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**§ 2.01 Introduction**

**[1] Real Estate as a Tax Investment**

Although some of the tax benefits relating to real estate have been whittled away over the years, real estate ownership still remains a tax-favored investment. For example, as explored below, real estate brings the ability to depreciate business or investment property, at ordinary income rates, while realizing capital gains on appreciation. In addition, real estate often provides the ability to deduct interest while leveraging an investment. The choice of entity used to hold the real estate investment will also dictate some of the tax consequences.

The tax consequences of each investment will vary depending on many factors, including the specific tax position of the owner in any given year. In addition, the economic and the tax results of an investment may be inconsistent. For example, a tax loss may be preferable for a taxpayer, while an economic loss is generally not desired. The complexity of the tax law will require the analysis of many factors involved in each investment and for each taxpayer’s set of facts and circumstances. The chapter will discuss the tax consequences of real estate financing and ownership in an approach generally following the life cycle of an investment, from acquisition, through operation, and then disposition, including:

1. the type of property involved;
2. the consequences of the choice of entity used by the taxpayer;
3. the acquisition of the property;
4. available tax benefits in the form of deductions and losses;
5. available tax benefits in the form of credits;
6. limits regarding the tax benefits; and
7. disposition of the property.

The following subsections present a general overview of the tax advantages of real estate ownership and how the tax rules vary with the type of property involved.

**[2] Tax Advantages of Real Estate Ownership**

**[a] Leverage**

The three basic tax advantages of real estate ownership, whether for commercial or residential property, are (1) leverage; (2) current, “ordinary” treatment for losses; and (3) deferred, and often capital, treatment for gains. The concept of leverage involves using borrowed funds to finance a portion of the purchase price of a property while enjoying the tax benefits with respect to the entire cost of the property.

**EXAMPLE:**

If The Euril Company (TEC) makes a twenty-percent cash down payment on a $1 million building to use in its business and borrows the balance of the purchase price from the America Bank, TEC can depreciate as much of the total purchase price (cash down payment *and* debt) as relates to the building and not to the underlying land. Therefore, if seventy percent of the purchase price applies to the building and thirty percent to land, TEC can take depreciation on $700,000 even though it is only “out of pocket” $200,000 in cash.

There are many potential exceptions to this general comment. For example, TEC may *not* be able to take depreciation on the full $700,000 if it leases the building to a tax-exempt entity or if it has passive activity limitations or if it is not at risk with respect to the debt. Determining whether these limitations apply may depend, in part, on TEC's entity status (*e.g.,* partnership, regular C corporation, closely-held C corporation, S corporation, etc.). These nuances will be discussed in more detail below. The “big picture” concept here, however, is that the *possibility* of recognizing tax losses in excess of cash actually invested exists in a real estate investment.

**[b] Ordinary Loss or Deduction**

Most deductions generated from real estate, such as depreciation and interest, are ordinary deductions, which offset ordinary income of the taxpayer, subject to other potential limitations as discussed below. This can be particularly advantageous in a leveraged investment, as described above, since ordinary deductions can exceed the cash invested by a taxpayer. Note that while the taxpayer’s basis in the property must be reduced by the depreciation deductions, the subsequent gain on sale produced by this reduced basis (assuming that the property’s value does not actually decline in the amount of the depreciation) may be capital gain. Thus, current ordinary deductions followed by later capital gain on sale will generally produce a favorable tax result to most taxpayers.

**[c] Capital Gains**

The sale of a capital asset will generally result in taxation at more favorable tax rates, perhaps at only 15% rather than 35% for ordinary income.[[2]](#footnote-3) Most real estate for individuals will be a capital asset, unless the individual is a dealer in that real estate.[[3]](#footnote-4)

**[3] Type of Property**

**[a] In General**

There are a variety of types of real estate, and the tax rules can vary according to the type of property involved. In general, from a tax standpoint, the tax rules may depend on whether the property is (1) residential rental property; (2) non-residential rental property; (3) property used by the taxpayer in the taxpayer’s trade or business; (4) personal use residential property; or (5) undeveloped land. For example, the latter two categories of property are not eligible for depreciation, and the amount of depreciation allowed on rental properties will depend on whether the property is residential or commercial.[[4]](#footnote-5) In addition, special gain exclusion rules apply to the disposition of personal residences.[[5]](#footnote-6)

**[b] Use Determines Type**

The above categories do *not* describe particular pieces of property, but they *do* describe the use to which a piece of property is put. For example, a building designed to be a so-called “single-family residence” can be all of the above. If it is owner-occupied and used as a personal residence, it is residential (personal use) property. If it is rented to a tenant and used as a residence, it is residential rental property. If, on the other hand, it is either owner-occupied or rented to another and used as a commercial establishment (*e.g.,* a law office), it is non-residential property. And if the owner of the building also owns the underlying land, some portion of the property cost is attributable to undeveloped property. A high-rise building in a downtown business district could be non-residential rental real property or residential rental real property, depending on its use.

**[c] Split Use**

Property need not be used exclusively in one of the above categories. For example, the owner of a single-family residence using the property as his or her personal residence but also renting out a spare room has property that is partially personal use residential property and partially residential rental property. Similarly, if the owner of a commercial building uses the lower floor for his or her business and the upper floor as a personal residence, the property will be partially commercial real estate and partially personal use residential property. Thus, the property may have to be “split” based on square footage or some other equitable method, and be subject to different rules for the different types of real property.[[6]](#footnote-7)

**[d] Conversion**

Another factor to keep in mind in determining the characterization of real property for federal tax purposes is that the property type can change with a change in use. For example, if a taxpayer moves from San Francisco to Florida but chooses to rent his or her former residence in California rather than sell it, the character of the property changes from personal use residential to residential rental property. The property will be eligible for depreciation after the conversion,[[7]](#footnote-8) but may also still be subject to some of the rules applicable to personal residences.[[8]](#footnote-9) Note that for basis purposes, on the conversion of personal use property to business or rental property, the basis of the property will be the lower of its fair market value or current basis at the time of the conversion.[[9]](#footnote-10) Since losses on the sale of personal residences are not deductible,[[10]](#footnote-11) this basis rule prevents a taxpayer from converting a personal residence where the fair market value is less than its basis into business property and claiming a loss on its subsequent sale.

**[e] Used in Business**

Property that is used by a taxpayer in his or her trade or business (e.g., the taxpayer owns the building that houses the business’s headquarters, warehouse, or retail setting) often carries similar tax advantages to property that is owned and leased to others (e.g., both types of buildings may be depreciated). While both types of investments in real estate may be considered “business” investments, there are also differences in some of the tax rules as applied to property used rather than rented by the taxpayer. For example, as discussed below, the passive loss rules and the involuntary conversion rules may apply differently based on whether the business property is owner-occupied or rented to tenants.[[11]](#footnote-12)

**[f] Dealer vs. Investor**

The taxpayer’s motive in holding the property can also determine if the taxpayer is entitled to capital gain treatment on the disposition of the property, or whether the taxpayer will recognize ordinary income on the property’s appreciation. Capital gain treatment does not apply to property held primarily for sale to customers in the ordinary course of business.[[12]](#footnote-13)If a taxpayer holds property primarily for sale to customers in the ordinary course of business, the taxpayer is called a “dealer” in real estate.

To determine whether a taxpayer is a dealer in real estate, courts look to all the facts and circumstances.[[13]](#footnote-14) It is often a difficult distinction whether a taxpayer is buying and selling real property so extensively as to constitute a separate business, or is just periodically disposing of investment assets. Courts have often looked to the following factors in distinguishing between a dealer and an investor:

1. the frequency, number, and continuity of sales;
2. subdivision, platting, and other improvements or developments tending to make the property more marketable;
3. the extent to which the taxpayer engaged in sales activity;
4. the length of time the property has been held;
5. the substantiality of the income derived from the sales, and what percentage that is of the taxpayer’s total income;
6. the nature of the taxpayer’s business;
7. the taxpayer’s purpose in acquiring and holding the property;
8. the extent of sales promotional activity such as advertising; and
9. the listing of property directly or through brokers.[[14]](#footnote-15)

A taxpayer can be a dealer in real estate and yet hold certain property as an investment, thus obtaining capital gain treatment for some property.[[15]](#footnote-16)

**§ 2.02 Choice of Entity**

**[1] In General**

There is no one type of entity in which real estate should be always be held. There are so many different variables, objectives, and fact patterns involved—both tax and non-tax—from taxpayer to taxpayer, that it is difficult to generalize. Nevertheless, the relatively recent advent of limited liabilities companies (LLCs), and their favorable tax consequences, as discussed below, have resulted in the LLC perhaps being the entity of choice for holding real estate. The principal entities for holding real estate discussed here are: (1) individuals or sole proprietorships; (2) C corporations; (3) S corporations; (4) partnerships; (5) liability companies; and (6) real estate investment trusts (REITs). This chapter generally does not separately consider trusts and estates, personal service corporations, or publicly traded partnerships.[[16]](#footnote-17)

In considering the best entity in which to hold a real estate investment, taxpayers should consider not only the operating rules of the entity, but also an exit strategy for the investment. Since real estate is generally an appreciating asset, the taxpayer must determine the tax consequences of liquidating the real estate and the entity.

**[2] Types of Entities**

**[a] Individuals and Sole Proprietorships**

When an individual holds real estate directly or as a sole proprietorship,[[17]](#footnote-18) the investor should consider the tax consequences of the acquisition of the property, the operation of the property, and the subsequent disposition of the property. The tax rates applicable to individuals will dictate the tax cost of the property’s income or gains, and the tax benefit of the property’s deductions. Generally, the highest tax rate currently applicable to individuals is 35 %.[[18]](#footnote-19) Since real estate generally produces capital gains to individuals,[[19]](#footnote-20) taxpayers should also consider that the maximum capital gain rate for individuals is 15%.[[20]](#footnote-21)

Individual taxpayers are subject to the passive activity loss rules and the at-risk rules, both of which may limit an individual’s ability to deduct losses generated from the real estate activities. Under the passive activity loss rules, individual taxpayers are limited in their ability to use losses from certain passive investment activities to offset income from other non-passive investments and activities.[[21]](#footnote-22) Under the at-risk rules, individuals may be limited in their ability to deduct losses generated from a real estate investment, except to the extent that the taxpayer has amounts “at risk” in the investment.[[22]](#footnote-23)

One of the benefits of holding real estate as an individual is that there is no entity level tax or concern of the tax consequences of distributing sale proceeds from the entity to the individual. A non-tax concern, of course, with holding real estate as a sole proprietorship is the potential for personal liability to the owner.

**[b] C Corporations**

Real estate held in a C corporation is generally not advantageous from a tax standpoint due to the double level of taxation for C corporations. The C corporation will be taxed on its income at a maximum rate of 35%[[23]](#footnote-24) but a distribution of the income to the shareholders will be taxed again as a dividend.[[24]](#footnote-25) While the limited personal liability afforded by the use of a C corporation is a key advantage, this double level of taxation for C corporations is particularly problematic for highly appreciating assets such as real estate.[[25]](#footnote-26)

In addition, losses generated by the real estate investment may be trapped in a C corporation with no benefit to the shareholders. While net operating losses can be carried forward or back to offset corporate income,[[26]](#footnote-27) these corporate losses will not be able to be passed through for use by the shareholders in a C corporation.

The tax consequence of the distribution of appreciated property from a C corporation, including distributions on the liquidation of the corporation, is one of the main reasons to avoid using a C corporation to hold real estate.[[27]](#footnote-28) Internal Revenue Code § 311 provides that a distribution of appreciated property to the shareholders will result in gain (but not loss) recognized to the corporation equal to the difference between the fair market value of the property and the corporation’s basis in the property. In addition, the shareholder recognizes income in the amount of the fair market value of the distribution.[[28]](#footnote-29) Thus, whether the corporation sells an asset and then distributes the proceeds, or distributes the asset directly to the shareholders, the appreciation in the asset will be taxed first to the corporation and then the total value of the distribution will taxed to the shareholders.[[29]](#footnote-30)

The at-risk and passive loss rules generally do not apply to C corporations, other than closely held corporations and personal service corporations.[[30]](#footnote-31)

**[c] S Corporations**

The S Corporation’s income, gain, deductions, losses, and credits are “passed through” to the shareholders on an annual basis.[[31]](#footnote-32) The corporation itself is generally not subject to a corporate level tax.[[32]](#footnote-33) This flow-through taxation allows losses generated in the early years of a real estate project to be passed through to the individual shareholders for use on their personal returns. Likewise, the flow-through of gains, including gain from the sale of real estate, will only be taxed once at the shareholder level. Since the corporation itself is not generally subject to tax, the tax rates involved will be the individual tax rate applicable to each shareholder.

