Real Estate Taxation: Critical Considerations

RET4/21/W1

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Today's Presenter

William I. Eskin, CPA

Bill is very active in the accounting, auditing, and fraud investigation fields in general, and the construction and surety industries in particular, where he may be best known for identifying and proving CPA malpractice. Recently, he had three books published: *Construction Contractors: Real-World Guide to Accounting & Auditing, Real Estate: Real-World Guide to Accounting & Auditing,* and *Taking Advantage of Installment Sales and Like-Kind Exchanges*. Previously, Eskin was the Director of Financial Analysis & Investigation for the world's largest surety group. His professional experience also includes more than 12 years of experience working for various CPA firms where he specialized in construction, real estate, litigation support, and other services.

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Bill Eskin's Background

- Twelve years in public where I specialized in:
  - Real Estate & Construction
  - Litigation Support

Bill Eskin's Background

- After exiting public, I went to work for USF&G, the world's largest surety bond provider (at that time) where I held the position of Director of Financial Analysis & Investigation in their Surety Claims Department. I developed (alleged) expertise in the following areas:
  - Financial Statement Analysis related to virtually all types of developers and contractors
  - Work-out issues involving all types of developers and contractors in all different stages of development and failure
  - Recovery venues

Bill Eskin's Background

Since leaving the Surety, I have been involved in:

1. Working with the AICPA reviewing and authoring various Guides and Updates
2. Working with various banks & surety providers in their underwriting and claims functions specifically related to work-out and forensic issues
3. Assisting banks and sureties with their **RECOVERY** functions

Bill Eskin's Background

What do I mean by RECOVERY?

I sue CPAs for Malpractice!!!

Bill Eskin's Background

Pursuing malpractice against CPAs when the bank or surety incurs losses based on financial statements audited or reviewed by the CPA, relied upon by the bank or surety, which were ultimately determined to contain material GAAP errors, which were then determined to have caused the bank or surety to incur their loss

Hey, Eskin

Hey, Eskin, aren't you in the wrong place? This is a TAX webinar, not GAAP!

Well, folks, to be honest, my expertise is considered in GAAP; except

Hey, Eskin

For two industries:

- Real estate – The topic of this presentation, and
- Construction – From the many years working in the surety industry

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Hey, Eskin

Hey Eskin, why and, more importantly, how did you gather "expertise" in tax for these 2 industries when you hold yourself out to be an "expert" in GAAP compliance?

- How we use the tax returns (both the real estate entity itself and related personal tax returns) in our pursuit of malpractice, and
- What is included in those tax returns
  - M-1 adjustments, and
  - Related parties

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A Critical Question

<u>A critical question must be raised:</u>

Is the entity working as a contractor or as a real estate developer?

Is it a Construction or Real Estate Development Project?

As a general rule, if an entity is building on land that it owns or for its own use, it is considered to be a <u>real estate developer</u> whose principal guidance is IRC Sec 263

However, if the entity is building on land owned by someone else for someone else's use, it is considered a <u>construction contractor</u> whose principal guidance is IRC Sec 460

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Is it a Construction or Real Estate Development Project?

Due to the many tax implication differences between real estate developer activities and construction contractor activities, it is critical that the CPA recognize these distinctions

Not knowing these differences may result in very significant errors in the entity's income tax reporting

Today's Presentation

- We will always briefly discuss the "theory" behind the many tax issues related to the real estate industry
- However, we will attempt to show you in practical terms how the various issues affect you as a CPA, your practice, and your company!

Workpaper Documentation

One of the most important ways to deal with the many issues we will be discussing throughout this webinar is

"SOLID WORKPAPER DOCUMENTATION"

This is equally applicable for you folks both in public as well as our clients

Throughout this presentation we will be providing instances where workpaper documentation is essential

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Today's Presentation

Watch out during this webinar for a couple of quizzes we will be taking

It will be your opportunity to earn CHECKS in order to win a "fabulous" prize

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However:

WARNING!   WARNING!

You want to be sure you earn enough CHECKS or there could be

DANGER! DANGER!

☹☹☹☹

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Chapter 1

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

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Introduction

Everyone watching this webinar is aware that at the end of 2017, Congress passed, and President Trump signed into law:

“THE TAX CUTS AND JOBS ACT”

Which for the remainder of this presentation will be referred to as the “Act”

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Introduction

- Without a doubt it has resulted in the most significant changes to the IRC since the 1980s
- There is also little doubt that the #1 industry that has been impacted by the new Act is **“REAL ESTATE”**
- As with everything else in life, there are: **“WINNERS” AND “LOSERS”**

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Introduction

- Fortunately (or maybe, unfortunately), both of these appear to be members of the **“<u>REAL ESTATE INDUSTRY</u>”**
  - The winners – Investors in real estate
  - The losers – Homeowners

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Home Ownership

- We all know that the Act has basically doubled the standard deduction as compared to 2017
- To help “pay” for this, many popular deductions and exemptions were reduced or eliminated
- And as we previously mentioned, homeowners will bear a large portion of these reductions
- We will spend the next few minutes looking at the Act’s provisions, exclusively how they impact real estate

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Mortgage Interest Deduction

- Here is a prime example of how homeowners have gotten hit
  - Through 2017 – Interest associated with mortgage loans up to $1,000,000 was deductible
  - Starting in 2018 – This amount has been reduced to $750,000 for new loans taken out after 12/14/17

Note: Mortgages that were in place prior to 12/15/17 are "grandfathered" and not subject to the $750,000 cap

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Mortgage Interest Deduction

- A few more tidbits concerning what are now faced with:
  - A taxpayer may refinance mortgage debts existing as of 12/14/17 up to $1,000,000 and still deduct the interest as long as the new loan does not exceed the amount of the mortgage that is being refinanced
  - Up through 2017, you were able to deduct interest on home equity loans (as long as total mortgage debt did not exceed $1,000,000). Starting in 2018 (through 2025) home equity loans are generally not deductible

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Mortgage Interest Deduction

- The one exception to this rule is if the proceeds of the home equity loan are used to substantially improve the taxpayer's primary residence. In this situation, the interest remains deductible.
- Interest on a second home is still deductible

Note: This was a huge victory for the real estate industry (after intensive lobbying) as the provisions originally proposed by the House would have eliminated this deduction

Real Estate Taxes

- One of the more controversial provisions of the act is the limitation on the deductibility of state and local taxes "SALT" (which includes real estate taxes)
  - Through 2017, there was no limitation, so as long as the taxpayer was able to itemize deductions, he/she could fully deduct these taxes
  - However, starting in 2018, the cap on the deductibility of all state and local taxes is $10,000

Note: Another victory for the real estate lobby as Congress was really looking to completely eliminate the state and local tax deduction

Standard Deduction

- As we noted a few minutes ago, the Act did significantly increase the standard deduction
  - 2017 – Single $6,350; married $12,400
  - 2018 – Single $12,000; married $24,000
  - After 2018 – These amounts adjusted for inflation; i.e. in 2020 they are $12.400 for a single and $24,800 for married

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Casualty Losses

- Unfortunately for us homeowners, it keeps on coming
  - Though 2017 – If a homeowner incurred a casualty loss related to their property, they were able to deduct the amount of loss that exceeded 10% of AGI if they itemized
  - Starting in 2018 – A casualty loss deduction will only be allowed if the loss is attributable to a Presidentially declared disaster
  - It should be noted that the original House bill would have completely eliminated this deduction

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What Is Not Changing

- So that concludes the bad news for homeowners
- What has not changed under the Act?
  - The exclusion of recognizing gain when a taxpayer sells his or her primary residence
  - Both the House and Senate wanted to put some limitations on that exclusion but at the end of the day, the exclusion remains; for married filing jointly the exclusion is $500,000; $250,000 for everybody else

Commercial Real Estate

Now, let's flip the coin and discuss the other side of real estate

"INVESTING IN COMMERCIAL REAL ESTATE"

We will briefly discuss the changes now with a more thorough discussion in the appropriate chapter

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Pass-Through Entities

- One of the provisions of the Act which has generated a lot of excitement involves taxation of income from pass-through entities (Code Section 199A)
- For these purposes, a pass-through entity includes:
  - S corporations
  - Partnerships
  - LLCs
  - Sole proprietorships, and
  - REITs

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Pass-Through Entities

- And since most people invest in real estate via these types of entities, some (but for sure not all) real estate investors have reaped the rewards under the Act
- Let's now discuss the major change
  - Through 2017 – All income generated by these entities and passed to partners, etc. was taxed as ordinary income
  - Starting in 2018 – Some taxpayers are able to deduct 20% of the pass-through income from these entities

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Pass-Through Entities

The really, really good news is that the deduction can be taken even if the taxpayer is not able to itemize deductions; they still are eligible to take this deduction

