Estates; and
- Trusts.

The election must be made by the due date (including extensions) of the applicable tax return for the year in which any of the following occurs:

1. Two or more activities are first grouped together;
2. A new activity is added to an existing group; or
3. An existing group is regrouped.

1. Sample election

The following is a suggested format for making the election:

> Taxpayer name: Mayer Norman, LLC
> Taxpayer ID No.: 12-3456789
> The taxpayer hereby reports the following grouping activity in accordance with Rev. Proc. 2010-13
> NEW GROUPINGS

The following activities have been grouped as a single activity:

Name of Activity **Address** **ID Number** **Business or Rental**

_____

ADDITION OF ACTIVITIES TO AN EXISTING GROUP

The following activities have been added to a previously existing group during the current tax year

Activities Added **Address** **ID Number** **Business or Rental**

_____

REGROUPING OF ACTIVITIES

The following activities have been regrouped due to error in original grouping or a change in acts and circumstances during the current tax year

Revised Grouping

Name of Activity **Address** **ID Number** **Business or Rental**

_____

The following are reasons are provided for this regrouping

_____

---------- hereby declares that any and all groupings created above constitute an appropriate economic unit for the measurement of gain or loss for purposes or IRC Sec. 469

Installment Sales

Installment Sales

Learning objectives

Upon reviewing this material, the reader will be able to:

- Understand the general rules concerning installment sales in general and how they apply to real property in particular;
- Learn which properties are permitted and which are prohibited from using the installment method;
- Learn the differences between a "dealer" and a "non-dealer" regarding installment sales;
- Learn the implications of installment sales involving related parties;
- Understand the computations involving installment sales; and
- Learn, through a detailed case study, how to complete Form 6252.

I. Introduction

There is another venue available under certain circumstances for some taxpayers to defer immediate recognition of income resulting from gain from the sale of real estate, known as an *installment sale*. IRC §453 defines an installment sale as any disposal of property where at least one payment is received after the close of the tax year.

Although Congress considered it, the final Tax Cuts and Jobs Act which became effective in 2018 did not make any changes to existing law concerning the use and taxation of installment sales.

II. General rules concerning installment sales

The following are general rules concerning the use of the installment method to report installment sales under IRC §453:

- The installment method is used for reporting gains from an installment sale;
- The installment method cannot be used for reporting losses;
- The installment method applies to an installment sale even if only one payment is to be received, as long as that payment is received in a tax year following the year of sale;
- The installment method applies without regard to the timing of the transfer of title (e.g., even if the transfer of title will not incur until after all of the agreed-upon selling price has been paid);
- The installment method may apply to the sale of a single asset, the sale of several assets, or the sale of a business;
- Installment sales apply (when allowed) to both personal property and real property (which will be the focus of this chapter); and
- The taxpayer has the option to "elect out" of the installment method for properties sold for gains.

A. Electing out of the installment method

A few additional comments concerning the "elect out" option noted in the last bullet point:

This "election" must be made on or before the due date for filing the taxpayer's tax return (including extensions) for the year of sale and is made by reporting the entire gain as income in the year of sale on Form 4797, *Sales of Business Property,* for property held in a trade or business; or on Form 1040,

Schedule D, *Capital Gain or Loss*, and Form 8949, *Sales and Other Dispositions of Capital Assets*, for property held for investment. Consequently, Form 6252, *Installment Sale Income*, should not be filed.

The election must be made property by property, which means that a taxpayer can elect out for one sale and use the installment method for other sales in the same year.

It should be noted that based on facts and circumstances, a taxpayer may want to elect out of the use of the installment method. Why would a taxpayer want to make this election and accelerate the recognition of income? The only situation in which it may make sense would be if the taxpayer has expiring carryforwards (net operating loss, charitable contributions, or investment credits) that would not be able to be utilized if the taxpayer deferred income recognition by using the installment method.

If a partnership or S corporation (i.e., pass-through entity) enters into an installment sale during the year, an election not to use the installment method must be made at the partnership or S corporation level. Accordingly, partners and shareholders must use the method adopted at the entity level to report their portion of installment sale income.