A key difference between an S corporation and a C corporation or a partnership is that the S corporation is limited with respect to the types of permissible shareholders and the number of shareholders. In addition, only certain types of corporations are eligible to be S corporations. An S corporation must be a domestic corporation[[33]](#footnote-34) and:

1. cannot have shareholders who are not individuals, estates, certain trusts, certain qualified retirement trusts, or charitable organizations, and cannot have nonresident alien shareholders;[[34]](#footnote-35)
2. cannot have more than 100 shareholders (with certain family groups counted as one shareholder);[[35]](#footnote-36)
3. can only have one class of stock (although differences in voting rights are allowed);[[36]](#footnote-37)
4. cannot be an insurance company, a § 936 corporation, a DISC or former DISC, and certain types of financial institutions.[[37]](#footnote-38)

An S corporation may own 100% of the stock of a subsidiary, and that subsidiary may elect to be treated as a disregarded entity (a “qualified subchapter S subsidiary”), despite the fact that it has a corporate parent.[[38]](#footnote-39) As a disregarded entity, it is not treated as a separate taxable entity but instead its assets, liabilities, and items of income, deduction, and credit are treated as those of the parent S corporation.[[39]](#footnote-40) A qualified subchapter S subsidiary could thus be used in a manner similar to a single member LLC, such as to hold real estate in separate legal entities for liability purposes under the umbrella of the parent corporation.

[i] Eligible Shareholders

Only certain types of shareholders may own stock in an S corporation. If a corporation has non-qualifying shareholders, it will not be entitled to make an S election, or an existing S corporation that acquires a non-qualifying shareholder will lose its S election and be taxed as a C corporation.[[40]](#footnote-41)

Individuals are permissible S corporation shareholders, and may hold stock as a tenant in common, a joint tenant, a tenant by the entirety, or as a community property asset.[[41]](#footnote-42) In those cases, each owner must be a qualified shareholder, and the question is how those joint owners are counted for purposes of the limit on the number of S corporation shareholders.[[42]](#footnote-43) In addition, the bankruptcy estate of an individual is a permitted shareholder. However, nonresident aliens are not permitted S corporation shareholders.[[43]](#footnote-44) Moreover, if a nonresident alien has a community property interest in S corporation stock (i.e., a qualifying shareholder is married to a nonresident alien and the stock held by the qualifying shareholder is a community property asset), the entity will not qualify as an S corporation.[[44]](#footnote-45)

While partnerships and corporations may not be shareholders of an S corporation,[[45]](#footnote-46) decedent’s estates are permitted S corporation shareholders,[[46]](#footnote-47) as well as tax-exempt organizations described in I.R.C. § 501(c)(3),[[47]](#footnote-48)and tax-exempt retirement plans.[[48]](#footnote-49) However, only certain types of trusts may be S corporation shareholders. Testamentary trusts may hold S corporation stock for up to two years,[[49]](#footnote-50) and voting trusts are permissible shareholders.[[50]](#footnote-51) Individuals are also permitted to hold their S corporation stock through grantor trusts,[[51]](#footnote-52) and the trust will continue to be a qualified shareholder for two years after the death of the grantor.[[52]](#footnote-53) If a trust does not meet one of the above definitions, it may also be a qualified S corporation shareholder if it is either a Qualified Subchapter S Trust (“QSST”) or an Electing Small Business Trust (“ESBT”).[[53]](#footnote-54) In order for a trust be a considered a QSST, the trust must meet certain strict requirements.[[54]](#footnote-55) The requirements for the other type of permitted S corporation trust – the ESBT – are much less onerous and the permissible terms of the trust much more flexible.[[55]](#footnote-56)

[ii] Number of Shareholders

Currently, an S corporation is allowed to have 100 shareholders.[[56]](#footnote-57) Under previous versions of this limitation, an S corporation was only allowed to have 10 shareholders,[[57]](#footnote-58) then 15 shareholders,[[58]](#footnote-59) then 35 shareholders,[[59]](#footnote-60) and, until 2004, 75 shareholders.[[60]](#footnote-61)

In addition, the Code and the Regulations establish certain rules for counting the number of shareholders. For example, all members of a family may be counted as one person for purposes of determining the permissible number of shareholders,[[61]](#footnote-62) although this family rules applies only if a special election is in effect.[[62]](#footnote-63) Family is very broadly defined for this purpose, and includes common ancestors and lineal descendants of that common ancestor, and their spouses or former spouses. A common ancestor may not be more than six generations removed from the youngest generation of shareholders.[[63]](#footnote-64)

If stock is held as tenants in common or joint tenants, each person counts as a shareholder.[[64]](#footnote-65) Moreover, the Code also provides who is counted as a shareholder with the different types of trusts that are permissible shareholders. For example, in the case of a voting trust, each beneficiary is treated as a shareholder,[[65]](#footnote-66) the estate is the shareholder when a testamentary trust holds stock,[[66]](#footnote-67) the grantor is the shareholder when a grantor trust hold stock,[[67]](#footnote-68) the income beneficiary with a QSST,[[68]](#footnote-69) and each potential current beneficiary is an shareholder when an ESBT hold S corporation stock.[[69]](#footnote-70)

**[iii] One Class of Stock Requirement**

An S corporation cannot have more than one class of stock,[[70]](#footnote-71) although differences in voting rights are allowed.[[71]](#footnote-72) Thus, an S corporation may not have preferred stock, although it may have both voting and nonvoting common stock. While differences in voting rights are allowed, differences in economic rights are not. Therefore, any attempt to create different rights to distributions or liquidation proceeds among the shareholders may violate the one class of stock requirement and disqualify the corporation from being taxed as an S corporation. However, the regulations do allow S corporation stock to be subject to bona fide agreements to redeem or purchase stock at death, divorce, disability, or termination of employment.[[72]](#footnote-73)

**[iv] Flow-through Taxation**

A shareholder of an S corporation may deduct his or her share of the S corporation’s losses to the extent of the shareholder’s basis in the corporation’s stock and the basis of any debt owned to the shareholder by the corporation.[[73]](#footnote-74) Disallowed deductions and losses can be carried forward and deducted in a subsequent year when the shareholder has stock or debt basis.[[74]](#footnote-75) Unlike partnerships or LLCs,[[75]](#footnote-76) an S corporation shareholder does not have any basis in entity-level debt. Therefore, the shareholder’s ability to deduct losses of the venture will be limited to the shareholder’s actual investment in the corporation, whether in debt or equity. This is one limitation of S corporations for real estate that is generating taxable losses.

Since shareholders only receive debt basis for loans made directly by the shareholder to the S corporation, and not for any loans of the entity from any other source, shareholders have tried to obtain debt basis through methods that do not require a direct outlay of money to the corporation. Generally these methods have been unsuccessful. For example, if the S corporation borrows funds from a creditor and the shareholder guarantees the loan, the shareholder will not receive debt basis due simply to the guarantee.[[76]](#footnote-77) Shareholders have also tried creative circular transfers of cash in order to claim debt basis, which are generally ignored.[[77]](#footnote-78) However, a shareholder can structure a back-to-back loan from a lender to the shareholder and then from the shareholder to the S corporation. These are generally respected as creating debt basis to the shareholder.[[78]](#footnote-79)

Under the Code, each S corporation shareholder must take into account that shareholder’s “pro rata share” of the various corporate items.[[79]](#footnote-80) I.R.C. § 1377(a)(1) defines “pro rata share” as being the sum of the amounts determined by (i) dividing an item into equal portions for each day in the tax year, and then (ii) dividing each day’s portion among the shares outstanding on that day. This is referred to as the “per-share, per-day” method. Upon certain events, the shareholders may elect to use a “closing of the books” method of allocating income and losses, rather than the “per-share, per-day” method.[[80]](#footnote-81) This is a further limitation for S corporations in real estate ventures, since partnerships and LLCs may use “special allocations” to allocate certain tax items among the partners.[[81]](#footnote-82)

Unlike partnerships and LLCs, which may have special allocations of profits and losses amongst their owners, an S corporation is only permitted to have one class of stock.[[82]](#footnote-83) Accordingly, income and losses may not be allocated among the shareholders other than on the basis of their proportionate ownership interests. However, the rules under Subchapter S do not tax pre-contribution appreciation to the contributing shareholder, as the partnership tax rules do.[[83]](#footnote-84) Thus, a shareholder contributing appreciated property to an S corporation in a tax-free incorporation[[84]](#footnote-85) will only be taxed on that shareholder’s proportionate share of gain, based on the percentage of stock owned by that shareholder, when the corporation sells the asset and recognizes the gain. This allows shareholder to effectively shift income to other shareholders.

In some situations, S corporations are subject to an entity-level tax. Under I.R.C. § 1374, the S corporation may be subject to tax on the disposition of appreciated assets that were held by a C corporation before it made an S election. For C corporations that are currently holding appreciated real estate, an S election is still beneficial. If the entity remains a C corporation, the appreciation in that asset will be subject to two levels of tax upon a taxable sale of that asset. By electing to be an S corporation, all future appreciation that accrues while the asset is held in an S corporation will only be subject to one level of gain. In addition, if the corporation is willing to hold that asset for an additional 10-year period beyond the date it converts to an S corporation, all of the appreciation can escape a corporate level tax. The I.R.C. § 1374 built-in-gain tax only applies for 10 years after the corporation becomes an S corporation.[[85]](#footnote-86)

In addition, under I.R.C. § 1375, an S corporation may be subject to a tax on its excess passive investment income if the corporation was formerly a C corporation and has undistributed C corporation accumulated earnings and profits. Passive investment income for this purpose includes rental income.[[86]](#footnote-87) However, this tax can be avoided if the corporation has no taxable income for the year, if the accumulated earnings and profits are distributed, or if the rental income is not considered “passive” under the regulations.[[87]](#footnote-88)

In addition, in order to be taxed as an S corporation, the corporation must make an election. On the effective date of that election, the corporation will be taxed under Subchapter S rather than under Subchapter C (i.e., it will generally not be subject to a corporate level tax on its income). The election requirements are in I.R.C. § 1362, and once a valid election is made, it stays in effect until it is terminated.[[88]](#footnote-89) The election is made on Form 2553, which must be signed by a corporation officer and consented to by all of the shareholders.[[89]](#footnote-90) The election must be filed on or before the fifteenth day of the third month of the corporation’s taxable year (or any time during the prior taxable year).[[90]](#footnote-91)

It is important for taxpayers to determine the accuracy of their election, as the Internal Revenue Service does not rule on the validity of an election when it is filed. The I.R.S. does, however, have the authority to waive untimely or invalid elections.[[91]](#footnote-92)

Distributions of property from an S corporation, whether in a current distribution or upon a stock redemption or liquidation of the entity, are treated similarly to distributions of property from a C corporation.[[92]](#footnote-93) Under the combination of I.R.C. § 1371(a) and I.R.C. § 311, an S corporation recognizes gain on the distribution of appreciated property as if the corporation sold the asset for its fair market value.

Although the S corporation recognizes gain on the distribution of appreciated property to a shareholder, the corporation pays no tax on its income.[[93]](#footnote-94) Instead, that income flows through and is taxed to the shareholders.[[94]](#footnote-95) This gain recognized by the shareholders increases their stock basis. Consequently, this appreciation is generally taxed at only one level rather than the two levels recognized by a C corporation. However, this treatment is less favorable than the treatment of the distribution of an appreciated asset from a partnership or LLC, where gain is deferred.[[95]](#footnote-96)

One limitation on the use of S corporations involves corporate employee fringe benefits. S corporation employees who are more than two-percent shareholders are not entitled to a variety of tax-free fringe benefits available to C corporation employees. Tax-free benefits not available to S corporation shareholder/employees include medical and accident coverage, group-term life insurances, and qualified transportation fringe benefits. S corporation employees are treated as partners for fringe benefit purposes.[[96]](#footnote-97)

**[d] Partnerships**

The definition of a partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization that carries on any business, financial operation, or venture, and that is not a trust, estate, or corporation.[[97]](#footnote-98) All partnerships formed under state law (whether a general partnership, a limited partnership, or a limited liability partnership) will be taxed under Subchapter K of the Internal Revenue Code.[[98]](#footnote-99)

**[i] Flow-through Taxation**

Generally no gain or loss is recognized to a partner on the contribution of appreciated (or depreciated) property to a partnership.[[99]](#footnote-100) Therefore, the contribution of appreciated real estate to a partnership should generally not trigger a taxable event. Unlike corporations,[[100]](#footnote-101) a partner need not be in control of the partnership in order to achieve a tax-free contribution of property to the partnership. The basis of the property contributed will be its basis in the hands of the partnership.[[101]](#footnote-102) The partner’s basis in his or her partnership interest will be a substituted basis from the property contributed.[[102]](#footnote-103)