However, there are limitations in taking the deduction

Everyone take a few minutes and read about these limitations from the bottom of Page 1-1 to the middle of Page 1-2

Depreciation and Section 179

IMHO, one of the primary reasons more people will want to invest in real estate will be the new rules regarding both depreciation and §179

Bottom line is that the Act now allows more assets to be currently expensed under IRC §179 as compared to previous regulations

Note: we will discuss both depreciation and §179 in much more detail later today

Section 199A Deduction

- In 1/19, Notice 2019-97 was issued by the IRS, which gave clarification regarding Qualified Business Income (QBI) and rental real estate
- Provides a safe-harbor to be considered a trade or business if four conditions are met:
  1. Real property is owned directly through a disregarded entity
  2. Separate books are maintained for each entity
  3. At least 250 hours of rental services are provided by the taxpayer, and
  4. Detailed records are maintained detailing hours worked, description of the services, date, and who performed the service

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Section 199A Deduction

- If the safe-harbor provisions are not met, the taxpayer may still be eligible for the deduction if they meet the definition of a trade or business
- Problem areas include:
  - Residences used by the taxpayer during the year, and
  - Triple-net leases

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Section 199A Deduction

If the taxpayer does not meet the safe-harbor requirements, in order to be considered a trade or business, the taxpayer must show:

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

Each property owned by the taxpayer will need to be analyzed to determine if income is eligible for the deduction

Of particular concern will be vacation homes due to the profit motive issue previously discussed

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Capitalization vs. Expensing

- Notice 2015-82 allows current expensing of otherwise capitalized items if:
  - The item costs < $2,500 or less, and
  - The taxpayer makes the appropriate election
  - Note: the amount increases to $5,000 if the taxpayer has an applicable financial statement

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Capitalization vs. Expensing

Lessors with average annual gross receipts for the three preceding years of $10 million on 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% of the unadjusted basis of the property or
- $10,000 during a given year

CARES Act

Without question, COVID-19 has had a humongous impact on our economy in general and the real estate industry in particular

Our 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 deals with the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)

CARES Act

The 2 most important provisions of the CARES Act that impacts the real estate industry are

1. Net Operating Losses – Under the Act, corporate net operating losses (NOLs) arising in 2018 or in subsequent years are not allowed to be carried back to offset prior years' taxable income and carryforwards may be used to offset no more than 80% of taxable income. The CARES Act postpones the 80% carryforward limitation to taxable years beginning before 1/1/21 and allows taxpayers to carry back NOLs arising in taxable years beginning after 12/31/17 over a 5-year period, and

CARES Act

2) Bonus Depreciation for Qualified Improvement Property – The Act permitted taxpayers to deduct the full cost of certain depreciable property placed in service by the taxpayer in a taxable year before 1/1/27. 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 permit immediate expensing for various types of personal property (equipment, furniture, and fixtures, etc.), it was intended to also apply to structural improvements made to commercial properties. However, the general 39-year recovery period for these improvements prevented them from being eligible for the immediate expensing (continued)

CARES Act

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. The provision is effective retroactively to property placed in service in 2018 and beyond. 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 and may also encourage taxpayers to make needed improvements in the coming years as the economy continues to recover from the COVID-19 pandemic. (continued)

CARES Act

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

My Other Career

I do have to mention that I have a 2nd career

As beautiful as a Philadelphia Eagle touchdown run

Is the fact we just completed Chapter 1

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Chapter 2

Determining the Basis of Acquired Real Property

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Introduction

So, now that we have briefly covered the impacts of the Tax Cuts and Jobs Act and the CARES Act on the real estate industry, we can move on to our next topic:

"DETERMINING THE BASIS OF ACQUIRED REAL PROPERTY"

Basis of Property

- When real property is purchased, we are required to determine the total basis in that property. Why?
  - That amount is used in computing current year depreciation, and
  - It is used when computing gain or loss upon disposal of the property

Basis of Property

- When determining the property's basis, the first component is known as its **<u>"Original Basis"</u>**
- It generally represents the cash payments the purchaser made to acquire the property (although it could also include assuming the seller's debt)

Basis of Property

- The next component in deriving total basis is known as **<u>"Adjusted Basis"</u>**
- This is defined as the original basis increased or decreased for various modifications which we will now detail

Basis of Property

- The "popular" increase modifications incurred when the property is purchased include
  - Title charges related to the purchased property
  - Title insurance purchased for the benefit of the acquirer
  - Option payments
  - Appraisal fees purchased for the benefit of the acquirer
  - Survey costs
  - Transfer taxes and other governmental fees, and
  - Any amounts owed by the seller that the buyer agrees to pay

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Basis of Property

Note: it should be noted that typical items incurred at settlement such as:

- Title insurance, and
- Appraisal fees

that are incurred for the benefit of the bank are not added to the basis of the property but are considered **"deferred financing costs"**

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Basis of Property

Note: Deferred financing costs are capitalized and amortized over the life of the related loan (which is most likely a much shorter period as comparted to depreciation as part of the basis of the property)

A Bill Eskin Observation

- Folks, it is critical that you utilize a signed, final **"Settlement Statement"**
- It is only through this document (not the cash disbursements journal) that you are able to obtain this basis information
- If the client is unable to provide a statement signed by all applicable parties, at the very least you may have a "scope limitation"; at the very worst, you may have to start suspecting impropriety by the client

A Bill Eskin Observation

- Everyone take a few minutes now and read the settlement statement we provided in Chapter 2, Pages 2-6 to 2-8
- This particular document (HUD-1) is utilized primarily for real estate transactions involving residential properties

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Settlement Statement

Unfortunately, it has been my experience involving litigation that far too many CPAs in both public and industry do not understand the mechanics of this document which results in errors not just involving the financial statements, but also the related tax return

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Settlement Statement

- The following errors have been noted in our litigation work involving the Settlement Statement:
  - **Real estate taxes** – Any amounts reflected on the Settlement Statement paid in advance or unpaid by the buyer/seller will impact the current year amount of deduction; not added to or decrease basis
  - **POC ("Paid Outside Closing")** – Refers to any cost that is not being disbursed at the closing. These amounts must be picked up to record the transaction properly.

Settlement Statement

- **Transfer taxes** – These and other government charges should never be currently deducted as a tax expense. At the purchase of the property, they should be added onto its basis. At the sale of the property, they should be included as a cost of sale.
- **Title fees** – two types of title fees:
  1. For the benefit of the buyer – should be capitalized as part of the basis of the property
  2. For the benefit of the lender – should be capitalized as deferred financing fees and amortized over the life of the related loan

Basis of Property

- Next, we have other increases to the basis that are incurred after the property is acquired. These include:
  - Capital improvements to the property
  - Cost of extending utility services to the property
  - Impact fees (imposed by a government for improving a property)
  - Certain professional fees (defending title)
  - Zoning costs, and
  - Capitalized value of redeemable ground rent

Basis of Property

- And finally, we would <u>reduce</u> the original basis for the following
  - Depreciation
  - Any tax credits taken
  - Casualty or theft losses and insurance reimbursements
  - Certain cancelled debt that is not included in income
  - Rebates from a manufacturer or seller, and
  - Easements treated as a sale of an interest in real property

Basis of Property

- We then combine each of the previous slides together and that creates the **"adjusted basis in the property"**
- The next step is to take this adjusted basis and allocate as required

Basis of Property

- This allocation will typically be required between
  - Non-depreciable assets (such as land)
  - Depreciable assets (building, improvements, and personal property)
- It may also apply when
  - More than one property has been acquired in a transaction, and
  - A portion of the acquired real property is used for personal use

Basis of Property

- When performing the allocation between building and land, many CPAs will simply use the boilerplate "80/20" formula
- However, this could create a problem upon audit by the IRS since there for sure is a major difference in making this allocation between rural land in the middle of nowhere and downtown Beverly Hills

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Basis of Property

- Therefore (***<u>whenever feasible</u>***), the taxpayer should obtain some kind of outside source to substantiate their allocation. This may include:
  - An independent appraisal
  - Values set forth in the settlement statement, or
  - Local tax assessments

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Basis of Property

- In addition to the allocation between building and land, there may be situations where an allocation of the purchase price (basis) has to be made between:
  - Assets with longer depreciable lives (real property), and
  - Those with shorter depreciable lives (personal property)
- Similar to our discussion a couple of slides back, a random allocation between real and personal property may not be acceptable to the IRS agent

Basis of Property

- Similar to our discussion in allocating the purchase price between building and land, it may not be acceptable under audit if the taxpayer does not have some substantiation to support their allocation
- For these purposes, substantiation may include (when feasible):
  - An engineering firm
  - Information provided by the architect and/or builder, or
  - Amounts detailed in the settlement statement (as long as they are determined in an arm's length negotiation)

Quiz Time

OK, folks

It is time for our first quiz. It will consist of 12 questions involving taxation of real estate.