The following transactions are prohibited from using the installment method:

- Sales of inventory related to personal property;
- Sale of stocks and securities traded on an established securities market;
- Sales of depreciable property to a related person;
- Sales of personal property under a revolving credit plan;
- Sales of publicly traded property;
- Gains attributable to depreciation recapture; and
- Sales made by a dealer (which we will soon discuss in more detail).

According to IRC §453(B), an installment obligation may be sold, satisfied at other than face value, or otherwise disposed of before all the gain from the installment sale has been recognized. In this situation, with a couple of very unusual exceptions, the entire unrecognized gain would be fully recognized in the year this occurs.

It should also be noted that an installment sale gain for regular tax purposes may differ from the installment sale gain recognized for alternative minimum tax (AMT) purposes resulting from a different adjusted basis of the real property sold due to different depreciation methods.

B. Dealer vs. non-dealer

The final bullet point in the previous section had noted that a “dealer” may not use the installment method. So now would be the time to discuss this issue in more detail and provide a couple of examples of this concept.

The Internal Revenue Code forbids use of the installment method for sales on dealer property. If a taxpayer is defined as a dealer, then they can only sell assets other than inventory. If a taxpayer is defined as a non-dealer, then they can utilize the installment method for both inventory and assets other than inventory.

Generally, a dealer in real property is any taxpayer who holds real property primarily for sale to customers in the ordinary course of a trade or business.[1] A non-dealer (i.e., investor) is a "passive" owner who holds real property for future increase in value or for present income-producing potential. The ultimate determination is based on the taxpayer's activities in connection with the property. The following factors have been used in recent Tax Court rulings in deciding the dealer vs. non-dealer issue:

- Was the taxpayer involved in a trade or business? If so, what business?
- The number and frequency of sales during a certain period;
- The purpose and use for which the property was acquired and later held;
- The time elapsed between the purchase and sale date;
- The taxpayer's actions in advertising and promoting sales;
- The amount of time the taxpayer spends to improve and/or develop the property in preparation for sale;
- The degree of supervision or control exercised over the property's sale;
- The amount of gain derived from sales compared to the taxpayer's other income;
- The existence of a liquidation intent at the time of the sale;
- The taxpayer's involvement in purchasing developing and selling property before, during, and after the years of the sales in question; and
- The replacement of the properties disposed of with additional real property.

It is obvious that the burden will be on the taxpayer to prove to the IRS that he or she is not a dealer, and accordingly may use the installment method.

We will now provide a couple of examples demonstrating the dealer vs. non-dealer issue:

Example 1: Melvin owns an automobile dealership located in Renton, Washington. Melvin sells his automobiles to customers. Since the automobiles would be considered Melvin's inventory, he would not be able to use the installment method, even if a customer pays for the purchase of the automobile over time.

Example 2: Eli is a construction contractor also located in Renton, Washington. Eli uses a company-owned automobile to travel to various job sites. During 2020, Eli sold the automobile to a third party in a deal where payment for the purchase would be made over a three-year period. Eli is considered a non-dealer. And since at least one payment is scheduled to be received after the close of his tax year, Eli can use the installment method for this particular sale.

III. Installment sales involving related parties

When discussing the tax treatment using the installment method throughout this chapter, we are assuming the sale was made with an unrelated party. However, if the sale is made with a party related to the taxpayer, things get more complex. This will be our current focus.

A. Depreciable vs. nondepreciable property

First off, we need to differentiate between depreciable property and nondepreciable property.

- Depreciable property is defined as any property that can be depreciated by the purchaser.
- All payments from sales of depreciable property are deemed received in the year the sale occurs.

[1] IRC §1221(1).

- The purchaser in the related party sale cannot increase his or her basis of the property acquired in the transaction until the income has been report by the seller.

The following are the key issues:

- Gain recognized from the sale or exchange of depreciable property between related parties is treated as ordinary gains; and
- Installment reporting cannot be used on sales of depreciable property between related parties.