A partner does have the potential for gain recognition upon formation in certain circumstances. A partner receiving a capital interest in the partnership in exchange for services will recognize income in the amount of the fair market value of the capital interest received.[[103]](#footnote-104) In addition, if a contribution of property subject to debt relieves the partner of debt in excess of his or her basis in the partnership, the partner will recognize gain in the amount of that excess.[[104]](#footnote-105) Similar gain recognition could also arise if a new partner enters into an existing partnership, and a share of the existing partnership debts are allocated to the new partner. In that case, the existing partners will have a deemed cash distribution in the amount of their reduction in their share of the partnership debt, which deemed cash distribution will be taxable if it exceeds the partner’s basis in his or her partnership interest.[[105]](#footnote-106)

A partner may also be subject to the disguised sale rules of I.R.C. § 707, which may convert a tax-free contribution of property and related distribution into a taxable sale of property to the partnership.[[106]](#footnote-107) These rules presume that a sale occurred if a partner contributes property and receives back cash or other property from the partnership within two years of the contribution, unless a specific regulatory exception applies. Furthermore, if the contributor's property is distributed to another partner, or if the contributor receives other property from the partnership, within seven years of the contribution, gain may be recognized.[[107]](#footnote-108)

With partnerships, or any entity taxed as a partnership (i.e., an LLC), the partner’s basis in his or her partnership interest includes that partner’s share of partnership level debt. This is accomplished under I.R.C. §752(a), which provides that an increase in a partner's share of partnership liabilities,[[108]](#footnote-109) or an increase in a partner's individual liabilities due to the assumption of partnership liabilities, is treated as a contribution of money to the partnership. This deemed contribution of money results in an increased basis for the partner in his or her partnership interest.[[109]](#footnote-110) Conversely, under I.R.C. §752(b), a decrease in a partner's share of partnership liabilities, or a decrease in a partner's individual liabilities by reason of the assumption of such individual liabilities by the partnership, is treated as a distribution of money to the partner. This deemed cash distribution will reduce the partner's basis for his or her partnership interest.[[110]](#footnote-111) I.R.C. § 731(a) will require gain to be recognized when a partner receives an actual or constructive cash distribution from the partnership that is in excess of the adjusted basis of his or her partnership interest. A partner’s share of liabilities for purposes of I.R.C. § 752 is determined under the Treasury Regulations, and will depend on whether the liability is a recourse liability or a nonrecourse liability.[[111]](#footnote-112)

This inclusion of entity-level debt in the partner’s basis is a benefit of partnerships and LLCs (and any other entities taxed as partnerships). An increased basis will allow partners to deduct a greater amount of losses that flow through from the entity.[[112]](#footnote-113) However, partners must be careful of liability shifts and reductions, which produce a deemed cash distribution under I.R.C. §752(b), and perhaps gain if the reduction in the partner’s share of debt exceeds the partner’s basis in his or her partnership interest.[[113]](#footnote-114)

The partnership’s income, gain, loss, and deduction items are allocated among the partners, who report these items on their personal tax returns. A partner's “distributive share” of these income or loss items is passed through the partnership to the partners and included in taxable income for the taxable year within or with which the partnership's taxable year ends.[[114]](#footnote-115) Partnership taxable income is generally computed in the same manner as an individual's taxable income, with certain personal items disallowed.[[115]](#footnote-116) Some of the partnership’s income and deduction items that flow-through to the partners must be “separately stated" so they can be properly reported on the partner’s individual return, such as capital gains and losses, charitable contributions, dividends received, and foreign taxes.

A key advantage that partnerships possess over corporations, including S corporations, is the ability to “specially allocate” items of income, gain, loss, and deduction disproportionately among the partners. This means, for example, that a partner who contributed 50% of the capital could be allocated 90% of the profits and losses. Thus, a partnership (or any entity taxed as a partnership) may be able to allocate items of loss or deduction to those partners who can best utilize such items, or allocate income or gain to those partners who can best absorb the tax burden of such items. This special allocation is not available in an S corporation. Generally the partnership agreement controls the allocations of partnership items for tax purposes and a special allocation will be respected if the allocation has “substantial economic effect.”[[116]](#footnote-117) The Treasury Regulations provide detailed rules to determine whether a special allocation has “substantial economic effect.”[[117]](#footnote-118)

The flexibility of partnership allocations is subject to a limitation if, at the time of contribution of property, there is a difference between the fair market value of property contributed and its adjusted basis. In that event, allocations of income, gain, loss, and deduction with respect to that contributed property are governed by I.R.C. § 704(c). I.R.C. §704(c)(1)(A) requires that the precontribution gain or loss be allocated to the contributing partner when that gain or loss is recognized by the partnership or in certain other instances.[[118]](#footnote-119) For example, if a partner contributed property with a fair market value of $10,000 and an adjusted tax basis of $4,000 to a partnership, that partner would be allocated the first $6,000 of gain recognized from the eventual sale of that property. Any additional appreciation accruing after the contribution to the partnership would be allocated among the partners in the manner in which they shared profits under the partnership agreement.

The rules under I.R.C. § 704(c) also affect the way in which depreciation on contributed property with precontribution gain or loss is shared among the partners.[[119]](#footnote-120) The concept behind these rules is to allow the non-contributing partner the advantage of what he or she essentially paid for their partnership interest. Thus, the regulations sanction three different methods to compensate the non-contributing partner from receiving less than his or her share of depreciation deductions on the property. While the application of these methods is complicated, the effect is that the partners have flexibility to choose a § 704(c) allocation method for each piece of property subject to the rules, and can often substantially impact the manner in which depreciation deductions are allocated among the partners.[[120]](#footnote-121)

Once deductions and losses are allocated to a partner, that partner may be limited in his or her ability to deduct those items on the partner’s personal income tax return. In addition to any potential limitations on the deductibility of losses due to the passive loss rules[[121]](#footnote-122) or the at-risk rules,[[122]](#footnote-123) I.R.C. § 704(d) prevents a partner from deducting partnership losses in excess of the partner’s basis in his or her partnership interest at the end of the partnership year in which such loss occurred. Any losses in excess of the partner’s basis in his or her partnership interest are carried over indefinitely and allowed as a deduction when the partner has basis in the partnership interest.[[123]](#footnote-124) One of the benefits of partnerships, however, is the inclusion of entity level debt in a partner’s basis in his or her partnership interest.[[124]](#footnote-125) Thus, a partner is entitled to deduct losses leveraged with entity-level debt, sometimes even with debt for which the partner is not personally liable.

One of the important advantages of an entity taxed as a partnership is the ability to distribute appreciated property from the partnership to a partner/member without triggering a taxable event and consequently without gain recognition of the appreciation in that asset. Under I.R.C. § 731(b), no gain or loss is recognized to a partnership upon the distribution of appreciated or depreciated property.[[125]](#footnote-126) Similarly, a partner does not recognize gain upon the distribution of an appreciated asset from the partnership to the partner. Loss could be recognized to a partner on a distribution but only if the distribution is in liquidation of the partner’s interest in the partnership and the partner receives no property other than money, unrealized receivables, and inventory.[[126]](#footnote-127)

The unrecognized gain in the property distributed will remain with the property due to the carryover basis rules. The tax basis for the property received by the partner will be the adjusted basis for that property in the hands of the partnership immediately before the distribution.[[127]](#footnote-128) Such basis may not exceed, however, the adjusted basis of the partner’s interest in the partnership, reduced by any money distributed in the same transaction.[[128]](#footnote-129) The holding period of the property received will include the period held by the partnership.[[129]](#footnote-130) The partner’s basis in his or her partnership interest will be reduced by the basis of the asset received in the distribution.[[130]](#footnote-131)

The rules are slightly different for a liquidating distribution. In that case, the partner’s basis in his or her partnership interest is allocated among all the assets received in the liquidation, under rules set forth in I.R.C. § 732(c). However, both the current and liquidating distribution rules allow a partner to receive appreciated property from a partnership and defer the taxable event until the partner sells that property.

Of particular significance to real estate partnerships and any entity taxed as a partnership is a potential decrease in available depreciation deductions after a “technical termination” of the partnership. Under I.R.C. § 708, a partnership will be considered terminated whenever there is a sale or exchange within a 12-month period of 50 percent or more of the interests in the partnership capital and profits. This “technical termination” is considered to exist for tax purposes, and may carry certain tax consequences, even though the partnership continues operations for business and state law purposes.

The cost recovery rules of I.R.C. § 168 generally provide that when assets are contributed to a partnership, the partnership continues to use the same depreciation method as the transferor.[[131]](#footnote-132) However, that section also provides that this step-into-the-shoes rule does not apply in the case of a technical termination.[[132]](#footnote-133) Although the “new” partnership resulting from a technical termination assumes the carryover basis of the assets from the “original” partnership, the assets must now be depreciated over a new recovery period. Thus, if a real estate asset with a 39-year recovery period is in a partnership that undergoes a technical termination after depreciating that asset for 10 years, the partnership must depreciate the remaining basis over a new 39-year recovery period. This could significantly reduce depreciation deductions to such a partnership.

Partnerships and LLCs must be careful not to inadvertently trigger a technical termination, especially if negative tax consequences will result.

**[ii] Co-ownership or Partnership[[133]](#footnote-134)**

Property may be held as co-owners without the formation of a partnership. Whether a joint enterprise is a partnership under state partnership statutes is not determinative of its status for income tax purposes.[[134]](#footnote-135) Thus, with respect to real property, a large question looms as to when a co-ownership of property will be treated as a partnership for tax purposes.[[135]](#footnote-136) The Treasury Regulations provide some guidance for determining when a co-ownership of property will be respected as such and when it will be treated as a partnership for federal tax purposes. The Treasury Regulations provide that:

A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.[[136]](#footnote-137)

Where property is co-owned and rented, and the rents divided among the co-owners, the venture may be treated as a partnership because of the sharing of expenses and division of profits. However, in certain situations co-owners of property may divide the profits therefrom and not be treated as a partnership. The Regulation quoted above suggests that the degree of activity of the co-owners may result in partnership status.

In Revenue Ruling 75-374,[[137]](#footnote-138) co-owners of an apartment building were not treated as a partnership for tax purposes, even though they leased apartments and provided “customary tenant services” such as heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal, and cleaning of public areas. However, the ruling indicated that if the co-owners directly provided non-customary services, their co-tenancy would be treated as a partnership for tax purposes. In the ruling, non-customary services could be provided by another party, provided the other party received all the compensation for those non-customary services. Thus, the co-ownership of property, even where expenses and rents are shared, may not constitute a partnership if the level of activity is similar to that of Revenue Ruling 75-374. However, application of these standards to specific factual situations is difficult and uncertain.

The Internal Revenue Service has issued guidance on when it will issue a ruling that undivided fractional interests in rental real estate are not interests in a partnership or entity but will be respected as co-ownership interests.[[138]](#footnote-139) These guidelines are stated to be only applicable to rental real estate. In addition, these guidelines are for the purpose of requesting a private letter ruling. Thus, the Revenue Procedure specifically states that these guidelines are “not intended to substantive rules and are not to be used for audit purposes.”[[139]](#footnote-140) However, practitioners may want to consider these guidelines in determining whether a co-ownership is likely to be considered a partnership for tax purposes.

Revenue Procedure 2002-22 requires the following conditions to be satisfied in order to receive a ruling that a co-ownership is not to be treated as a separate (partnership) entity:

1. Title. Each co-owner must hold title to the property as a tenant in common. Title to the property may not be held in the name of an entity.

2. Number of Co-owners. The number of co-owners of the property may not exceed thirty-five persons.

3. Entity Treatment. The co-owners must not file an entity return, conduct business under a common name, or hold themselves out as partners or other members of an entity. The Internal Revenue Service will generally not issue a ruling if the co-owners held the property in a partnership or other entity immediately prior to becoming co-owners.

4. Co-Ownership Agreements and Management Agreements. The parties may enter into a co-ownership agreement, but the Revenue Procedure contains various restrictions on the provisions allowed in any co-ownership agreement. The co-ownership agreement may provide for a right of first refusal and call options, subject to certain limitations.

5. Voting Rights. The co-owners must retain the right to approve the hiring of any manager, the sale or lease of the property, and certain other transactions, some of which must be by unanimous approval.

6. Restrictions on Alienation. Each co-owner must maintain the right to transfer, partition, and encumber their ownership interest without any approvals, other than those customarily required by lenders. Other co-owners are allowed to have the right of first offer.

7. Sharing of Sale Proceeds, Profits, and Debt. If the property is sold, after payment of liens, the remaining proceeds must be distributed proportionately to the co-owners. All sharing of profits and losses must also be shared by the co-owners in proportion to their undivided interests. The co-owners must share in any debt on the property in proportion to their undivided interests.

8. Other Restrictions. The Revenue Procedure restricts the lease and loan terms that may be used in a co-ownership, and the nature of payments to a sponsor of the co-ownership.