“GO FOR THE CHECKS”

1) Today, which of the following is no longer a common form of real estate ownership?

   a) REIT
   b) S corporation
   c) General partnership
   d) LLC

2) All of the following are defined as direct costs as per the IRC EXCEPT:

a) Quality control

b) Materials used at a particular location

c) Labor used at a particular location

d) Payroll taxes related to answer c)

3) Which of the following have a similar treatment for both tax and GAAP purposes?

a) Organization costs

b) Start-up costs

c) Both a) and b)

d) Neither a) nor b)

4) All of the following would generally be considered start-up costs EXCEPT:

a) Research expenses involving a proposed property

b) Legal fees

c) Insurance, licenses, and permits necessary for future real estate operations

d) Supply purchases before active trade or business begins

5) For determining depreciation, which type of convention should be used for residential and nonresidential real property?

a) Mid-month

b) Mid-quarter

c) Half-year

d) Full-year

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6) When acquiring real property, which of the following costs incurred at settlement would be considered a “deferred financing cost”?

a) An appraisal fee for the benefit of the purchaser

b) An appraisal fee for the benefit of the lender

c) Transfer taxes

d) Title charges

7) Which of the following type of real property is generally depreciable?

a) Land

b) Land improvements

c) Real property purchased and disposed with the same taxable year

d) None of the above are depreciable

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8) Which of the following is TRUE regarding installment sales and real property?

a) It can be utilized to defer losses but never gains

b) It can be utilized to defer gains but never losses

c) It can be used to defer both gains and losses

d) The Act will disallow all use of the installment method beginning in 2022

9) How does the definition of a real estate developer differ from that of a construction contractor?

a) A developer generally works with real property while a contractor generally works with personal property

b) A developer develops its own property for its own use while a contractor develops someone else's property for their use

c) A contractor develops its own property for its own use while a developer develops someone else's property for their use

d) Both definitions are synonymous

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10) When computing the tax basis of real property acquired, which of the following costs would **NOT** be included?

a) Amount paid into escrow at settlement

b) The purchase price of the property

c) Capital improvements to the property

d) The cost of extending utility services to the property

11) Which of the following is TRUE concerning the Tax Cuts and Jobs Act?

a) All interest incurred by all real estate entities will remain 100% deductible

b) The depreciable lives of residential and nonresidential real property have not been changed

c) Like-kind exchange treatment is no longer allowed for real property

d) The use of Section 179 on fixed asset additions has been significantly limited

12) All of the following are characteristics of Section 1231 property EXCEPT

a) It is used for the production of income
b) It is used in the entity's trade or business
c) The property has to be held for at least 1 year
d) It is not a capital asset as defined by the IRC

Completion of Chapter 2

Everyone let out a great big MOOOOOOOOOOOOOOOOOOOO

Because we just completed Chapter 2

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Chapter 3

Rental Operations

Our Next Topic

Having determined the basis, we can now move on to the next chapter dealing with

"RENTAL OPERATIONS"

Rental Operations

- The property development is complete, and now the real estate entity has begun to obtain tenants
- Therefore, our first topic of discussion will deal with how the IRC requires us to report **"lease acquisition costs"**

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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 lease acquisition costs for the lessor include:
  - Commissions
  - Professional fees, and
  - Tenant incentives

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Acquisition Costs

- Some of the lease acquisition costs related to the lessee include:
  - The cost of purchasing a leasehold estate, and
  - Professional fees
- IRC §178 generally requires that these costs be capitalized and amortized over the life of the original lease term (even if there may be expectations of renewal beyond the original lease term)
- Note: this amortization period is different from what is required for GAAP and financial statement reporting purposes

Rental Income

- Now it is time for the lessee to pay the lessor its rent
- When each party recognizes its income or deduction depends on whether they report on the cash method or the accrual method

Rental Income

- For the lessor, rental income is taxable when the following circumstances happen:
  - 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)
- However, it should be noted that an accrual basis lessor is required to recognize rental income when received, not when earned
- On the next slide, we will provide an example of this concept

Rental Income – Example

- Michael Scott (lessee) pays his rent due on 1/1/21 to Pam Beasly (lessor) on 12/31/20
- Even if Pam Beasly reports on the accrual basis (and obviously if she reports on the cash basis), she must recognize the income in 2020; not 2021

Rental Income

- It should be noted that the term “rental ” is not restricted to solely rent payments due
- The term may also include various types of expense reimbursement which may include real estate taxes, insurance, and common area maintenance (CAM)
- And finally, any payments made by the lessee of any expenses of the lessor are deductible by the lessee and rental income to the lessor

Rental Income

- In regards to the lessee:
  - Cash basis taxpayer can deduct rent when paid,
  - Accrual basis taxpayer can generally deduct rent when due per the terms of the lease

Rental Income

- <u>Security Deposits</u>
- When a lessee pays a security deposit to the lessor according to the lease terms, it is not deductible by the lessee, nor included into income by the lessor, unless the security deposit is used for noncompliance of the lease terms
- In that situation, both the lessee and the lessor would bring the security deposit into their perspective income

Rental Income

- <u>Contingent Rents</u>
- Is defined as additional rent due in addition to the base rent and is based on the lessee's sales
- Referred to in the real estate industry as "percentage rent"
- Once the lessee hits the target sales amount, the lessor (accrual basis) must recognize this additional taxable income
- We will provide an example of this concept on the next slide

Rental Income – Example

- Eagles Fly (lessee) leases space from Cowboys Don't Anymore (lessor). The lease calls for monthly payments of $10,000 plus 2% of all sales recognized by Eagles Fly in excess of $1,000,000 annually. The additional amount based on Eagles Fly's sales would be considered percentage rent.
- Once Eagles Fly reaches the target amount of $1,000,000, even though it has not been actually billed for the additional rent, Cowboys Don't Anymore will need to recognize additional taxable income

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A Most Difficult Expense

One of the more difficult incurred expenses that we will need to discuss in quite a bit of detail is

INTEREST

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Interest Expense

- Generally, interest expense used in the ordinary course of business is currently deductible under IRC §163
- For cash basis taxpayers, it is deductible when paid. For accrual basis taxpayers, it is deductible when the expense is fixed and determinable, and upon economic performance
- However, there are a number of types of interest related to the real estate industry that are not currently deductible, including:

continued →

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Interest Expense

- Interest on debt to a related party cannot be deducted until it is included in the income of the related taxpayer
- The deduction for interest expense incurred in passive activities may be limited, but only if the taxpayer is subject to the passive activity rules
- 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, and
- The deduction by cash basis taxpayers for prepaid interest is deferred

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Interest Expense

Our next subject of discussion is directly related to interest expense and deals with

“POINTS”

Points are associated with the obtaining of financing

Points

- The IRS considers points to be “prepaid interest” so accordingly, under certain circumstances, may be currently deductible by the taxpayer on Schedule A
- However, it should be noted that:
  - If the taxpayer is able to deduct all of the interest on their mortgage, they may be able to deduct all of the points
  - If acquisition debt >$750,000, or home equity >$100,000, the taxpayer cannot deduct all interest paid and cannot deduct all the points paid, and
  - The amount of the deductibility of the points may be reduced by the amount of the taxpayer’s AGI

Points

- Taxpayers are able to currently deduct points if all of the following nine requirements are met:
  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 stated separately on the settlement statement (appraisals, etc.)

continued →

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Points

- The funds provided by the taxpayer at or near closing 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
- The taxpayer must use the proceeds of the loan to buy or build the taxpayer's primary residence
- The points were computed as a percent of the principal amount of the mortgage, and
- The amount shows clearly as points on the settlement statement

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Points

- A few more considerations concerning points:
  - 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 1-6 detailed a couple of slides back have been met
  - Points charged for specific services such as preparation costs, appraisal fees, or notary fees are not considered interest and 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

- 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
- The following points <u>cannot</u> be currently deducted, but should be amortized over the life of the related loan
  - Financing a second home (not a primary residence), and
  - Those for refinancing a mortgage on the taxpayer's primary residence

Changes to Interest Expense From the Act

- The following are the key changes that became effective starting in 2018 as a result of the Act:
  - Through 2017, interest associated with mortgage loans up to $1,000,000 was deductible. The Act reduced the limit to $750,000 for new mortgage loans taken out after 12/15/17.
  - A taxpayer may refinance mortgage debts existing as of 12/14/17, up to $1,000,000 and still deduct the interest as long as the new loan does not exceed the amount of the loan being refinanced

Changes to Interest Expense From the Act

- The Act repeals the deduction for interest paid on home equity loans from 2018 through 2025
  - However, the interest paid on home equity loans where the proceeds are used to substantially improve the residence are still deductible, and
  - Interest remains deductible on second homes subject to the $750,000 limitation
  - It should be noted that it is the obligation of the taxpayer to demonstrate that the proceeds of the home equity loan were in fact used for residential improvement and not for any other purpose