There is one exception to the gain recognition rule we just mentioned. According to IRC §453(g)(3), if the taxpayer can demonstrate that the transaction's principal purpose was not the avoidance of federal income tax, he or she can then report the sale under the installment method. A lack of a significant tax deferral can be used to establish that avoidance of federal income taxes was not the transaction's principal purpose.

According to an IRS Letter Ruling, when the sale or exchange to a related party involves both depreciable and nondepreciable property, the gain should be allocated between the two types of property. The installment method can be used only on the gain from the sale of nondepreciable property.

Example: Roy North sold a property to Aaron Associates, a related party. The total sales price, which equaled the fair market value, was $200,000 (20%) for the land (nondepreciable property) and $800,000 (80%) for the building. Accordingly, that portion of the gain attributed to the building is not eligible for installment sale treatment and income must be recognized in full in the year of sale while the portion of the gain related to the land is eligible for installment sale treatment.

We now must ask the question: What is a related party, for installment sales purposes? For installment sales of depreciable property, related parties include:

- Individuals and all entities controlled by the individual;
- More-than-50-percent-owned corporations (based on stock value);
- Partnerships (based on capital or profits ownership);
- Two partnerships in which the same person owns, directly or indirectly, more than 50 percent of the capital interests or profit interests;
- An estate and a beneficiary of the estate (with a few exceptions); and
- A trust and a beneficiary of the trust (with a few exceptions).

B. Two-year disposition rule

One of the most important issues that must be considered in a sale to a related party is known as the **two-year disposition rule**. According to IRC §453(e), recognized gain on the installment sale of property to a related party is accelerated if the related party disposes of the property within a two-year period. According to IRC §453(f)(1), for purposes of the two-year disposition rule, a related party includes:

- A spouse;
- A child;
- A grandchild;
- A parent;
- A sibling; or
- A related C corporation, S corporation, partnership, estate, or trust.

1. Exceptions

There are three exceptions to this general rule:

a. The second disposition is the result of an involuntary conversion, and the first conversion occurred before the threat of conversion.

b. The second disposition occurs after the earlier of the deal of --

(i) The person marking the first disposition, or

(ii) The person who acquired the property in the first disposition; or

c. Neither the first nor the second disposition had tax avoidance as one of its principal purposes (as we previously discussed). Generally, second dispositions that are involuntary (e.g., the result of bankruptcy or foreclosure) are not considered to be tax motivated. If the terms of payment on the second disposition are substantially equal to or longer than those of the first disposition, the second disposition generally will not be viewed as tax motivated.

IV. Calculating the installment sale

Before we discuss the issue of calculating the installment sale, we need to define a number of terms that will be used throughout this section.

A. Definitions

- **Selling price:** The total consideration received by the seller for the sale of property. This would include both the fair market value of the property and any debt assumed by the buyer.
- **Adjusted basis:** Generally is determined by taking the seller's original cost of the property, then increasing it for any improvements or additions and decreasing it for any depreciation. Basis also includes expenses paid by the seller.
- **Gross profit:** The selling price less the seller's adjusted basis in the property sold (i.e., the expected gain on the sale).
- **Total contract price:** Represents the selling price less any qualified indebtedness assumed by the buyer (but only to the extent that the debt assumed does not exceed the seller's basis in the property sold). For this purpose, qualified debt is defined as a mortgage or other indebtedness encumbering the property, and indebtedness not secured by the property, but incurred or assumed by the purchaser incidental to the purchaser's acquisition, holding, or operation of the property.
- **Gross profit percentage:** Represents the ratio of the gross profit to the contract price.

B. Taxation of payments

As we previously discussed, unless the taxpayer elects out, any qualified sale when amounts are received after the end of the tax year occurred are required to use the installment method. Now is the time to discuss the mechanics.

Under the installment method, income is recognized for any taxable year in proportion to the payments received in that year. The payments themselves are taxed based on the following three components:

1. **Capital gain** – Calculated each year by multiplying the gross profit percentage on the sale by the total value of the installment payments (not including interest) received during the year. This amount is reported by the taxpayer as a capital gain.