9. Customary Activities. The co-owners’ activities with respect to the property must be limited to “customary activities” for the maintenance and repair of rental real estate, as indicated by Revenue Ruling 75-374.[[140]](#footnote-141) Activities will be treated as customary for this purpose “if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder.”The regulations under I.R.C. § 512(b)(3)(A) provide as follows:

[P]ayments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts, or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.[[141]](#footnote-142)

The Service has issued a ruling under this Revenue Procedure sanctioning a co-ownership arrangement and ruling that it was not a business entity (i.e., partnership), thus treating it as an undivided fractional interest eligible as replacement property under I.R.C. Section 1031.[[142]](#footnote-143)

**[iii] Electing Out of Subchapter K**

The Code allows certain unincorporated organizations, that might otherwise qualify as partnerships, to elect to be excluded from Subchapter K. The organizations that can make this election under I.R.C. § 761 are (i) organizations used solely for investment purposes and not for the active conduct of a business; (ii) organizations used for the joint production, extraction, or use of property, but not for selling services or property produced or extracted; and (iii) dealers in securities who wish for a short period to underwrite, sell, or distribute a particular issue of securities.

The Regulations under I.R.C. Section 761 set forth the requirements for the election out of Subchapter K for eligible organizations.[[143]](#footnote-144) In order to qualify for this election, the owners must be able to compute their income from the venture without the need to compute partnership income.[[144]](#footnote-145) The Regulations define an “investing” partnership as one in which the participants: (i) own the property as co-owners; (ii) reserve the right separately to take or dispose of their shares of any property acquired or retained; and (iii) do not actively conduct business or irrevocably authorize some representative to purchase, sell, or exchange the investment property, although each separate participant may delegate authority to purchase, sell, or exchange his or her share of the investment property for a period of not more than a year.[[145]](#footnote-146)

An organization may also be excluded from the provisions of Subchapter K if it is one in which the participants in the joint production, extraction, or use of property (i) own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights; (ii) reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used; and (iii) do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his or her share of the property produced or extracted, but not for a period in excess of the minimum needs of the industry or more than one year.[[146]](#footnote-147)

The election to be excluded from Subchapter K must be made no later than the time prescribed by Regulations[[147]](#footnote-148) for filing the partnership return for the first taxable year for which the exclusion from Subchapter K is desired,[[148]](#footnote-149) and requires the consent of all members.[[149]](#footnote-150)

**[e] Limited Liability Companies**

Although Limited Liability Companies (LLCs) are relatively new,[[150]](#footnote-151) all fifty states and the District of Columbia have enacted laws enabling businesses to operate as LLCs. An LLC allows limited liability to its owners (similar to a corporation, including an S corporation) yet may be taxed as a flow-through entity (similar to a partnership or an S corporation). For federal income tax purposes, LLCs are entities that are eligible to “check-the-box” under the “check-the-box” regulations.[[151]](#footnote-152) Therefore an LLC with two or more members may choose whether to be taxed as a partnership or to be taxed as a corporation, and an LLC with one member may choose to be taxed as a corporation or treated as a disregarded entity.[[152]](#footnote-153) Due to the flexibility with which LLCs may be structured and governed, coupled with the limited liability for all members and flow-through taxation, LLCs have become the predominant entity in which to conduct any business, and especially real estate.

Both start-up and existing businesses can consider whether to become an LLC. Often, an LLC can provide the best combination of liability protection and tax advantages. There are no restrictions on the number or type of owners in an LLC as there are in an S corporation. Thus LLCs have more flexibility, growth potential and access to capital than S corporations.

LLC members do not have to give up management rights in order to achieve limited liability, as limited partners often do. Therefore, the LLC structure can be simpler than the typical limited partnership arrangement, which includes a separate (and usually corporate) general partner.

An LLC will generally be taxed as a partnership for federal income tax purposes.[[153]](#footnote-154) Consequently, an LLC has several additional advantages over an S corporation, including the following:

(1) An LLC member's share of the LLC's debt increases the basis of the LLC member's interest in the LLC.[[154]](#footnote-155) This enables the member to deduct more losses[[155]](#footnote-156) and receive more tax-free distributions[[156]](#footnote-157) than a shareholder in an S corporation.

(2) Members in an LLC can specially allocate specific distributive share items, as long as the allocations have substantial economic effect.[[157]](#footnote-158)

(3) An LLC can generally make a property distribution to a member without subjecting either the LLC or the member to tax,[[158]](#footnote-159) while tax is triggered by a distribution of appreciated property by an S corporation and passed through to the shareholders.[[159]](#footnote-160)

(4) An LLC can elect to step-up its basis in LLC property at the death or retirement of a member or on the sale or exchange of a member's interest, which an S corporation cannot do.[[160]](#footnote-161)

**[f] Real Estate Investment Trusts**

A real estate investment trust, or REIT, is an investment vehicle that allows investors to own a direct interest in a pool of real estate assets with beneficial tax consequences. A REIT is a corporation, trust, or association that meets the requirements set out in the Internal Revenue Code.[[161]](#footnote-162) These rules include the requirement that REITs must have at least 100 shareholders.[[162]](#footnote-163) Consequently, REITs are often publicly traded. REITs that comply with the I.R.C. rules generally pay no federal income tax on income and gains distributed to shareholders. This pass-through feature, which effectively eliminates taxes at the corporate level, is one of the main benefits enjoyed by REIT shareholders. Most of a REIT's income must come from passive real estate related investments. In addition, a REIT must satisfy a number of tests each year that relate to the entity's organizational structure, source of income, nature of assets, and distribution of income.[[163]](#footnote-164) Failure to satisfy these tests may result in penalties or disqualification as a REIT.[[164]](#footnote-165)

A unique aspect of REITs is the requirement that REITs distribute at least ninety percent (90%) of their taxable income to shareholders each fiscal year.[[165]](#footnote-166) Pursuant to I.R.C. § 4981, REITs are subject to a nondeductible excise tax on the excess of their required distributions over their distributed amounts for a calendar year.[[166]](#footnote-167)

While most of a REIT’s income must be from real estate sources, including rents,[[167]](#footnote-168) a REIT may receive a small amount of income from furnishing otherwise impermissible tenant services without causing all of the amounts received with respect to the property to fail to qualify as rent. This de minimus amount can not exceed one percent of the gross income from the property.[[168]](#footnote-169) A REIT is not treated as providing services to tenants or as managing or operating the property and has not generated impermissible tenant services income, if an independent contractor conducts the activities and the REIT does not derive any income from the independent contractor.[[169]](#footnote-170)

**[g] Environmental Remediaton Trusts**

Interest in environmental law by investors, lenders, and lawyers is in part because of the tremendous expense that can be involved in addressing environmental contamination. Given the evolving nature of environmental law, it is not surprising that the tax treatment of environmental clean–up costs can present problems, particularly in view of the number of parties that may be legally liable for such costs.

An environmental remediation trust is an organization created to collect and disburse amounts used for environmental cleanup costs. For tax purposes, the trust will be treated as a grantor trust.[[170]](#footnote-171) Pursuant to Treasury Regulation § 301.7701–4(e), an organization qualifies as an environmental remedial trust if:

1. It is organized under state law as a trust;
2. The trust's primary purpose is the collection and disbursement of amounts for the environmental remediation of an existing waste site;
3. The remediation is needed to address actual or potential liability or a reasonable expectation of liability of persons under state, local, or federal environmental laws.
4. At the time of their contributions, all trust contributors face liability under state, local, or federal environmental laws for remediation of waste; and
5. The trust cannot be a qualified settlement fund within the meaning of Treasury Regulation § 1.468B–1(a).

The regulations state: “An environmental remediation trust is classified as a trust because its primary purpose is environmental remediation of an existing waste site and not the carrying on of a profit–making business that normally would be conducted through business organizations classified as corporations or partnerships.”[[171]](#footnote-172) However, an environmental remediation trust can lose its status as such if the trust's purpose becomes altered by business or investment activities such that the trust's declared remedial purpose is no longer controlling.

Environmental remediation includes the costs of assessing environmental conditions, remedying and removing environmental contamination, monitoring the remedial activities and the release of substances, preventing future releases of substances, and collecting amounts from persons liable or potentially liable for the costs of these activities. Persons have potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for remediation of the existing waste site if there is authority under federal, state, or local law that requires or could be reasonably expected to require that such persons satisfy all or a portion of the costs of the environmental remediation.[[172]](#footnote-173)

Contributors to an environmental remediation trust are treated as owners of the portion of the trust that they have contributed under the grantor trust rules of I.R.C. § 677 and Treas. Reg. § 1.677(a)-1(d). These sections provide the rules regarding the treatment of a grantor as the owner of a portion of a trust applied in discharge of the grantor's legal obligation. Therefore, items of income, deduction, and credit of the trust are taken into account by the contributors in proportion to their trust contributions. The trustee must furnish statements to each contributor/grantor showing the items of income, deduction, and credit attributable to the portion of the trust treated as owned by that contributor.[[173]](#footnote-174) Items of income, deduction, and credit attributable to an environmental remediation trust are not reported by the trust on Form 1041, but are instead shown on a separate statement attached to that form. The statement furnished by the trustee to each grantor must not only show the items that the grantor is to take into account in computing the grantor's taxable income, it must also provide the grantor with the information necessary to take the items into account in computing the grantor's taxable income, including information necessary to determine the federal tax treatment of the items. For example, the statement should indicate whether an item is a deductible expense under I.R.C. § 162(a) or a capital expenditure under I.R.C. § 263(a) and how the item should be treated under the economic performance rules of I.R.C. § 461(h) and the regulations thereunder.[[174]](#footnote-175)

Special treatment applies to a potentially responsible person who makes a fixed contribution to an environmental remediation trust pursuant to an agreement with other grantors relieving that person from making further trust contributions. The regulations refer to such a grantor as a “cash–out grantor.” Such a grantor's contributions are still considered to be for remediation purposes, provided the grantor remains liable or potentially liable under the applicable environmental laws. The trust agreement can direct that the trustee spend the contributions of the cash–out grantor first. This accelerates deduction or capitalization of the cash-out grantor's contributions. A cash–out grantor ceases to be treated as an owner of a portion of the trust when the grantor's portion is expended by the trust.[[175]](#footnote-176)

Treasury Regulation § 301.7701–4(e)(4) offers the following examples:

**Example:**

(a) X, Y, and Z are calendar year corporations that are liable for the remediation of an existing waste site under applicable federal environmental laws. On June 1, 1996, pursuant to an agreement with the governing federal agency, X, Y, and Z create an environmental remediation trust within the meaning of Treas. Reg. § 301.7701–4(e)(1) to collect funds contributed to the trust by X, Y, and Z and to carry out the remediation of the waste site to the satisfaction of the federal agency. X, Y, and Z are jointly and severally liable under the federal environmental laws for the remediation of the waste site, and the federal agency will not release X, Y, or Z from liability until the waste site is remediated to the satisfaction of the agency.

(b) The estimated cost of the remediation is $20,000,000. X, Y, and Z agree that, if Z contributes $1,000,000 to the trust, Z will not be required to make any additional contributions to the trust, and X and Y will complete the remediation of the waste site and make additional contributions if necessary.

(c) On June 1, 1996, X, Y, and Z each contribute $1,000,000 to the trust. The trust agreement directs the trustee to spend Z's contributions to the trust and the income allocable to Z's portion before spending X's and Y's portions. On November 30, 1996, the trustee disburses $2,000,000 for remediation work performed from June 1, 1996 through September 30, 1996. For the six–month period ending November 30, 1996, the interest earned on the funds in the trust was $75,000, which is allocated in equal shares of $25,000 to X's, Y's, and Z's portions of the trust.

(d) Z made no further contributions to the trust. Pursuant to the trust agreement, the trustee expended Z's portion of the trust before expending X's and Y's portion. Therefore, Z's share of the remediation disbursement made in 1996 is $1,025,000 ($1,000,000 contribution by Z plus $25,000 of interest allocated to Z's portion of the trust). Z takes the $1,025,000 disbursement into account under the appropriate federal tax accounting rules (i.e., capitalizable or deductible). In addition X's share of the remediation disbursement made in 1996 is $487,500, and Y's share of the remediation disbursement made in 1996 is $487,500. X and Y take their respective shares of the disbursement into account under the appropriate federal tax accounting rules.