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Changes to Interest Expense From the Act

- There is another change in the deductibility of interest expense brought on by the Act which has not gotten much publicity and could only potentially impact larger-type real estate entities
- The purpose of this particular provision is to discourage entities (including real estate) from borrowing large amounts of cash (especially with today's low interest rates) and enjoying a full deduction of these amounts

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Changes to Interest Expense From the Act

- However, beginning in 2018, a real estate entity will only deduct its "net interest expense" up to 30% of EBIDTA
- Definitions:
  - Net interest expense – Interest expense incurred/paid net of recognized interest income
  - EBITDA – Entity's earnings before interest, taxes, depreciation, and amortization

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Changes to Interest Expense From the Act

- So what are the details of this provision?
  - Only impacts entities whose average gross receipts > $25,000,000
  - A real estate entity can avoid this provision (even if over $25,000,000) if they are engaged in a "real property trade or business"

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Changes to Interest Expense From the Act

- What is a "real property trade or business"?
- If the taxpayer is engaged in one of the following lines of business
  - Leasing
  - Construction
  - Development
  - Acquisition
  - Management, or
  - Brokerage

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Changes to Interest Expense From the Act

Even if they were not engaged in one of the businesses detailed on the previous slide, a real estate entity could still escape the limitation on deducting all of its interest expense by making the following election whereby they will be required to deduct their residential and nonresidential real property along with a new category known as "qualified improvement property" using the Alternative Depreciation System or "ADS"

Note: We will be discussing the concepts of qualified improvement property and ADS in more detail later in this webinar

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Time Out for a Personal Question

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Completion of Chapter III

Everyone watching this webinar can now laugh with glee

Because we just completed Chapter 3

Chapter 4

Depreciation

Introduction

One of the most important deductions associated with real property, and one of the primary reasons investing in real estate is so popular is

"DEPRECIATION"

Depreciation

First off, let's summarize the major differences between GAAP and tax regarding depreciation:

GAAP

- Assets depreciated over their estimated useful lives
- Assets are depreciated usually using the straight-line method
- The asset may have its basis reduced for salvage value, and
- The concepts of §179 and bonus depreciation do not exist

Tax

- Assets are depreciated over lives prescribed by the IRS
- Assets are depreciated in accordance with the IRC generally using MACRS
- The concept of salvage value does not exist, and
- Section 179 expensing of personal property is allowed in addition to additional bonus depreciation (subject to numerous limitations)

Depreciation

- The bottom line difference is that:
  - Tax – Generally allows greater depreciation in the first year placed in service with
  - GAAP – Catching up to Tax in subsequent years

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Depreciation

Taking the wrong amount of depreciation (i.e. using GAAP instead of Tax) could result in improperly recognizing gain or loss upon the sale of the property until the property is fully depreciated

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Depreciation

- Virtually all types of real property are depreciable; the only exceptions are:
  - Land, and
  - Property placed in service and disposed of in the same year

Depreciation

- In order for a taxpayer to be allowed a depreciation deduction for real property, the property must meet all of the following requirements:
  - The taxpayer must own the property
  - The taxpayer must use the property in either a trade or business or in an income-producing activity, and
  - The property must have a definitive useful life of more than one year

Depreciation

- When discussing depreciation and recognizing the amount of gain or loss on the sale of real property, one of the key concepts is "**Allowed or Allowable"**
- According to IRC §1016(a), the tax basis of the property should be reduced by the greater of the following:

continued →

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Depreciation

1. 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 the tax return, or
2. The amount of depreciation allowable. Allowable depreciation is the amount a taxpayer may deduct using the methods, conventions, and recovery periods provided in the current tax law.

- Everyone take a look at the Alicia, LLC example on the bottom of Page 4-2 and the top of Page 4-3

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Depreciation

- For any real property placed in service after 12/31/86, the IRC requires the use of MACRS
- There are four issues that must be considered:
  1. The type of depreciable real property
  2. The recovery period of the asset
  3. The applicable convention, and
  4. The method used to depreciate the asset

Depreciation

- #1 – The type of depreciable property
- Through 2017, there were five types of identified real property
  1. Residential real property – Any building if 80% or more of the gross rental income for the taxable year is rental income from dwelling units
  2. Nonresidential real property – Depreciable real property which is not residential real property

continued →

Depreciation

3. Qualified leasehold improvement property – Any improvements to an interior portion of a building that is nonresidential real property and placed in service more than 3 years after the date the building was first placed in service
4. Qualified restaurant property – Any IRC §1250 property that is a building or an improvement to a building if more than 50% of the building's square footage is devoted to the preparation of and seating for on-premises consumption of prepared meals, and

continued →

Depreciation

5. Qualified retail improvement property – Any improvement to an interior portion of a building that 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 sell goods (but not services) and include grocery stores, convenience stores, clothing stores, etc.

Depreciation

- #2 – The recovery period of the asset
  - Residential real property – 27.5 years
  - Nonresidential real property – 39 years
  - Qualified leasehold, restaurant, and retail property – 15 years

Depreciation

- #3 – The applicable convention
  1. Residential and nonresidential real property – the mid-month convention, and
  2. Qualified leasehold, restaurant, and retail property – the half-year convention

Depreciation

- #4 – The method used to depreciate the asset
- Very simply, the IRC requires the use of MACRS depreciation in determining the amount of depreciation to be taken for real property
- The IRS provides table for computing the annual depreciation deduction

A Few More Items to Discuss

We still have a few more items to discuss regarding real property and depreciation

- Section 179 – As long as the other conditions related to §179 are met, the following types of real property are eligible for §179 expensing
  - Qualified leasehold improvements
  - Qualified restaurant property, and
  - Qualified retail improvement property

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A Few More Items to Discuss

In addition to §179 is the issue of

"BONUS DEPRECIATION"

The following are some of the rules concerning this through 2017

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Bonus Depreciation

- Eligible property for bonus depreciation included newly constructed or original use property with a recovery period of 20 years or less
- Qualified leasehold property was eligible for bonus deprecation
- Only new property was eligible; not used property
- Unlike §179 expensing, taxpayers did not need to recognize net income in order to take the bonus depreciation deduction, and

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Bonus Depreciation

- The following types of property were not allowed to use bonus depreciation
  - Used property (as we just mentioned)
  - Property used outside the USA
  - Assets depreciated under the ADS
  - Tax-exempt use property, and
  - Tax-exempt financed property
- And finally, qualified restaurant and qualified retail improvement property were generally not eligible for bonus depreciation

A Few More Items to Discuss

- We have previously noted that the depreciable life for nonresidential real property is 39 years. Accordingly, there is a long period between the time when the taxpayer incurs 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 partly get around this problem is via a concept known as **"cost segregation"**

A Few More Items to Discuss

- Under this concept, 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 (seven years as personal property)
- Toward the end of Chapter 4 we have some examples of these components

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A Few More Items to Discuss

- Truth be told, the vast majority of CPAs do not have an engineering background. Therefore, it would be very difficult for us to determine how much of the construction/development cost could be allocated to seven year property. Accordingly, should the taxpayer desire to cost segregate, they would probably need the services of a qualified person.
- Everyone take a look at the “Jerry” example on Page 4-8 and the top of Page 4-9

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The Act

- Everything we have discussed to this point is applicable regarding filing 2017 tax returns
- However, starting in 2018, with the passing of the Act, a whole bunch of changes were made to depreciation and §179 which we will now discuss in detail

Types of Depreciable Property

- We had previously noted the five categories of real property that were effective through 2017:
  1. Residential real property
  2. Nonresidential real property
  3. Qualified leasehold improvement property
  4. Qualified restaurant property, and
  5. Qualified retail improvement property

Types of Depreciable Property

- **But this changed under the Act**
- The first two categories remain unchanged
  1. Residential property, and
  2. Nonresidential property
- But the <u>other three categories</u> (qualified leasehold property, qualified restaurant property, and qualified retail improvement property) have all been eliminated and replaced with **<u>"Qualified Improvement Property"</u>**

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Types of Depreciable Property

Let's now spend a minute and discuss how Qualified Improvement Property has been "improved" over the three categories it replaced

1. It does not require that the improvement be subject to a lease; accordingly, interior improvements made by the owner of an owner-occupied building that meet the other requirements for qualified improvement may now qualify for bonus depreciation

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Types of Depreciable Property

2. Under previous law (through 2017), <u>no bonus depreciation</u> could be taken on improvements made to a building within three years when it was originally placed in service. The Act removed this restriction allowing tenant improvements made in a < three year old building to be eligible for bonus depreciation, and
3. Common area improvements in an owner-occupied building are now eligible for bonus depreciation