2. **Return of capital (basis)** – Any amount of the payment remaining after gain has been accounted for is considered a return of the seller's basis. This amount is non-taxable to the seller.
3. **Interest income** – Amounts received by the seller in addition to the principal payments. This amount is reported as portfolio income by the seller.

For each payment received in connection with an installment sale, the seller must determine the correct amount of the aforementioned three items.

C. Case study

We will now provide a straightforward example.

1. Facts

Costanza, LLC sold a parcel of land located in Queens, New York, to Kramer, LLC, on October 15, 2019. Costanza and Kramer are not related parties. The terms of the sale are as follows:

Sales price:	$ 1,200,000
Costanza's basis in the land (original cost)	$ 800.000
	$ 200,000

Payment terms are as follows:

	Total	Principal	Interest
2019	$ 800,000	$ 790,000	$ 10,000
2020	160,000	130,000	30,000
2021	160,000	138,000	22,000
2022	160,000	142,000	18.000
Total payments	$ 1,280,000	$ 1,200,000	$ 80,000

Other pertinent information:
The property was originally purchased by Costanza on May 10, 2007.

Since some payments are scheduled to be received by Costanza after the year of sale, the gain on the sale qualified for installment sale treatment.

Costanza did not elect out the installment method.

Kramer did not assume any of Costanza's debt.

Since the property consisted solely of vacant land, there was no depreciation taken which could be subject to the recapture rules.

The land was held by Costanza for investment.

2. Solution

Solution to the case study:

The gross profit Costanza will recognize is computed as follows:

Sales price	$ 1,200,000
Less: cost basis	(1,000,000)
Gross profit	$ 200,000

Since Kramer did not assume any of Costanza's debt, the contract price equals the sales price of $1,200,000.

The gross profit percentage would be 16.67% (200,000/1,200,000). Accordingly, 16.67% of every dollar collected by Costanza from Kramer would be considered a capital gain (with the balance of the payment allocated between principal i.e., return of capital, and interest income).

V. Form 6252

Installment sales are reported on Form 6252, *Installment Sales*. The form is required to be completed and attached to the taxpayer's tax return in any year that property is sold in a qualifying installment sale and in any year that the taxpayer receives a payment from an installment sale, assuming the taxpayer did not elect out of the installment method (previously discussed). Attached is a blank Form 6252.

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.
▶ Go to *www.irs.gov/Form6252* for the latest information.

OMB No. 1545-0228

2020

Attachment Sequence No. **67**

Name(s) shown on return | Identifying number

1	Description of property ▶			
2a	Date acquired (mm/dd/yyyy) ▶	b Date sold (mm/dd/yyyy) ▶		
3	Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4		☐ Yes	☐ No
4	Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale		☐ Yes	☐ No

Part I **Gross Profit and Contract Price.** Complete this part for all years of the installment agreement.

5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7			
8	Cost or other basis of property sold	8			
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10			
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form. See instructions			14	
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. See instructions. Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	
18	**Contract price.** Add line 7 and line 17			18	

Part II **Installment Sale Income.** Complete this part for all years of the installment agreement.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. (For years after the year of sale, see instructions.)			19	
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated			21	
22	Add lines 20 and 21			22	
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	
25	Enter the part of line 24 that is ordinary income under the recapture rules. See instructions			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions			26	

Part III **Related Party Installment Sale Income. Don't** complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party ▶

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy) ▶

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

d ☐ The second disposition occurred after the death of the original seller or buyer.

e ☐ It can be established to the satisfaction of the IRS that tax avoidance wasn't a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See instructions.

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2020 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules. See instructions	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions	37	

A. Components

The form consists of three parts:

1. Gross Profit and Contract Price – to be completed only in the year of sale.
2. Installment Sale Income – to be completed both in the year of sale and any year the taxpayer receives a payment.
3. Related Party Installment Sale Income – only applies if the installment sale was with a related party (as we previously discussed).

B. Example solution

We will now present, based on the Costanza, LLC, example, completed Forms 6252 for 2019 and 2020.

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.
▶ Go to *www.irs.gov/Form6252* for the latest information.