(e) The trustee made no further remediation disbursements in 1996, and X and Y made no further contributions in 1996. From December 1, 1996 to December 31, 1996, the interest earned on the funds remaining in the trust was $5,000, which is allocated $2,500 to X's portion and $2,500 to Y's portion. Accordingly, for 1996, X and Y each had interest income of $27,500 from the trust and Z had interest income of $25,000 from the trust.[[176]](#footnote-177)

**[3] Classification of Entity for Tax Purposes[[177]](#footnote-178)**

Business entities could be classified as one thing for state law purposes but fall into another classification for state law purposes. Prior to 1997, the Treasury Regulations required an analysis of an entity’s characteristics to determine if the entity was to be taxed as a partnership or as an association taxable as a corporation.[[178]](#footnote-179) Beginning in 1960, the entity classification regulations leaned towards partnership taxation, based on a desire to prevent doctors, lawyers, and accountants, who traditionally operated in partnership form, from obtaining retirement benefits that at the time were available only to corporations. Limited partnerships, which have some characteristics of corporations (i.e., centralized management in the general partner and limited liability in the limited partners), after analysis of the factors required by the former regulations, were typically taxed as partnerships. However, the advent of LLCs, which often have additional corporate characteristics (i.e., continuity of life separate from its owners and complete limited liability for all members), resulted in concerns about whether these entities would be taxed as corporations or taxed as partnerships. Most LLCs could be classified as partnerships under the former regulations, provided they adhered to certain formalistic requirements. With the purpose of eliminating some of the uncertainty surrounding the taxation of LLCs and the classification of unincorporated entities in general, the Treasury adopted the “check-the-box” regulations effective January 1, 1997, under which most unincorporated entities will simply be able to elect whether to be taxed as a corporation or as a partnership.[[179]](#footnote-180) The “check-the-box” regulations abandon the corporate-resemblance test that was the prior basis for classification of entities.

**[a] Entity Classification Under “Check-the-box” Regulations**

The “check-the-box” regulations permit entities that are not classified as corporations per se to choose their federal tax classification by election. The regulations apply to organizations that are treated as entities separate from their owners. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.[[180]](#footnote-181) The election under the “check-the-box regulations is available only for “business entities,” which are defined as any entities recognized for federal tax purposes that are not properly classified as a trust.[[181]](#footnote-182) A business entity with two or more members may choose to be classified as either a corporation or a partnership. A business entity with only one owner may choose to be classified as a corporation or as a disregarded entity.[[182]](#footnote-183)

Under the regulations, if an entity is incorporated under a federal or state statute as a corporation, it is not eligible to elect its classification. It will be taxed as a “per se” corporation.[[183]](#footnote-184) However, a business entity not classified as a per se corporation can elect its classification.[[184]](#footnote-185) Thus, an entity formed as a partnership, limited partnership, or limited liability company can elect to be taxed as either a partnership or a corporation, if it has at least two owners, or can elect between corporation status and disregarded entity status if it has only one owner. This clarification of the taxation of LLCs as partnerships has led to the proliferation in the use of LLCs

The regulations contain default classifications, so that entities do not have to make an affirmative elective if they desire to be treated as the default classification.[[185]](#footnote-186) Thus, unless the entity elects otherwise, a domestic eligible entity (a business entity that is not a per-se corporation) is taxed as a partnership if it has two or more members, or is disregarded as an entity separate from its owner if it has a single owner.[[186]](#footnote-187)

If an entity desires to elect a classification other than its default classification, or desires to change its classification, it does so by filing Form 8832 with its designated service center.[[187]](#footnote-188) Although an entity can generally choose the desired effective date for its classification election, the effective date specified on the Form 8832 cannot be more than 75 days prior to the date on which the election is filed nor more than 12 months after such date.[[188]](#footnote-189) However, to limit the number of letter rulings requesting approval for late elections, the Service issued Revenue Procedure 2002-59[[189]](#footnote-190), which provides guidance for requesting relief from a late classification election, and allows up to the due date of the tax return for filing the election.

A classification election under the “check-the-box” regulations must be signed either by each member of the entity, or by any officer, manager, or member of the entity who is authorized to make the election and who represents to having such authorization under penalties of perjury.[[190]](#footnote-191)

If an eligible entity makes an election under the check-the-box regulations to change its classification, the entity cannot change its classification by election again during the 60 months succeeding the effective date of the election. However, the Commissioner may permit the entity to change its classification election within the 60 months if more than 50 percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity’s prior election.[[191]](#footnote-192)

**[b] Change in Classification Resulting from Change in Number of Members**

The classification of an eligible entity that is taxed as a corporation is not affected by any change in the number of members of the entity.[[192]](#footnote-193) Thus, an entity that has elected to be taxed as a corporation will continue to be taxed as a corporation even if it goes from multiple owners to a single owner, or from a single owner to multiple owners. However, an eligible entity classified as a partnership becomes disregarded as an entity separate from its owner when the entity’s membership is reduced to one member. Likewise, the classification of a single member disregarded entity is changed to that of a partnership when it acquires more than one member.[[193]](#footnote-194)

**[c] Tax Consequences of Change in Classification of Entity**

An election by an entity to change its classification by making a “check-the-box” election may carry adverse tax consequences. If an entity being taxed as a partnership elects to be taxed as a corporation, for federal income tax purposes the partnership will be deemed to contribute all of its assets and liabilities to a corporation in exchange for stock in a corporation, and immediately thereafter the partnership is deemed to liquidate by distributing the stock of the corporation to its partners.[[194]](#footnote-195) The entity will be taxed under all relevant Internal Revenue Code provisions applicable to such a transaction.[[195]](#footnote-196) Likewise, if an eligible entity being taxed as a corporation elects to be classified as a partnership, the (corporate) entity is deemed to distribute all of its assets and liabilities to its owners (shareholders) in liquidation of the corporation, and immediately thereafter the owners contribute all of the distributed assets and liabilities to a newly-formed partnership.[[196]](#footnote-197) This will generally produce both an entity (corporate) level tax on the liquidation[[197]](#footnote-198) and an owner (shareholder) level tax.[[198]](#footnote-199)

An eligible entity with only one owner (e.g., a single member LLC) that had previously elected to be taxed as a corporation, will be deemed to undergo a taxable corporate liquidation if it subsequently elects to be taxed as a disregarded entity.[[199]](#footnote-200) An eligible entity with only owner that is being taxed as a disregarded entity (e.g., a single member LLC) will be deemed to transfer all of the assets and liabilities of the entity to a corporation in exchange for stock.[[200]](#footnote-201)

**[4] Choice of a Tax Year**

The choice of a tax year is another distinction between types of entities. There can be several reasons for wanting to choose a fiscal year other than the calendar year for tax purposes, the primary one most likely being the deferral of income recognition.

**EXAMPLE:**

Individual *A* is a partner in Partnership *AB,* which owns real estate generating taxable income. If the partnership has a fiscal year ended January 31, 2007, *A*'s share of the income is treated as all passing through to her on January 31, 2007.[[201]](#footnote-202) Thus, *A* will not report the income until she files her 2007 individual income tax return, even though 11 months of that income was earned in calendar 2006 (February 1, 2006 – December 31, 2006).

To prevent this type of deferral, most flow-through entities (partnerships, LLCs, and S corporations) must conform their taxable years to the taxable years of their owners, unless there is a business purpose for having a different tax year.[[202]](#footnote-203)

**[a] Partnerships and LLCs**

A partnership, or any entity taxed as a partnership, is limited with respect to the tax year that it can choose. The partnership's tax year must be the same tax year as that of the partners holding a greater than 50% interest in partnership capital and profits (called the “majority interest tax year”).[[203]](#footnote-204) If no partners with the same tax year in the aggregate hold more than 50% of the capital and profits, then the partnership’s tax year must be the year used by all 5% or greater partners (defined as “principal partners”).[[204]](#footnote-205) If no common year is available under that rule either, then the regulations apply a “least aggregate deferral” method to determine the tax year that will result in the least amount of deferral to all the partners.[[205]](#footnote-206) The least aggregate deferral method is intended to minimize any deferral of the reporting of income that flows through to a partner on the last day of the partnership’s tax year that differs from the partner’s tax year. Thus, some deferral is possible in a partnership or other entity taxed as a partnership where at least two partners have different tax years.

A partnership may request a tax year that differs from the required year as determined above if it can demonstrate a business purpose for its requested year.[[206]](#footnote-207) In addition, a partnership may elect a tax year other than its required year under I.R.C. § 444, which allows for a limited deferral of income to be minimized by required payments to the I.R.C.[[207]](#footnote-208)

**[b] S corporations**

An S corporation must use a calendar tax year, unless it can establish, to the satisfaction of the I.R.S., a business purpose for the use of a different accounting period.[[208]](#footnote-209) An S corporation may, however, in limited circumstances elect a tax year under I.R.C. § 444, subject to certain limitations on the benefit of that deferral.

**[c] C corporations**

A C corporation can generally adopt any fiscal year. However, personal service corporations are limited to using the calendar year, unless the corporation can establish a business purpose for using a different tax year.[[209]](#footnote-210) Moreover, a personal service corporation could elect a year resulting in less than three months’ deferral under I.R.C. § 444, subject to certain limitations on the benefit of that deferral.

**§ 2.03 Costs of Obtaining a Mortgage**

**[1] In General**

Among the costs a purchaser of real property may incur in connection with obtaining a mortgage loan are the following: (1) loan fees or points; (2) commitment fees; (3) appraisal fees; (4) credit reports; (5) land surveys; (6) fees to the lender's attorney; and (7) mortgage brokerage commissions.

Other than the loan fees or points, discussed separately below, the Internal Revenue Service (IRS) may consider these costs not to constitute interest but rather service charges properly associated with and attributable to the acquisition of the loan. In the case of a mortgage obtained to acquire a *personal* residence, such costs are capital expenditures nondeductible in the year incurred and non-amortizable over the term of the mortgage.[[210]](#footnote-211) Furthermore, in the case of a personal residence, the costs of obtaining the loan (as distinguished from the costs to obtain the property; *e.g.,* purchaser's title insurance, recording fees, etc.) are *not* added to the basis of the property as they do not relate to the property. Indeed, they are “lost” for tax purposes.

In contrast, mortgage costs incurred in connection with property used in carrying on a trade or business or for the production of income are deemed capital expenditures and may be amortized over the life of the mortgage loan.[[211]](#footnote-212)

**EXAMPLE:**

If $10,000 of costs are incurred in connection with obtaining a ten-year mortgage, $1,000 may be deducted each year. If the mortgage is pre-paid or if the underlying property is sold subject to the mortgage, the entire unamortized cost of the mortgage is deductible in the year of prepayment or sale. If the mortgage term is, in contrast, extended, the unamortized portion of the costs is spread ratably over the remaining years of the mortgage plus the extension.[[212]](#footnote-213)

**[2] Standby Fees**

Standby fees are fees paid to a mortgage lender to make funds available to the borrower on an “as needed” basis (*i.e.,* the lender holds funds aside or commits them to the borrower for a specified period of time). The IRS's current position is that standby fees should be treated similar to an option; *i.e.,* if the “option to acquire funds” is exercised, the fee becomes part of the cost of acquiring the loan and is deducted ratably over the term of the loan. If a loan is not obtained, the standby fee may be deductible as a loss in the year in which the “option” expired unexercised.[[213]](#footnote-214)

**[3] Points**

The term “points” refers to the fee paid by a borrower to a lending institution at the time the lending institution makes a loan to the borrower. The fee is generally intended to compensate the lending institution. A point is equal to one percent of the amount loaned. For example, two points on a $100,000 loan would be $2,000. Points are charged in addition to the stated interest rate on the loan.

The deductibility of points depends on whether the points represent additional interest or a service charge, and on whether they are incurred in a business or personal transaction. These criteria are discussed immediately below.

**[a] Additional Interest**

Points (loan origination fees, loan processing fees, maximum loan charges, premium charges, etc.) paid by a borrower to a lender solely for the use or forbearance of money and not for specific services that the lender performs in connection with the borrower's account are treated as interest.[[214]](#footnote-215) However, even where points are considered additional prepaid interest, they are generally not currently deductible, even for a cash basis taxpayer. The general rule is that prepaid interest must be deducted over the period of the loan to the extent that the interest represents the cost of using the borrowed funds during each tax year in the period.[[215]](#footnote-216) Thus, points in the nature of additional interest incurred in the course of a business transaction are deductible ratably over the term of the mortgage.

However, points paid by a cash method taxpayer on indebtedness incurred for the acquisition or improvement of, and secured by, the taxpayer’s principal residence, are not subject to this amortization requirement (i.e., they are currently deductible in the year of payment) if certain requirements are satisfied. In order to qualify for this exception, the charging of points must reflect an established business practice in the geographical area where the loan is made, and the amount of points paid must not exceed the amount generally charged in that area.[[216]](#footnote-217)

In addition, to be fully deductible, otherwise qualifying points must be paid with funds other than those obtained from the mortgage lender. Therefore, points withheld from loan proceeds are technically not fully deductible in the year withheld.[[217]](#footnote-218) However, the IRS will allow individuals to deduct points paid by the seller in connection with the purchase of a principal residence.[[218]](#footnote-219) In that case, the seller is treated as having paid the amount of the points to the buyer who is treated as having used that cash to pay the points charged by the lender. The amount of the seller-paid points is subtracted from the purchase price in computing the basis of the residence.

Points paid in connection with refinancing a home mortgage are non-deductible if funds are not to be used for home improvements. Instead, the points must be deducted ratably over the term of the mortgage.[[219]](#footnote-220) The IRS's rationale is that points incurred for such a refinancing are attributable to the repayment of the existing debt rather than the purchase or improvement of the residence.