Types of Depreciable Property

- Under the Act, the recovery period of the three categories are:
  - Residential real property – 27.5 years (unchanged)
  - Nonresidential real property – 39 years (unchanged)
  - Qualified improvement property – 15 years

Applicable Convention

- All three classes of real property recognized under the Act will utilize the mid-month convention
- And similar to pre-Act rules, if > 40% of qualified improvement property was placed in service during the final quarter of the entity's accounting year, then a mid-quarter must be used

Alternative Depreciation System

- 99.9% of the time, when we depreciate assets, including real property, we use the General Depreciation System or GDS
- But we all should be aware there is another method of depreciating assets known as the Alternative Depreciation System or ADS

Alternative Depreciation System

- In the previous chapter we had discussed a limitation on the deductibility of interest expense if the entity's gross receipts exceed $25,000,000 and the amount of net interest paid/incurred exceeds 30% of EBIDTA
- We had also noted that a way to avoid this restriction would be for the taxpayer to elect to depreciate their fixed assets (including real property) using the ADS
- So now would be a good time to spend a minute and discuss ADS and real property under the Act

Alternative Depreciation System

- The lives used for depreciating real property under GDS and ADS are as follows

	GDS	ADS
Residential real property	27.5	30
Nonresidential real property	39	40
Qualified Improvement Property	15	20

- So by making the election, the taxpayer may be able to recognize more interest expense but would recognize less depreciation expense

Our Final Item to Discuss

We saved the best for last, probably the most significant change that the Act has done for the real estate industry is the expansion of the use of **"Section 179"**

Section 179

- The following are the key provisions brought on by the Act
  - The limitation has been increased to $1,000,000
  - The phase-out was increased from $2,050,000 to $2,500,000
  - Through 2017, §179 was allowed regarding qualified leasehold, qualified restaurant, and qualified retail property. The Act recharacterized those three categories and now allows §179 on qualified improvement property.

Section 179

- 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 §179 expensing
- The following improvements made to the structural component are eligible for immediate expensing
  - Roofs
  - Heating, ventilation, and air conditioning property (HVAC)
  - Fire prevention and protection systems, and
  - Security systems

Big Change

A few hours back, we discussed tax changes that impacted the real estate industry as the result of COVID-19

We briefly mentioned that the CARES Act made a major change involving real estate and depreciation; we will now discuss that change in much more detail

CARES Act

Bonus Depreciation for Qualified Improvement Property

The Act permitted taxpayers to deduct the full cost of certain depreciable property placed in service by the taxpayer in a taxable year before 1/1/27. 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 permit immediate expensing for various types of personal property (equipment, furniture & fixtures, etc.), it was intended to also apply to structural improvements made to commercial properties. However, the general 39-year recovery period for these improvements prevented them from being eligible for the immediate expensing (continued)

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CARES Act

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. The provision is effective retroactively to property placed in service in 2018 and beyond. 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 and may also encourage taxpayers to make needed improvements in the coming years as the economy continues to recover from the COVID-19 pandemic. (continued)

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CARES Act

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.

Our Final Item for Discussion

The last item I would like to discuss in this chapter is one that, through experience, I've noticed too many CPAs striking out on, and that is the issue of

"LAND IMPROVEMENTS"

Land Improvements

- As we have noted earlier:
  - Land – not a depreciable asset, however
  - Land improvements – are depreciable
- The reason why land improvements are depreciable, unlike land, is that land improvements gradually wear out, resulting in a definite life, resulting in allowable depreciation
- This now brings us back to our previous discussion concerning cost segregation

Land Improvements

- Land improvements are defined as enhancements to a plot of land to make the land useable
- If the taxpayer is incurring costs to prepare the land for its intended use, then these costs are generally <u>not</u> depreciated. Examples of this include:
  - Demolishing an existing building, and
  - Cleaning and leveling the land

Land Improvements

- However, if the taxpayer is adding functionality to the land and the expenditures have a useful life, they can be depreciated as land improvements. Examples of this include:
  - Drainage and irrigation systems
  - Fencing
  - Roads
  - Bridges
  - Shrubbery
  - Parking lots, and
  - Walkways

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Land Improvements

- If the taxpayer determines that the land improvements are in fact depreciable, they would be depreciated over 15 years
- However, §179 expensing is <u>not</u> allowed
- And finally, look at the "Bruce" example on the bottom of Page 4-9 and the top of Page 4-10, which illustrates the concept of eligible and ineligible land improvements

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Completion of Chapter IV

Open the window and close the door

Because we just completed Chapter 4

Chapter 5

Determining Gain or Loss on the Sale of Real Property

Moving On to Our Next Topic

Having spent some time discussing taxation of rental operations and depreciation, we now move forward to one of the most difficult but crucial topics of real estate taxation

"RECOGNIZING GAIN OR LOSS ON SALE"

Recognizing Gain or Loss

- Generally, there are five steps to consider when determining the gain or loss upon the 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),
  5. Whether a gain or loss is realized

Recognizing Gain or Loss

- #1 – The type of asset being sold
- The first issue that needs to be considered is whether the asset being sold is either:
  - A capital asset
  - An IRC §1231 asset, or
  - Ordinary income property

Recognizing Gain or Loss

- IRC §1221 defines a capital asset as any asset with a number of exceptions
- One of those exceptions is “depreciable or real property used in a trade or business” (which is §1231 property)
- If a noncapital asset does not qualify as §1231 property, it is then considered ordinary income property

Recognizing Gain or Loss

- #2 – The period for which the asset was held
- In order for the disposed property to be considered IRC §1231 property, it must be held for at least one year
- What is meant by "one year"?
  - The measurement of a property's holding period commences the day after its acquisition
  - It ends on the day of its disposal

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Recognizing Gain or Loss

- A holiday falling on the purchase or disposal days does not affect measuring the holding period
- Therefore, in real-life practicality, in order for property to qualify for IRC §1231 treatment, the entity must hold the property for one year and one day

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Recognizing Gain or Loss

- <u>#3 – Allocating the sales price among various components</u>
- When real property is sold or exchanged, the total amount realized must be allocated among §1250 property, §1245 (i.e. not §1250) property, or nondepreciable land
- Accordingly, the sale of depreciable real property typically requires an allocation of the sales price between:
  - Land
  - Building, and
  - Personal property

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Recognizing Gain or Loss

- And similar to the purchase of the property, a "guess" on how to make the allocation may not stand up to an IRS examination
- The taxpayer will need something more to substantiate how they made the allocation (as we previously discussed)

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Recognizing Gain or Loss

Since we have already mentioned it on a few occasions, let's spend a minute discussing

"SECTION 1231 PROPERTY"

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Recognizing Gain or Loss

- IRC §1231 property has three characteristics
  1. It is used in the entity's trade or business
  2. The property has to be held for at least one year (as we just discussed), and
  3. It is not a capital asset as defined by the IRC
- If property does not meet these three criteria, it is <u>not</u> considered IRC §1231 property and any gain must be taxed as ordinary income

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Recognizing Gain or Loss

Why should an entity want an asset classified as §1231 property?

- Two great attributes
  1. Gains are classified as long-term capital gains (subject to a number of limitations which we will shortly discuss), and
  2. Losses are recognized as ordinary
- Accordingly, §1231 property is said to have the "best of both worlds"

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Recognizing Gain or Loss

Before we get too excited about Sec 1231 property, keep in mind there are a couple of speed bumps in the road known as

"SECTIONS 1245 AND 1250 RECAPTURE"

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Recognizing Gain or Loss

What does the IRC mean by the term "recapture"?