OMB No. 1545-0228

2019

Attachment Sequence No. **67**

Name(s) shown on return: **COSTANZA, LLC**

Identifying number: **99-9999999**

1 Description of property ▶ **LAND LOCATED IN QUEENS, NEW YORK**

2a Date acquired (mm/dd/yyyy) ▶ **5/10/2007** b Date sold (mm/dd/yyyy) ▶ **10/15/2019**

3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 . . . . ☐ Yes ☑ No

4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . . ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.

5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	1,200,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6	0		
7	Subtract line 6 from line 5	7	1,200,000		
8	Cost or other basis of property sold	8	800,000		
9	Depreciation allowed or allowable	9	0		
10	Adjusted basis. Subtract line 9 from line 8	10	800,000		
11	Commissions and other expenses of sale	11	200,000		
12	Income recapture from Form 4797, Part III (see instructions)	12	0		
13	Add lines 10, 11, and 12			13	1,000,000
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form (see instructions)			14	200,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-			15	0
16	**Gross profit.** Subtract line 15 from line 14			16	200,000
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	0
18	**Contract price.** Add line 7 and line 17			18	1,200,000

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. (For years after the year of sale, see instructions)			19	16.67%
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	0
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated			21	790,000
22	Add lines 20 and 21			22	790,000
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	131,693
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)			25	0
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)			26	131,693

Part III Related Party Installment Sale Income. Don't complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy) . . . ▶

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

d ☐ The second disposition occurred after the death of the original seller or buyer.

e ☐ It can be established to the satisfaction of the IRS that tax avoidance wasn't a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2019 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.
▶ Go to *www.irs.gov/Form6252* for the latest information.

OMB No. 1545-0228

2020

Attachment Sequence No. **67**

Name(s) shown on return: COSTANZA, LLC

Identifying number: 99-9999999

1 Description of property ▶ LAND LOCATED IN QUEENS, NEW YORK

2a Date acquired (mm/dd/yyyy) ▶ 5/10/2007 b Date sold (mm/dd/yyyy) ▶ 10/15/2019

3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 . . . . ☐ Yes ☑ No

4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . . ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.

5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7			
8	Cost or other basis of property sold	8			
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10			
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form. See instructions			14	
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. See instructions. Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	
18	**Contract price.** Add line 7 and line 17			18	

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. (For years after the year of sale, see instructions.)		19	16.67%
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-		20	0
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated		21	130,000
22	Add lines 20 and 21		22	130,000
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated	23 790,000		
24	**Installment sale income.** Multiply line 22 by line 19		24	21,671
25	Enter the part of line 24 that is ordinary income under the recapture rules. See instructions		25	0
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions		26	21,671

Part III Related Party Installment Sale Income. Don't complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party ▶

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy) ▶

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

d ☐ The second disposition occurred after the death of the original seller or buyer.

e ☐ It can be established to the satisfaction of the IRS that tax avoidance wasn't a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See instructions.

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2020 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules. See instructions	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions	37	

Note:

Since the land was held for investment, the gain would flow directly to Form 1040, Schedule D, as a long-term capital gain. If the land had been held as part of the taxpayer's trade or business, the gain would go to Form 4797.

VI. Conclusion

Similar to like-kind exchanges (which will be discussed in the next chapter), when a sale qualifies for an installment sale, it may make sense for the taxpayer to allow deferral of receipt of all consideration from the buyer in order to utilize the installment method. However, it has its advantages and disadvantages:

A. Advantages

- Gain is deferred over the life of the receipt of payments from the buyer;
  The taxpayer may benefit from the rate differential in each year subsequent to the year of sale; and
- If the buyer defaults on the payments, the seller may be able to repossess the property.

B. Disadvantages

- The possibility of losing various expiring carryforwards.
- More time and expense incurred by the taxpayer accounting for tor this method.
- The cost and time involved in repossessing the property if the buyer defaults on his or her payments.
- If tax rates are expected to increase in future years, it may cost the taxpayer additional tax as compared to paying the entire tax in the year of sale.