The IRS has issued guidance on filing information returns for points received in connection with financing the purchase of a principal residence.[[220]](#footnote-221)

**[b] Service Charge**

Points in the nature of a service charge (e.g., an appraisal fee, the cost of preparing a note, etc.) are charges for services rendered and therefore not deductible as interest. If incurred in a business transaction, the points here would be deductible ratably over the term of the loan.[[221]](#footnote-222) In connection with the acquisition of a personal residence, however, the points may be deductible if the safe harbor of Rev. Proc. 94-27, discussed above,[[222]](#footnote-223) applies.

**§ 2.04 Deductions**

**[1] In General**

The general tax rules with respect to business and income-producing expenses apply to real estate activities in much the same manner as they apply to other areas. Ordinary and necessary expenses incurred in a real estate business or in holding real property for the production of income are generally deductible, subject to capitalization requirements.[[223]](#footnote-224) This section 2.04[1] covers some miscellaneous real estate deductions, and the following sections cover more significant areas in detail.

**[a] Moving Expenses**

Employees and self-employed persons may deduct the reasonable expenses of moving themselves and their families if the move is related to starting work in a new location.[[224]](#footnote-225) This is an exception to the general rule that would consider these expenses to be nondeductible personal expenses.[[225]](#footnote-226) The employee must meet a distance test, a length of employment test, and a commencement of work test to qualify for the deduction.[[226]](#footnote-227) The definition of deductible moving expenses paid or incurred in connection with starting a job in a new principal workplace include only the reasonable expenses of (1) moving household goods and personal effects from the former residence to the new residence; and (2) traveling (including lodging) from the former residence to the new residence. The deduction for moving expenses is an “above the line” deduction, meaning it is not an itemized deduction, subject to limitations on itemized deductions.[[227]](#footnote-228)

**[b] Demolition Expenses**

I.R.C. § 280A generally precludes a deduction for amounts expended to demolish a structure, or for any loss sustained on account of such a demolition. Instead, these costs must be capitalized to the land on which the demolished structure was located.[[228]](#footnote-229)

However, the Tax Court has held that an abnormal retirement loss deduction may be claimed in connection with a subsequently demolished building if the loss arose from the sudden, unexpected termination of the property’s usefulness.[[229]](#footnote-230) In that case, the court found that the loss did not occur because of the building’s demolition, but rather as a result of the building’s sudden loss of usefulness in the taxpayer’s business. Noting that casualty damage is only one example of abnormal retirement, the court concluded that a loss sustained due to extraordinary obsolescence should also be distinguished from loss sustained on account of a subsequent demolition.[[230]](#footnote-231)

**[c] Deduction for Handicapped Accessibility Expenses**

I.R.C. § 190 provides a tax deduction to businesses for expenses in incurred in making a facility or public-transportation vehicle more accessible to the disabled or the elderly. A “facility” is defined as all or any portion of buildings, structures, equipment, roads, walks, parking lots, or similar real or personal property.[[231]](#footnote-232) A “public-transportation” vehicle is a vehicle, such as a bus or railway car, that provides transportation to the public, including service for a business taxpayer’s customers if the taxpayer is not in the business of providing transportation.[[232]](#footnote-233) (Businesses may not deduct any expenses paid or incurred to build or completely renovate a facility or public transportation vehicle, or to normally renovate depreciable property.)[[233]](#footnote-234) The deduction is limited to $15,000[[234]](#footnote-235) for any taxable year and must be claimed on the income tax return for the tax year the expenses were paid or incurred. Amounts spent in excess of the $15,000 limitation may be added to basis and depreciated.

**[2] Real Estate Taxes**

I.R.C. § 164 allows state and local real and personal property taxes to be deductible, whether or not they are incurred in a trade or business, in the year in which they are paid or accrued.

When real property is sold, the seller and the buyer may each deduct a pro rata amount of the real property tax for the “real property tax year” in which the sale is made.[[235]](#footnote-236) The Code treats part of the tax as a tax imposed on the seller and part as imposed on the buyer, in accordance with the number of days in the real property tax year that each owned the property. It does not matter on whom the real property tax is imposed under the local law. The seller is treated as being allocated so much of the property tax for the portion of the year before the date of sale, and the buyer’s share of the tax begins on the date of sale. Neither the buyer nor the seller may deduct more than the amount treated as imposed on him or her under the above rule.[[236]](#footnote-237)

**[3] Repairs vs. Improvements**

Repairs to real property are deductible.[[237]](#footnote-238) Improvements, additions, renovations, or alterations, however, are capital expenditures which must be capitalized and added to basis.[[238]](#footnote-239) The factual difficulty is, of course, distinguishing the two. Deductible repairs are incidental repairs which merely keep the property in ordinary, efficient operating condition. Repairs are deductible if they (1) do not materially add to the value of the property; (2) do not materially prolong the life of the property over the value and life of the property before the repairs; and (3) do not adapt the property to a new and different use.[[239]](#footnote-240)

In *Plainfield-Union Water Co. v. Commissioner*,[[240]](#footnote-241) the Tax Court articulated a test (the *Plainfield- Union* test) for determining whether an expenditure is capital by comparing the value, use, life expectancy, strength, or capacity of the property after the expenditure with the status of the property before the condition necessitating the expenditure arose.

Nevertheless, the IRS has ruled that the Supreme Court’s holding in *Indopco*[[241]](#footnote-242) does not affect the tax treatment of incidental repairs as business expenses that are generally deductible rather than capitalizable. Therefore, some incidental repairs may be currently deducted even though they provide future benefits.[[242]](#footnote-243)

For example, in Midand *Empire Packing Co .v. Commissioner*,[[243]](#footnote-244) the taxpayer, a meat-packing company, incurred expenses to line the walls and floor of its basement with concrete to protect it from seepage of underground oil. The oil seepage threatened continued operation of the packing plant. The purpose of the expenditure was not to make the plant suitable for new or additional use, but only to permit the continued use of the plant in normal operation. The Tax Court held that the expenditure was a repair and deductible as an ordinary and necessary business expense.

Alternatively, in *Vanalco, Inc. v. Commissioner*,[[244]](#footnote-245) an aluminum smelting company was not entitled to deduct costs of replacing aluminum reduction cell linings and parts of brick floors with cement. The court relied on the “put” versus “keep” test: if the improvements were made to “put” the particular capital asset in efficient operating condition, then they are capital in nature. If, however, they were made merely to “keep” the asset in efficient operating condition, then they are deductible repairs. In *Vanalco*, the cell linings were essential and substantial components without which the cell couldn't function, they had a three-year life independent from the cell unit, and they were a substantial portion of the cost of the rehabilitated cell unit. Also, the floor replacements were not to keep the building in operating condition but were for substantial functional improvements: the employees' safety was enhanced where floors were easier to repair, more electrically nonconductive, more level, and conducive to mechanical cleaning equipment.

Repairs to property used for personal purposes are not deductible.[[245]](#footnote-246)

Under the “rehabilitation doctrine,” where an expenditure is part of a general plan of rehabilitation, modernization, or improvement of property, the expense must be capitalized, even if the expense, standing alone, would be classified as a deductible repair.[[246]](#footnote-247) Thus, a commercial airline that performed a “heavy maintenance visit” on an aircraft, as well as made substantial improvements and modifications to the structure, exterior, and interior of the airframe, for the purpose of increasing its reliability and extending its useful life, had to capitalize all expenditures where the facts indicated they were made as part of a general plan of rehabilitation, modernization, and improvement of the aircraft, even though certain costs, standing alone, would be generally deductible under I.R.C. § 162.[[247]](#footnote-248) Similarly, expenses of a major renovation of rental buildings, such as replacing carpet, roof, doors, kitchen cabinets, sinks, windows, and porches, which made it easier to lease the buildings and enabled the taxpayer to charge higher rents, had to be capitalized.[[248]](#footnote-249)

Likewise, the Tax Court in *Norwest Corp. & Subsidiaries v. Commissioner,*[[249]](#footnote-250) held that a taxpayer incurred capital expenditures to remove all asbestos materials from its office building, because the asbestos removal was undertaken as an essential part of a general renovation and remodeling of the building. It was irrelevant that the asbestos removal by itself did not extend the building’s useful life or increase its value.

**[4] Fees and Commissions**

Fees and commissions for services that only involve a current benefit are deductible (*e.g.,* the cost of managing property).[[250]](#footnote-251) The capital expenditure rule, however, prevents the current deduction for fees and commissions that produce benefits that extend substantially beyond the end of the taxable year.[[251]](#footnote-252) Thus, commissions paid for the purchase of real estate must be treated as a capital expenditure and added to the cost of the property, whether or not the taxpayer is in the real estate business.[[252]](#footnote-253) A commission paid on the sale of real estate, where the seller is not in the real estate business, is not deductible but reduces the sales price of the property.[[253]](#footnote-254) However, for a seller in the real estate business, a commission paid is a deductible business expense.[[254]](#footnote-255)

Under Proposed Regulations which would be effective for tax years beginning on or after the date final regulations are published, *commissions* paid to facilitate a sale of property would generally have to be capitalized. Such amounts would be treated as a reduction in the amount realized and generally taken into account in the year in which the sale occurs. The capitalized amount is not added to the basis of the property.[[255]](#footnote-256)

With respect to a principal residence, selling expenses, including commissions and legal fees, reduce the amount realized on a sale.[[256]](#footnote-257)

The following fees incurred in connection with real estate investment, management, or development were required to be capitalized:

1. Impact fees[[257]](#footnote-258) in connection with the construction of a new residential rental building. The impact fees created a permanent betterment to the taxpayer’s development project and had to be capitalized to the cost of the building.[[258]](#footnote-259)
2. Educational, park, and road impact fees paid by a construction company as a condition of county approval for its development. The impact fees increased the value of the subdivision and had to be capitalized.[[259]](#footnote-260)
3. A rent up fee paid to an apartment management company for getting tenants for a newly built apartment complex before and after construction of the complex. The fee had to be amortized over the term of the leases.[[260]](#footnote-261)

**[5] Interest**

**[a] In General**

For federal tax purposes, interest is a payment for the use or forbearance of money that is made in connection with a valid debt.[[261]](#footnote-262) Since most real estate investments will be financed with debt, the deductibility of interest is a significant factor.

Under the general rule of I.R.C. § 163(a), interest paid or accrued during the taxable year is deductible, whether or not it is incurred in a trade or business. However, the exceptions here overwhelm the general rule. Under I.R.C. § 163(h)(1), noncorporate taxpayers may not deduct “personal interest.” “Personal interest” is defined as all interest other than:

(1) interest on trade or business debt;[[262]](#footnote-263)

(2) investment interest;[[263]](#footnote-264)

(3) passive activity interest;[[264]](#footnote-265)

(4) qualified residence interest;[[265]](#footnote-266)

(5) interest on certain deferred estate tax payments;[[266]](#footnote-267) and

(6) qualified education loan interest.[[267]](#footnote-268)

**[b] Definition of Interest**

It is not necessary for the payment to be labeled as interest by the parties in order for it to be deductible as interest, provided it is a payment “for the use or forbearance of money.” For example where a lender charged a borrower an annual “premium,” based on a percentage of the loan, in addition to stated interest, for the privilege of being granted the loan, the premium was treated as interest for tax purposes.[[268]](#footnote-269) In addition, a “loan processing fee” has been treated as interest.[[269]](#footnote-270) However, commitment or standby fees charged by a lender to a potential borrower are generally not interest because they are for the commitment to lend rather than payments for the use of funds.[[270]](#footnote-271)

It is also not necessary that the “interest” be computed at a fixed stated rate, provided the amount of interest is definitely ascertainable. For example, a fixed sum in addition to a percentage of the principal has been considered interest,[[271]](#footnote-272) as well as the greater of a percentage of the borrower's gross receipts or a fixed dollar amount per acre that the borrower bought from the lender.[[272]](#footnote-273)

**[c] Requirements for Deductibility**

**[i] Debt Must Be Valid**

There must be an existing, unconditional and legally enforceable obligation for the payment of money in order for the interest to be deductible.[[273]](#footnote-274) Whether indebtedness exists for federal tax purposes is determined by federal, not state or local, law,[[274]](#footnote-275) although state law will determine whether a debt is enforceable.[[275]](#footnote-276) Moreover, the debt may not be contingent on a future event.[[276]](#footnote-277)

A debt may not be a valid debt if a related lender does not expect payment of the debt. In such case, the “loan” may be recharacterized for tax purposes, based on the facts and circumstances, to reflect the true tax transaction. For example, a “loan” made by one family member to another may be recharacterized as a gift; a “loan” made from shareholder to corporation may be a contribution to capital, and a “loan” from corporation to shareholder may be a dividend. [[277]](#footnote-278)