- It means "recharacterization" regarding recognizing gain or loss on the sale of real property
- Several provisions of the IRC convert a §1231 gain (capital gain) into ordinary income when property is sold
- One of these provisions is the recharacterization ("recapture") of depreciation under §1245 and §1250

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Recognizing Gain or Loss

<u>Section 1245 Property</u>

- Includes the following types of assets
  - Tangible or intangible personal property (e.g. machinery, furniture & 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

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Recognizing Gain or Loss

Section 1250 Property

- Includes any depreciable real property not classified as IRC §1245 property and includes:
  - Buildings
  - Their structural components
  - Leasehold improvements
  - Leaseholds of real property, and
  - Other structures permanently attached to the land

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Recognizing Gain or Loss

- When Section 1250 property is disposed of, any recognized gain is treated as ordinary to the extent of additional depreciation taken on the property, which is defined as the amount of depreciation recognized in excess of the straight-line method
- However, since any property placed in service after 1986 uses what the IRC describes as the MACRS straight-line convention, this recharacterization does not apply to gains on real property placed in service after 1986

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Recognizing Gain or Loss

- When §1245 is disposed of, the amount of gain that should be treated as ordinary income is the lesser of
  - The sum of all allowable depreciation related the property, and
  - The realized gain on the disposition
- When §1245 property is sold for a loss, the entire loss would be recognized as ordinary under IRC §1231; the recapture rules apply only to gains, not losses
- Look at the Alan & Stanley example on Page 5-3

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Disposition of Business Property

- The exception to this "best of both worlds" is when there happens to be net §1231 losses in the prior five years requiring the taxpayer to net gains against those losses as ordinary gains

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Recognizing Gain or Loss

- There is one more recapture provision known as, IRC §291 recapture
- However, the great news for most taxpayers is that this provision only generally impacts C corporations (S corporations are generally exempt) and only when selling §1250 property

Recognizing Gain or Loss

- To assist everyone in understanding this whole concept of a §1231 gain and a §1250 recapture, we have a couple of examples
  - Look at Example 1 – Kahn Brothers, LLC: Mercer Island on Page 5-4
  - Look at Example 2 – Kahn Brother's, LLC: Brooklyn on Page 5-5

Recognizing Gain or Loss

Everything we have been discussing up to now is assuming that the property is sold for a gain. What happens if the property is sold for a loss (i.e., the sales price is less than the cost basis)?

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Recognizing Gain or Loss

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), which can be deducted against other types of income. Remaining capital losses can be carried forward indefinitely, retaining their character as either short-or long-term.

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Recognizing Gain or Loss

- A <u>C corporation's</u> capital losses are allowed only to the extent of capital gains. 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

Recognizing Gain or Loss

And finally we have <u>pass-through entities</u> (S corporations, partnerships, and LLCs classified as partnerships) where capital losses of these entities are passed through to their shareholders, partners, or members

Recognizing Gain or Loss

One more issue we need to discuss involving recognizing gain or loss on the sale of real property is the concept known as

"INVESTOR VS. DEALER"

Recognizing Gain or Loss

- We have spent the last few minutes discussing recognizing gain or loss between capital and ordinary
- I am sure everyone watching today knows the advantage of classifying a gain as a capital gain since the rate of taxation is generally lower than under ordinary taxation

Recognizing Gain or Loss

- Accordingly, 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 ordinary
- This brings us to our topic of investor vs. dealer and the differences between the two in regards to recognizing gain or loss on disposal of real property
- We are going to go into some detail on this matter since it is one that the IRS is reported to have had good success in clobbering taxpayers with

Recognizing Gain or Loss

- Keep in mind, everybody, that the point of this discussion is that:
  - An investor can recognize a gain as a capital gain
  - While a dealer must recognize its gains as ordinary income

Recognizing Gain or Loss

- Various Tax Court rulings over the years have assisted us in making the distinction between the two
- Bottom line, we have five factors when making the 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 (dealer), while infrequent sales are more indicative of real estate held for investment
   - **Note:** it should be noted that this factor concerning the frequency of sales is often considered the most important of the five factors

continued →

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Recognizing Gain or Loss

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 to be 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 efforts related to the disposition of a particular piece of real property. If the taxpayer advertises, markets, solicits customers, or merely lists the property for sale, it is more likely the taxpayer may be deemed a dealer.

continued →

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Recognizing Gain or Loss

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 course of business also factors into the dealer vs. investor determination
5. Nature and purpose for holding property – Courts have extensively analyzed taxpayer intent for acquiring the property. In other words, what is the nature and purpose of the acquisition. The ultimate questions are:
   - Why did the taxpayer acquire the property in the first place?
   - For what purpose was the property held at the time of sale?

Recognizing Gain or Loss

To expand on this final factor:

- 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

Recognizing Gain or Loss

- 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

Recognizing Gain or Loss

- In addition to the five factors we just discussed, other considerations in the investor vs. dealer issue include
  - The duration of ownership
  - The extent of subdividing and development in order to increase sales
  - The use of a business office for the sale of the property, and
  - The character and degree of supervision or control over representation selling the property

Recognizing Gain or Loss

To summarize:

- No one factor or combination of factors is determinative (although we did previously mention that frequency and occurrence of sales is often considered a key factor)
- Each case must be individually considered in its entirety to determine if the property sold was held for sale in the ordinary course of business

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Recognizing Gain or Loss

- In the event of an IRS audit, the agent would typically look upon the taxpayer as a dealer
- The taxpayer would be “guilty until proven innocent” which means that the burden of non-dealer status falls on the taxpayer
- It is his or her responsibility to have appropriate documentation showing intent:
  - When the property is acquired
  - While the property is held, and
  - When the property is sold

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Recognizing Gain or Loss

So now that we have identified whether the taxpayer is a dealer or an investor, the next step is to identify the tax attributes of each

- A Dealer
  - Treats sales-related expenses as business deductions
  - Treats gains or losses from the sale of real property as ordinary gains and losses rather than capital gains and losses, and
  - Is precluded from deferring gain recognition by not being able to use the installment method and like-kind exchange treatment

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Recognizing Gain or Loss

Contrast the dealer with:

- An Investor
  - Treats sales expenses as a reduction of sales proceeds
  - Treats gains or losses from the sale of real property as capital gains and losses rather than ordinary gains and losses (when qualified to do so), and
  - Is able to defer gain recognition by being able to use the installment method and like-kind exchange treatment

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The Act

To make our lives at least a little easier, the Act did not make any significant changes on the calculation of gain or loss on the sale of real property

Completion of Chapter V

Everyone watching this Webinar can start to jive

Because we just completed Chapter 5

Chapter 6

Passive Activity Rules

Our Next Topic

Our next topic in this presentation, due to its importance and due to a lack of knowledge demonstrated by far too many people in our profession, will be discussed in great detail

"PASSIVE ACTIVITY RULES"

When I noted at the beginning of this presentation that I have testified to problem areas noted in the preparation of related tax returns, the number one area of both abuse and lack of knowledge seems to be these rules

Passive Activity Rules

A Quick History

- For decades, taxpayers (usually the rich ones!) were able to shelter their income via investing in real estate
- This was primarily due to:
  - Real estate investments producing positive cash flow, while at the same time
  - Allowing for current year losses due primarily to depreciation

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Passive Activity Rules

- One of the ways Congress "corrected" this alleged abuse was passing the Tax Reform Act of 1986
- One of the major provisions of this Act was codified as "IRC §469"
- IRC §469 presents taxpayers with a number of new terms that must be considered before taxpayers can deduct a loss on their tax return

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Passive Activity Rules

- One of the major considerations of IRC §469 is the concept of "participation"
- We now have 3 terms to consider involving participation
  1. Active,
  2. Passive, and
  3. Material

Passive Activity Rules

- The key feature of IRC §469 is that it disallows a taxpayer from using losses generated from passive activities to offset income earned in which the taxpayer either materially or actively is involved
- In other words, losses generated from activities defined by the IRC as passive can generally only be used to offset passive income

Passive Activity Rules

- To the extent passive losses exceed passive income, they cannot be recognized as a current year loss, but generally are considered <u>suspended</u> and must be carried forward to be used against passive income generated in future years
- These losses are considered passive activity losses or "PALs"

Passive Activity Rules

- 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, then
  2. At-risk limitations, then
  3. Passive activity rules
- In other words, consideration of the passive activity rules are made only after consideration is made of the at-risk rules

Passive Activity Rules

- Two separate categories of passive activities are identified by IRC §469
  - A trade or business in which the taxpayer does not materially participate, and
  - Any rental activity, even if the taxpayer materially participates in the activity

Passive Activity Rules

- Nonpassive activities include (among others)
  - Any activity (except rental) in which the taxpayer does materially participate in (pass-through, trusts, sole proprietorship)
  - Salaries and wages
  - IRS Form 1099 commissions (and other related income)
  - Portfolio income (interest and dividends)
  - Investment income, and
  - Royalties

Passive Activity Rules

- Before we begin our discussion on the passive activity rules and the real estate industry, let's spend a minute and discuss these rules in general
- Income derived from passive activities can be used to offset:
  - Current year passive losses, and
  - Prior year suspended losses that were carried forward to the current year

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Passive Activity Rules

- These rules we are now discussing apply to virtually every type of entity with the exception of
  - C corporations that are not closely held and
  - Grantor trusts

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Passive Activity Rules

- Now let's now discuss in more detail the issue of <u>material participation</u>
  - The rules of material participation apply to both income and losses, and
  - A taxpayer can have a significant financial interest in a business, and yet not materially participate in that business

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Passive Activity Rules

- In regards to "tiered entities," the Regs instruct us that we should treat 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
- For an example of this concept, take a look at Alex Huber on Page 6-3

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Passive Activity Rules

- According to IRC §469, 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 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 of the services required by the entity

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Passive Activity Rules

- 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

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Passive Activity Rules

- 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 tests are met (we will briefly list them)
  1. The taxpayer works 500 hours or more during the year in the activity
  2. The taxpayer does substantially all of the work in the activity

continued →

Passive Activity Rules

3. The taxpayer works more than 100 hours in the activity during the year and no one else works more than the taxpayer
4. The activity is a significant participation activity – SPA (defined as an activity in which the taxpayer is active for more than 100 hours during the tax year)
5. The taxpayer materially participated in the activity in any five of the prior 10 years

continued →

Passive Activity Rules

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

Passive Activity Rules

- Again, it is the taxpayer's responsibility and burden of proof to show documentation indicating how he/she was in compliance with any of the seven previously-detailed conditions in order to prove material participation in the activity in the event of an IRS examination
- 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

Passive Activity Rules

- This is especially applicable regarding taxpayers who are employed in nonreal property trades or businesses and must establish that they are real estate professionals (which we will be discussing shortly) who devote more than 50% of their personal services during the year to real property trades or businesses
- **Note:** Material participation is a year-by-year determination. Consequently, it is conceivable that a taxpayer could be passive one year and active (materially participating) in other years.

Passive Activity Rules

- One way taxpayers can deal 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 purposes of demonstrating material participation

Passive Activity Rules

- 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

Passive Activity Rules

- As we discussed a number of slides back, passive losses are generally only deductible up to the amount of passive income and any excess PAL is deemed to be a suspended loss
- These suspended losses can be carried forward indefinitely and can be used (currently deducted) if one of the following two conditions are 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.

Passive Activity Rules

Now that we have spent some time discussing passive activities in general, we can now move to the main topic of this presentation:

"REAL ESTATE RENTAL ACTIVITIES"

Passive Activity Rules

First off, what is the definition of rental real estate per the IRC?

- "Rental real estate is any real property used by customers or held for use by customers in a rental activity"

Passive Activity Rules

- The following are six exceptions to this general rule and by definition are not considered to be rental activities:

1. The average period of customer use of the property is seven days or fewer (e.g. a hotel)
2. The average period of customer use of the property is 30 days or fewer, and significant personal services are provided by or on behalf of the property in connection with making the property available for use by customers

continued →

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Passive Activity Rules

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

continued →

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Passive Activity Rules

5. The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers, and
6. The provision for 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

Passive Activity Rules

- Losses from rental real estate activities are considered passive and are not currently deductible unless one of the following four exceptions apply
  1. Passive income exists
  2. The taxpayer actively participates in a rental real estate activity and qualifies for the special $25,000 allowance
  3. There is an entire disposition of a passive activity, or
  4. The taxpayer meets the qualifications of a real estate professional

Passive Activity Rules

Exception #1 – Good Tax Planning Tool

- Since passive losses can generally only be offset against passive income, it may make sense for the taxpayer to avoid material participation in an activity if it appears that it will generate passive income

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Passive Activity Rules

- This could be accomplished by not being in compliance with any of the seven conditions we discussed a few minutes ago
- Look at the "Emilio" example on Page 6-7

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Passive Activity Rules

Exception #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

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Passive Activity Rules

- In order to qualify for this particular deduction, the following needs to occur:
  1. The taxpayer must own at least 10% of the value of all interests in the activity at all times during the tax year
  2. 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
  3. The taxpayer’s modified adjusted gross income (MAGI) generally does not exceed $100,000
  4. If at any time during the tax year, the taxpayer’s interest falls below 10% of the value of all interests in the activity, the taxpayer is deemed not to be active, and
  5. A taxpayer does not own rental real estate through the following types of entities
     - A limited partnership
     - A trust or corporation, or
     - A taxpayer whose rental activity consists of a net lease (defined as where the tenant pays most of the expenses)

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Passive Activity Rules

- We spent quite a bit of time discussing the burdensome rules of material participation
- Fortunately, the rules concerning active participation are less stringent
- On the next slide we will present a summary of the active participation rules

Passive Activity Rules

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

Passive Activity Rules

- Even though the active participation rules are less stringent, it is still incumbent upon the taxpayer to have some type of documentation demonstrating their compliance
- To provide everyone with a better understanding of this critical issue, we have provided three examples
- Read examples 1, 2, & 3 (Earl, Dorothy, and David) on Pages 6-8 &6-9

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Passive Activity Rules

- Now that we have determined which taxpayers are eligible to take the special $25,000 deduction, we now have to determine the taxable income limitation
  - The $25,000 maximum amount that can be used to reduce nonpassive income is reduced by 50% of the amount by which the taxpayer's MAGI exceeds $100,000
  - Accordingly, for most filing statuses, when the taxpayer's MAGI > $150,000, the special deduction is completely lost even if he or she actively participates in the rental activity

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Passive Activity Rules

Note: It should be noted that in regards to the filing status "married filing separately," the amounts are halved whereby a taxpayer with more than $75,000 of MAGI completely loses the deduction

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Passive Activity Rules

- So our next issue to discuss is how to compute MAGI; we start with Adjusted Gross Income (AGI)
- This amount is reduced by the following:
  - IRA deductions
  - Student loan interest deduction
  - Taxable Social Security benefits, and
  - Any passive losses allowed (under the exception for real estate professionals)

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Passive Activity Rules

- MAGI would be increased by:
  - Income excluded form U.S. savings bond interest used for higher education expenses, and
  - Employer provided adoption assistance program

Passive Activity Rules

- So to summarize this section, the following are recommendations that should be considered in order to maximize the use of the $25,000 special deduction
  - Whenever feasible, avoid filing under the married filing separate status (due to the lower thresholds)
  - If a self-employed taxpayer (Schedule C) has historically used the accrual basis of accounting, consider switching to the cash method in order to reduce AGI & MAGI
  - Maximize contributions to SEPs, Keogh (not IRAs), and
  - Consider investing in tax-exempt securities

Passive Activity Rules

Exception #3 – Another Good Tax Planning Tool

- If a taxpayer fully disposes of a passive activity, then any suspended losses will be able to be deducted in the year of disposal
- Accordingly, it may be prudent if the opportunity presents itself that the taxpayer may want to sell a property that has suspended losses involving a passive activity prior to the year-end

Passive Activity Rules

Exception #4 – Real Estate Professional

- One of the major exceptions to the general rule that all rental activities (including real estate rentals) are deemed passive applies if a taxpayer is deemed to be a **"Real Estate Professional"**

Passive Activity Rules

If the taxpayer is fortunate enough to be able to be classified as a real estate professional, the taxpayer's rental real estate activities escape the per se passive activity rules otherwise applicable to the rental activity

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Passive Activity Rules

- A taxpayer would be considered a real estate professional if both of the following conditions are met
  1. More than 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 in, and
  2. The taxpayer performs >750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates

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Passive Activity Rules

- However, in order to be classified as a real estate professional, the taxpayer must spend the majority of his or her time in real property businesses, which include
  - Development or redevelopment
  - Construction or reconstruction
  - Acquisition
  - Rental
  - Management or operation
  - Leasing, and
  - Brokerage

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Passive Activity Rules

- A couple more issues involving real estate professionals:
  1. In addition to proving that they are real estate professionals, taxpayers must also prove that they materially participated in the activity, and
  2. 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 activities as one activity (a concept known as "grouping" which we briefly discussed earlier but will discuss now in more detail)

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Passive Activity Rules

- First off, everyone take a look at the "Norman" example on Page 6-12
- A few more things concerning "grouping"
  - The taxpayer may not group rental real estate with nonrental real estate activities in determining material participation in rental real estate activities unless either activity is insubstantial when compared to the other activity, and
  - This would include the grouping of real property and personal property

Passive Activity Rules

- The following entities can make a grouping election
  - Individuals
  - Closely-held C corporations
  - Personal service C corporations
  - S corporations
  - Partnerships
  - Estates, and
  - Trusts

Passive Activity Rules

- In regards to the actual election itself. It 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 grouped together
  2. A new activity is added to an existing group, or
  3. An existing group is regrouped

At the end of Chapter 6 is a suggested format for making the election

Completion of Chapter VI

With our feet and legs we let out kicks

Since we just completed Chapter 6

Chapter 7

Installment Sales

Introduction

If the stars align appropriately, there is an excellent venue available to owners of real estate to defer recognized gain on the sale of real property known as an

"INSTALLMENT SALE"

Introduction

IRC §453 (our guidance in this area) defines an installment sale as follows, “Any disposal of property where at least one payment is received after the close of the tax year”

General Rules

- The following are some general rules and facts concerning the use of the Installment Method under IRC §453
  - The installment method is used for reporting gains from an installment sale
  - The installment method cannot be used for reporting losses (only gains)

General Rules

- 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 sales price has been paid)

General Rules

- The installment method may apply to the sale of:
  - A single asset
  - Several assets, or
  - A business

General Rules

- Installment sales apply (when allowed) to both personal property and real property (which of course is the topic of conversation for today's presentation), and
- The taxpayer has the option to "elect out" of the installment method for properties sold for gains

General Rules

Let's expand a bit on that last bullet point;

"Electing out of the installment method"

- The election must be made on or before the due date for filing the taxpayer's tax return (including extensions) for the year of sale
- It is made by reporting the entire gain as income in the year of sale on Form 4797 for trade or business or Schedule D and Form 8949 for investments

General Rules

- Consequently, Form 8252 (Installment Sales) should not be filed if the election-out is made
- The election must be made property by property, which means that a taxpayer can elect out for one sale and use the installment for other sales in the same year
- Now we can ask a $64,000,000 question – Why would a taxpayer ever want to elect-out and accordingly, accelerate recognizing taxable income?