**[ii] Indebtedness Must Be Obligation of Borrower**

In addition to being valid debt, the debt must be the taxpayer's debt.[[278]](#footnote-279) Generally, this means the taxpayer may deduct interest only if he or she is primarily liable for the indebtedness.[[279]](#footnote-280) Thus, payment of interest on the obligation of another is not deductible. For example, interest paid by children on their parents' mortgage debt may not be deductible.[[280]](#footnote-281) Similarly, when a taxpayer makes a payment of interest under a loan guarantee, he or she is not entitled to an interest deduction but must treat it as a bad debt (if not reimbursed).[[281]](#footnote-282) However, where two or more persons are jointly and severally liable for a debt, each is entitled to a deduction for the interest on that debt that he or she pays.[[282]](#footnote-283)

**[d] Timing of Interest Deduction**

**[i] Method of Accounting**

The time for the deduction of interest depends upon the method of accounting used by the borrower. A cash basis taxpayer can deduct interest when paid (subject to certain limitations for prepaid interest).[[283]](#footnote-284) An accrual basis taxpayer is entitled to the deduction when: (1) all events have occurred which give rise to the liability (the “all-events” test); and (2) the amount of the liability can be determined with reasonable accuracy.[[284]](#footnote-285) If, however, the recipient of interest paid by an accrual basis taxpayer is a cash basis related party taxpayer, then the interest deduction is not allowed to the accrual basis taxpayer until the interest is actually paid (and therefore included in the cash basis taxpayer's income).[[285]](#footnote-286)

**[ii] Interest Must Be “Paid” By a Cash Basis Taxpayer**

No payment occurs if the borrower “pays interest” by giving his own note for the interest.[[286]](#footnote-287) Similarly, increasing the principal amount of the mortgage by the amount of interest owed does not constitute a “payment” for a cash basis borrower.[[287]](#footnote-288) A deduction will generally not be allowed if the source of the interest payment is the original lender. For example, if interest on a loan is paid with additional funds borrowed from the original lender, a deduction is not allowed if the primary purpose of the second loan was to pay interest on the first loan.[[288]](#footnote-289)

However, the Tax Court has allowed an interest deduction where the taxpayer borrowed additional funds from the lender if (1) the borrower had unrestricted control over the additional loan proceeds, and (2) the borrower paid the original loan interest with funds from an account with another financial institution.[[289]](#footnote-290) This test, which has been referred to as the “unrestricted control” test, meant that there could be no physical or mechanical restraints on the borrower's ability to withdraw the borrowed funds for a purpose other than paying interest. The Tax Court modified this test in the 1996 case of *Davison v. Commissioner*.[[290]](#footnote-291) In this case, the lender made a wire transfer of $1,587,310 to its borrower, which the borrower subsequently wired back to pay both principal and interest on an existing loan. The I.R.S. disallowed the taxpayer–debtor’s interest deduction for that amount. The Tax Court recognized that the unrestricted control test ignored the fact that the borrower may have obligated itself to use the proceeds to pay interest to the lender as a precondition of the additional loan. Thus the Tax Court modified the unrestricted control test to bring it more in line with the Fifth and Ninth Circuits.[[291]](#footnote-292)

In affirming the Tax Court’s *Davison* decision, the Second Circuit rejected the unrestricted control test while adopting the reasoning of the Tax Court.[[292]](#footnote-293) A taxpayer should not be able to deduct interest where the agreed purpose and economic substance of the second loan is to postpone rather than extinguish the debtor’s interest obligation.

However, a borrower may borrow from a third party and deduct interest payments made to the original lender with the borrowed funds. The interest is deemed to be paid currently rather than at the time the second loan is repaid.[[293]](#footnote-294)

**[iii] Prepaid Interest**

Cash basis taxpayers must generally capitalize prepaid interest and deduct it as if on the accrual basis.[[294]](#footnote-295)The major exception in this area is with respect to points paid in connection with a home acquisition or improvement loan.[[295]](#footnote-296)

**[iv] Prepayment Penalty**

Penalty payments for the privilege of prepaying a mortgage are considered to be in lieu of interest (i.e., for the use or forbearance of money) and are deductible as interest.[[296]](#footnote-297)

**[e] Investment Interest Limitations**

Noncorporate taxpayers can deduct the interest on funds borrowed to make investments but only up to the amount of their “net investment income.” The excess investment interest is carried forward indefinitely. It can be deducted in a future year, subject to the same limitation.[[297]](#footnote-298)

Investment interest is interest paid or accrued on debt allocable to property held for investment.[[298]](#footnote-299) However, investment interest does not include any qualified residence interest[[299]](#footnote-300) or interest taken into account in determining a taxpayer’s passive loss or gain.[[300]](#footnote-301) Investment interest expense does include any amount allowable as a deduction in connection with personal property used in a short sale.[[301]](#footnote-302)

Property held for investment includes:

(1) any property which produces a type of income described in I.R.C. § 469(e)(l) (income not treated as income from a passive activity), which includes:

(a) gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business (*i.e.,* portfolio income); or

(b) gain or loss not derived in the ordinary course of a trade or business which is attributable to the disposition of property described at (a) above or held for investment; and

(2) any interest held by a taxpayer in an activity involving the conduct of a trade or business which is not a passive activity and with respect to which the taxpayer does not materially participate (as the term is used in I.R.C. § 469).[[302]](#footnote-303)

A taxpayer’s investment interest may be deducted only to the extent of net investment income. “Net investment income” is defined as the excess of investment income over investment expenses (other than the interest expense).[[303]](#footnote-304) Investment income includes: (1) gross income from property held for investment; and (2) certain gains from the disposition of property held for investment.[[304]](#footnote-305) I.R.C. § 163(d)(4)(B)(ii) excludes net capital gain attributable to the disposition of property held for investment from investment income for purposes of computing the investment interest limitation. This prevents a taxpayer who recognizes long-term capital gain, which is taxable at favorable rates, from using that gain to deduct otherwise nondeductible investment interest expense against ordinary income. However, a taxpayer can elect to include as much net capital gain in investment income as the taxpayer chooses if the taxpayer also reduces the amount of net capital gain eligible for the favorable capital gains tax rate by the same amount.[[305]](#footnote-306)

In determining “net” investment income, investment expenses are those allowed after application of the rule limiting deductions for miscellaneous itemized expenses to those expenses exceeding 2% of adjusted gross income.[[306]](#footnote-307) In computing the amount of expenses that exceed the 2% floor, expenses that are not investment expenses are disallowed before any investment expenses are disallowed.[[307]](#footnote-308)

Any disallowed investment interest can be carried forward indefinitely.[[308]](#footnote-309)

**[f] Qualified Residence Interest**

Qualified residence interest is one of the few types of personal interest that remains deductible. Qualified residence interest means any interest which is paid or accrued during the taxable year on “acquisition indebtedness” or “home equity indebtedness” for any “qualified residence” of the taxpayer.[[309]](#footnote-310)

Acquisition indebtedness is debt which is incurred in acquiring, constructing, or substantially improving[[310]](#footnote-311) a qualified residence of the taxpayer, and which secures the residence.[[311]](#footnote-312) The term also includes any qualified indebtedness that is refinanced, but only to the extent the amount of the debt resulting from the refinancing does not exceed the original refinanced debt. Interest deductions are only allowed on acquisition debt for a taxpayer that does not exceed $1,000,000 (or $500,000 for married taxpayers filing separate returns).[[312]](#footnote-313)

In addition to qualifying acquisition indebtedness, a taxpayer may deduct interest on up to $100,000 of qualifying home equity indebtedness. Home equity indebtedness for this purpose is debt, other than acquisition indebtedness, which is secured by a qualified residence and which amount does not exceed the fair market value of the residence reduced by the acquisition debt with respect to that property.[[313]](#footnote-314)

Qualified residence interest must be for the acquisition of (in the case of acquisition indebtedness) and secured by (in the case of both acquisition indebtedness and home equity indebtedness) a “qualified residence.” A qualified residence is defined as the principal residence of the taxpayer and one other dwelling used by the taxpayer as a residence during the year.[[314]](#footnote-315) A dwelling, for example, a vacation home, is considered to be used as a “residence” if the taxpayer uses it for personal purposes[[315]](#footnote-316) for a period exceeding the greater of 14 days or 10 percent of the number of days during the year that the property is rented at fair market value.[[316]](#footnote-317) If a residence is not rented at any time during the taxable year, it shall be considered to be used as a residence.[[317]](#footnote-318) A residence can generally include a house, condominium, mobile home, boat, or house trailer that contains sleeping space and toilet and cooking facilities.[[318]](#footnote-319)

Taxpayers are allowed to deduct interest on $1,000,000 of acquisition debt and $100,000 of home equity debt for their residences. However, it is not clear whether taxpayers can deduct interest on a single $1,100,000 indebtedness. In its Publication No. 936 and in an old public ruling,[[319]](#footnote-320) the I.R.S. has indicated that a single debt may qualify partially as acquisition indebtedness and partially as home equity indebtedness. The I.R.S. cited as an example a single debt, secured by a qualified residence, which was partially used for purposes that qualified the debt for treatment as acquisition indebtedness, and which was partially used for other purposes. Under these circumstances, the portion of the debt that qualified for acquisition indebtedness treatment would be treated as acquisition indebtedness, and the remainder as home equity indebtedness, subject to the $100,000 limitation. However, IRS has privately stated that interest on any portion of a home acquisition loan, or loans, in excess of $1 million is not deductible as qualified residence interest.[[320]](#footnote-321)

In addition, the Tax Court considered a case where the taxpayers incurred a $1.3 million mortgage to purchase their principal residence. The taxpayers attempted to treat $1 million as acquisition indebtedness and $100,000 as home equity indebtedness. The Tax Court, however, limited their interest deduction to interest on $1 million, since the taxpayers failed to demonstrate that any portion of the debt was other than acquisition indebtedness.[[321]](#footnote-322)

**[6] Lessee Construction Allowance**

Under I.R.C. § 110, a retail tenant that receives cash or rent reductions from a lessor of retail space does not include that amount in gross income if the allowance is used for qualified construction or improvement to the space. The tenant must have a short term lease on the retail space, and the construction or improvement must be on qualified long-term property that is used in the tenant's trade or business at the retail space. The amount excluded from gross income must not exceed the amount expended by the tenant for the construction or improvement.

“Qualified long term property” is nonresidential real property that is part of or present at, the retail space.[[322]](#footnote-323) The property must revert to the lessor at the termination of the lease.

Qualified long term real property constructed or improved for the use of a retail lessee is treated as the lessor's nonresidential real property. A “short term lease” is a lease or other agreement for occupancy or use of a retail space, that has a duration of 15 years or less.[[323]](#footnote-324)

“Retail space” is real property leased, occupied or otherwise used by the tenant for the sale of tangible personal property or services to the general public.[[324]](#footnote-325)

The lessor and the tenant must provide information to the IRS concerning the amount of cash received or the rental reduction provided for construction and improvements, in the manner provided in the regulations.[[325]](#footnote-326) Under regulations, the lessor must attach a statement to the lessor's timely filed (including extensions) federal income tax return for the tax year in which the lessor paid the construction allowance (either in cash or as a rent reduction), and the lessee is required to attach a similar statement to its return for the tax year in which it received the construction allowance or rent reduction.[[326]](#footnote-327) The lessor's statement must contain the lessor's name (and the lessor's parent's name if applicable), employer identification number, and tax year, plus the following information for each lease:

(1) the lessee's name (and parent's name if applicable), address, and employer identification number;

(2) where the retail space is located, including the name of the mall or strip center, if applicable, and the name of the store;

(3) the amount of the construction allowance;

(4) how much of the construction allowance the lessor treated as nonresidential real property owned by the lessor.[[327]](#footnote-328)

**[7] Environmental Clean-Up Costs**

Under I.R.C. § 198,[[328]](#footnote-329) a taxpayer may elect to currently deduct certain environmental clean-up costs – the expenses of remedying environmental contamination - that would otherwise have to be capitalized. This election will not be available for expenses paid or incurred after December 31, 2007.[[329]](#footnote-330) Since property that has been contaminated by hazardous substances has come to be called “brownfields,” this provision is referred to as the “brownfields amendment” or “brownfields rule.”

In order to be deductible under I.R.C. § 198, the expense must be:

1. an expense that would otherwise be chargeable to capital account,[[330]](#footnote-331) and
2. which is paid or incurred in connection with the abatement or control of “hazardous substances” at a “qualified contamination site.”[[331]](#footnote-332)

A qualified contamination site for this purpose is defined as any area which is held by the taxpayer for use in a trade or business or for the production of income or is inventory in the hands of the taxpayer and at or on which there has been a release (or threat of release) or disposal of any hazardous substance.[[332]](#footnote-333) A hazardous substance is defined for this purpose as: (1) any substance which is a hazardous substance as defined in section 101(14) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, (2) any substance which is designated as a hazardous substance under section 102 of such Act, and (3) any petroleum product, as defined in I.R.C. § 4612(a)(3).