General Rules

There are 2 situations where it may make sense to elect out of the installment sale:

1. When the taxpayer has carryforwards (NOL, etc.) that may soon be expiring and deferring gain recognition via using the installment method may result in non-utilization of those carryforwards, or
2. The taxpayer expects tax rates to rise in future years so it may be beneficial to recognize the entire gain in the year of sale

General Rules

In regards to utilizing the Installment Method for pass-through entities (partnerships & S corporations), the decision is made on the partnership/S corporation level; the individual partners or shareholders must use the method adopted by the entity

General Rules

- The following transactions are not eligible to use the installment method
  - Sales of inventory related to personal property
  - Sales of stocks and of securities traded on an established securities market
  - Sales of depreciable property to a related party
  - 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 (our next topic to discuss)

General Rules

- Why do an installment sale?
- In addition to deferring the recognition of the full gain in the year of sale, it may possibly reduce the total amount of tax paid by spreading out the liability over several years. Because gain is in fact spread out the taxpayer may benefit from the differential in each of those years.

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General Rule

Now folks we come to the trickiest area in making the determination whether a taxpayer is able to use the installment method in order to defer gain recognition

"DEALER VS. NON-DEALER"

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General Rule

- The IRC forbids the use of the installment method of **Dealers** but allows its use by **Non-dealers**
- So who is a dealer and who is a non-dealer?

General Rule

- 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
- A non-dealer (aka 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

General Rule

- The following factors have been used in recent Tax Court rulings in deciding the dealer vs. non-dealer issue
  - 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

continued →

General Rule

- The degree of supervision or control exercised over the property 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

General Rule

- Folks, it is very obvious from this brief discussion that the entire burden of proof regarding dealer vs. non-dealer lies with the taxpayer
- Solid workpaper documentation is critical to support the position
- To wrap things up in this area, everyone take a brief look at Examples 1 and 2 on Page 7-3 where we provide examples of this whole issue

Calculating the Installment Sale

- So now that we have gone through the various "ground rules" we can now discuss the actual dynamics on computing an installment sale
- In order to accomplish this, we need to briefly run through a few definitions as they relate to installment sales:
  1. Selling price – The total consideration received by the seller for the sale of property. This would include both the fair market of the property + any debt assumed by the buyer.
  2. 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

continued →

Calculating the Installment Sale

3. Gross profit – The selling price less the seller's adjusted basis in the property sold (i.e. the expected gain on the sale)
4. Gross profit percentage – Represents the ratio of the gross profit to the contract price, and
5. Total contract price – Represents the selling price less any qualified indebtedness assumed by the buyer. 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.

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Calculating the Installment Sale

- Under the installment method, income is recognized for any taxable year in proportion to the payments received during the year
- The payments themselves are taxed based on the following three components:
  1. Capital gain – Calculated each year by multiplying the gross profit percent 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.

continued →

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Calculating the Installment Sale

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 nontaxable 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 above-detailed three items

In Conclusion

In conclusion, the IRC has provided the taxpayer (under specific circumstances) an opportunity to defer recognizing gain on the sale of real property via electing to utilize the installment method. But there are advantages and disadvantages

In Conclusion

Advantages

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

Disadvantages

- The possibility of losing expiring carryforwards
- More time and expense involved with using this method
- The cost and expense involved with repossessing a property, and
- If income tax rates are expected to increase in future years, it may cost the taxpayer additional tax as compared to paying the entire amount in the year of sale

The Act

- When Congress was authoring the Act, there was very serious consideration of either putting major restrictions on the use of installment sales or even eliminating them completely
- But fortunately due to heavy lobbying by the real estate industry, the opportunity still remains

Final Quiz Time

We will now take our second and final quiz consisting of 10 more real estate tax questions

Remember, it is your last chance to earn those CHECKS and win the fabulous "prize"

1) If business property is sold for a gain and does NOT qualify as IRC Sec 1231 property, how would the gain be taxed?

   a) As portfolio income

   b) As a long-term capital gain

   c) As ordinary income

   d) The entire gain may be deferred

2) If IRC Sec 1245 property is disposed of for a loss, how would the loss be recognized?

a) As a portfolio loss
b) As an ordinary loss
c) As a short-term capital loss
d) As a long-term capital loss

3) In 2014, Eskin Investors purchased a piece of land for $125,000 which they held for investment. The land was sold in 2020 for $200,000. Where and how should the gain be reported?

a) On Form 4797 as a long-term capital gain which will then flow to Schedule D
b) On Form 4797 as an ordinary gain
c) Directly to Schedule D as a long-term capital gain
d) It is a non-taxable transaction

4) All of the following will increase the tax basis of real property EXCEPT:

a) Survey costs
b) Depreciation
c) Owner’s title insurance
d) Transfer taxes

5) For whose benefit is title insurance NOT typically purchased for?

a) The purchaser of the property
b) The seller of the property
c) The lender
d) It is purchased for a), b), and c)

6) A lessee pays its 1/21 rent on 12/31/20. The lessee reports on the accrual basis. When should he/she deduct this expense?

a) In 2020
b) In 2021
c) The lessee can make an election to deduct the expense in either year
d) It is a nondeductible expense

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7) A lessor receives its 1/21 rent on 12/31/20. The lessor reports on the accrual basis. When should he/she recognize this income?

a) In 2020
b) In 2021
c) The lessor can make an election to recognize the income in either year
d) It is a nondeductible expense

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8) Under which of these circumstances may points paid be currently deductible?

a) In association with a loan to improve the taxpayer's primary residence
b) If they were paid for a taxpayer's 2nd home
c) If they were associated with refinancing a mortgage on the taxpayer's primary residence
d) If they were associated with financing an investment in real property

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9) When discussing depreciation in terms of "allowed" or "allowable," which of the following statements is TRUE?

a) Allowable depreciation is the depreciation claimed on an income tax return accepted by the IRS
b) Allowable depreciation is the amount a taxpayer may deduct from gross income using methods and recovered periods provided by current tax law
c) "Allowed" and "Allowable" have the same meaning
d) None of the above are true

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10) Which of the following is true if a C corporation realizes a capital loss upon the disposal of real property?

a) Capital losses are never deductible

b) Capital losses are only allowed to the extent of capital gains

c) They are passed through to the shareholders of the corporation

d) They can be offset with capital losses, and to the extent there are excess capital losses, up to $3,000 can be deducted against other types of income

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11) Which of the following would be an indicator that the taxpayer involved in real estate is a dealer?

a) The taxpayer's intent when purchasing a property is primarily for investment purposes

b) The taxpayer is involved in frequent and continuous sales of real property

c) The taxpayer has little involvement in improvement and development activities

d) The taxpayer has very little involvement in the sale and promotion of the property

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12) When you hear the term "avoided cost method," what type of cost should come to mind?

a) Direct production costs
b) Indirect production costs
c) Interest
d) Real estate taxes

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Completion of Chapter VII

The fact that the webinar is almost over is just like Heaven

And we have just completed Chapter 7

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☺☺ END OF THE WEBINAR ☺☺

Well, folks,

it is now time to determine our

☺☺☺ "WINNERS" ☺☺☺

For The Winners

If you have earned at least 18 checks, well you get to sing the next song along with me and are considered an honorary fan for 1 year

FLY EAGLES FLY

Fly Eagles Fly on the road to victory
Fight Eagles Fight, score a touchdown 1, 2, 3

Hit ‘em low
Hit ‘em high
And watch our Eagles Fly

Fly Eagles Fly on the road to victory
E-A-G-L-E-S EAGLES

FLY EAGLES FLY

And for Our Non-Winners

Unfortunately, if you did not earn 18 checks, you are required to keep the following picture above your desk as an inspiration when preparing your various tax returns

And a Final Wish to Everyone

And my final wish to everyone watching this webinar today:

That we never meet under the wrong circumstances

☺ THANK YOU, FOLKS ☺

billeskin@gmail.com

Q&A

We will now answer viewer questions that have come in during the webinar

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Thank you!

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