Expenses deducted under this section will be treated as depreciation deductions for purposes of I.R.C. § 1245 depreciation recapture on a subsequent sale of the property.[[333]](#footnote-334)

**[8] Home Office Deduction**

Generally, taxpayers may not deduct the expenses of their homes, other than property taxes and qualified home mortgage interest.[[334]](#footnote-335) However, home related expenses, such as a portion of the home’s insurance, utilities, and depreciation, attributable to a taxpayer’s trade or business conducted in the home (i.e., a home office), are deductible, subject to certain limitations.[[335]](#footnote-336) In order to deduct home office expenses, the office must be used “exclusively” and on a “regular basis” as either (1) the taxpayer’s principal place of business;[[336]](#footnote-337) (2) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his or her trade or business; or (3) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.[[337]](#footnote-338) In addition, in the case of an employee, the home office deduction is allowed only where the use of the home office is for the “convenience” of the employer, which has been essentially interpreted as “required” by the employer. According to the Tax Court, an employee's use of a home office is for the convenience of his employer where the employee must maintain the home office as a condition of employment.[[338]](#footnote-339) The home office cannot be merely for the convenience of the employee.[[339]](#footnote-340)

If the taxpayer qualifies for a home office deduction, the taxpayer must determine the portion of the home used for business purposes. This can be done by any method that is reasonable under the circumstances. According to the Regulations, if the rooms in the dwelling unit are of approximately equal size, the taxpayer may ordinarily allocate the general expenses for the unit according to the number of rooms used for the business purpose. The taxpayer may also allocate general expenses according to the percentage of the total floor space in the unit that is used for the business purpose.[[340]](#footnote-341)

A further limitation on the use of the home office deduction is that the amount deducted cannot exceed the gross income derived from using that home office during the tax year.[[341]](#footnote-342) If the taxpayer engages in a business in the home and in one or more other locations (e.g., another business office), the taxpayer must determine the portion of the gross income from the business that is attributable to business activity in the home. In making this determination, the taxpayer shall take into account the amount of time that the taxpayer engages in business activity at each location, and any other facts and circumstances that may be relevant.[[342]](#footnote-343)

In addition, the taxpayer taking a home office deduction must reduce the gross income from the home office first by a portion (attributable to the home office) of the home mortgage interest expense and property taxes, which are otherwise deductible anyway.[[343]](#footnote-344) Thus rule thus limits the amount of gross income available for the remaining home office deductions, since the taxpayer cannot create a loss from the home office deduction.[[344]](#footnote-345)

**§ 2.05 Depreciation**

**[1] In General**

Capital acquisitions generally cannot be currently expensed.[[345]](#footnote-346) Although certain amortization provisions exist in the Code,[[346]](#footnote-347) depreciation is the mechanism which typically allows a ratable recovery of the capital outlay over time.

Depreciation (also known as a “cost recovery deduction”) is an item which seems to be adjusted in nearly every piece of tax legislation. Perhaps this is because increasing the allowance for depreciation is perceived to spur investment in depreciable capital assets, as economically rational investors scurry to take advantage of the incentive. On the other hand, decreasing the allowance for depreciation raises tax revenue, all other things being equal.

Tax changes affecting depreciation generally take place prospectively. Because real estate is generally long-lived, several otherwise “old” depreciation systems may still apply to certain properties. Also, it is possible that more than one depreciation system can apply to a single property. Consequently, it is necessary to mention the following depreciation systems:

(1) the Modified Accelerated Cost Recovery System (MACRS), introduced by the Tax Reform Act of 1986[[347]](#footnote-348) and applicable to most tangible depreciable property placed in service after 1986;

(2) the Accelerated Cost Recovery System (ACRS), introduced by the Economic Recovery Tax Act of 1981;[[348]](#footnote-349) and

(3) the Asset Depreciation Range (ADR) system, created by the Treasury Department and given a statutory basis by the Revenue Act of 1971.[[349]](#footnote-350)

Although both MACRS and ACRS generally classify property by reference to the ADR class guidelines, this is not true for real property. Arguably the most striking change under MACRS was limiting cost recovery for residential rental property to 27.5 years and for most other depreciable real property to straight line depreciation over 39 years.

**[2] Calculating the Deduction**

The computation of depreciation under MACRS generally involves using the: (1) applicable depreciation method; (2) applicable recovery period; and (3) applicable convention.[[350]](#footnote-351) The I.R.S. also provides optional tables for computing recovery allowances under MACRS.[[351]](#footnote-352)

**[a] Applicable Depreciation Method**

Under the general MACRS rules, the applicable depreciation method for each class of assets is prescribed and not elective. The depreciation methods include the 200-percent and the 150-percent declining balance methods and the straight-line method.[[352]](#footnote-353) However, the straight-line method is required for real estate.[[353]](#footnote-354)

**[b] Applicable Recovery Period**

As indicated above, under MACRS, the applicable recovery period for residential rental property[[354]](#footnote-355) is 27.5 years and for most other depreciable real property it is 39 years. Personal property is divided among six classes with recovery periods ranging from three to 20 years.[[355]](#footnote-356)

Several types of property that might be considered real property are defined as personal property for depreciation purposes. For example, fixtures (appliances, carpet, furniture) other than buildings and their structural components are treated as personal property, regardless of their classification under local law.[[356]](#footnote-357)

**[c] Applicable Convention**

A depreciation deduction is allowed for the year property is placed in service and for each succeeding year in the recovery period that the taxpayer holds the property. Property is placed in service when it “is first placed by the taxpayer in a condition or state of readiness and availability for a specifically assigned function.”[[357]](#footnote-358)

The allowance for the year property is placed in service is determined by a convention under which the property is deemed placed in service at an arbitrarily designated time within the year, and a proportionate amount of a full year's allowance is permitted for the year. The convention also determines how much of the recovery period falls in subsequent years. The effect of these conventions is to start the running of the prescribed depreciation period from the time it is deemed to begin rather than from the time the property is actually placed in service.

Real property must use the mid-month convention.[[358]](#footnote-359) The mid-month depreciation convention under MACRS treats residential rental property and nonresidential real property placed in service (or retired or disposed of) during any month of the tax year as placed in service (retired or disposed of) in the middle of that month. Under the mid-month convention, depreciation is allowable for a fraction of a year. The numerator of the fraction is equal to .5 plus the number of full months in the taxable year in which the property is placed in service. The denominator of the fraction is 12. The fraction (or percentage) as so computed is applied to the amount of depreciation that would be allowable for a full year under the straight-line method.[[359]](#footnote-360)

**[3] Additions and Improvements**

An addition or improvement to depreciable property has a recovery period the same length as that of the underlying property, but the recovery period for the addition or improvement begins when it is placed in service, not when the underlying property was placed in service.[[360]](#footnote-361)

**[4] Bonus Depreciation**

The Job Creation and Worker Assistance Act of 2002[[361]](#footnote-362) created what is known as “bonus depreciation” for qualified MACRS property. Bonus depreciation applies to the first year depreciation allowance. The original amount was 30 percent and applied to property acquired after September 10, 2001 and placed in service before January 1, 2005.[[362]](#footnote-363) The amount was increased to 50 percent by the Jobs and Growth Tax Relief Reconciliation Act of 2003.[[363]](#footnote-364) The 50 percent rate applies to property acquired after May 5, 2003 and placed in service before January 1, 2005.[[364]](#footnote-365)

The bonus depreciation is allowed for “50-percent bonus depreciation property,” which includes most new tangible property with a recovery period no longer than 20 years, water utility property, computer software, and certain leasehold improvements. Thus, it does not apply to most real estate holdings.

Bonus depreciation (50% additional first-year depreciation) is also available for “qualified Gulf Opportunity Zone[[365]](#footnote-366) property.” Generally, “qualified Gulf Opportunity Zone property” includes most buildings placed in service in the Gulf Opportunity Zone (GO Zone) after August 27, 2005 and before January 1, 2009, and most other tangible property and computer software placed in service in the GO Zone after August 27, 2005 and before January 1, 2008. In addition to the types of property eligible for the original bonus depreciation discussed above, the eligible GO Zone property also includes nonresidential real property or residential rental property (buildings and structural components of buildings).[[366]](#footnote-367)

**[5] Alternative Depreciation System (ADS)**

The Alternative Depreciation System (“ADS”) is required for certain MACRS property and is elective for all other property.[[367]](#footnote-368) The ADS system generally uses straight-line depreciation with a longer recovery period than the regular MACRS system.[[368]](#footnote-369) Elections to use the ADS system are irrevocable without I.R.S. consent.[[369]](#footnote-370)

The mandatory ADS system is required for certain types of property, such as tax-exempt use property, tangible property used outside the United States, tax-exempt bond financed property, and certain property imported from a foreign country.[[370]](#footnote-371) If the Alternative Depreciation System is elected for nonresidential real property or residential rental property, the prescribed recovery period is 40 years.[[371]](#footnote-372)

**[6] Disposition of Depreciated Property**

A disposition before the end of the property's recovery period is called an early disposition. For residential rental and nonresidential real property, the month of early disposition is treated as one-half month of use for purposes of prorating the depreciation calculation for the tax year.[[372]](#footnote-373)

Upon disposition of most property on which depreciation or cost recovery deductions have been taken, taxpayers may have to recognize part of their gain on sale as ordinary income rather than capital gain. These depreciation recapture rules prevent a taxpayer from converting ordinary income (due to depreciation deductions offsetting ordinary income) into capital gain (the gain on sale due to a depreciated tax basis in the property).

There are different depreciation recapture rules for “Section 1245 property” (generally personal property) and “Section 1250 property” (most real property). For most real estate (“Section 1250 property), other than property held for one year or less, the only amount subject to recapture is the *excess* of the depreciation deductions taken over the depreciation deductions that would have been taken had a straight line depreciation method been used.[[373]](#footnote-374) Since the current depreciation system of MACRS requires straight-line depreciation for most real property, most real property dispositions will not be subject to depreciation recapture (i.e., there is no excess depreciation taken over the straight-line method).

Under the recapture rules for personal property, all depreciation deductions taken are subject to recapture.[[374]](#footnote-375)

**§ 2.06 Credits**

**[1] In General**

Tax credits are another potential “benefit” of real estate ownership. Indeed, they are generally seen as more favorable to the taxpayer than deductions, because credits operate to offset tax on a dollar-for-dollar basis.

I.R.C. § 38 provides for various general business credits. One component of the general business credit is the investment credit determined under I.R.C. § 46. Another is the low-income housing credit determined under I.R.C. § 42(a). The rehabilitation credit, a component of the investment credit, is governed by I.R.C. § 47.

**[2] Rehabilitation Tax Credit**

**[a] In General**

The rehabilitation tax credit is a two-tiered credit. It is the sum of: (1) ten percent of the qualified rehabilitation expenditures with respect to any qualified rehabilitated building other than a certified historic structure; and (2) twenty percent of the qualified rehabilitation expenditures with respect to any qualified historic structure.[[375]](#footnote-376)

Qualified rehabilitation expenditures are amounts:

1. properly chargeable to capital account;
2. for property for which depreciation is allowable and which is
   1. nonresidential real property;
   2. residential rental property;
   3. real property which has a class life of more than 12.5 years; or
   4. an addition or improvement to property described at (a), (b), or (c) above; and
3. made in connection with the rehabilitation of a qualified rehabilitated building.[[376]](#footnote-377)

The rehabilitation credit must be claimed in the tax year in which the property attributable to the expenditures is placed in service, as long as the building is qualified for the tax year. However, the credit may be claimed before the date the property is placed in service under the qualified progress expenditure rules of I.R.C. § 47(d).

Certain expenditures are not included. The following are not qualified rehabilitation expenditures:

1. Any expenditure for which the straight-line method of depreciation over a recovery period specified in I.R.C. § 168(c) or (g) (MACRS or alternative MACRS) is *not* used. This rule does not apply if I.R.C. § 168(g) applies because the property is tax-exempt use property or tax-exempt bond financed property, presumably because both are already subject to the alternative depreciation system via I.R.C. § 168(g)(1)(B) or (C)).[[377]](#footnote-378)

1. The cost of acquisition of the building.[[378]](#footnote-379)
2. Any expenditure attributable to enlarging an existing building.[[379]](#footnote-380)
3. Any expenditure attributable to the rehabilitation of a “certified historic structure” or a building located in a registered historic district, *unless* the building is a “certified rehabilitation.”[[380]](#footnote-381) Note that this means the rehabilitation of a non-historic building within a registered historic district does *not* qualify for the credit. There is an exception to this non-qualification rule if:
   1. the rehabilitated building was not itself a certified historic structure;
   2. the Secretary of the Interior certified to the Secretary of the Treasury that the rehabilitated building is not of historic significance to the district; and
   3. if the Secretary of the Interior's certification (at b. above) occurs after the beginning of the rehabilitation of the building, the taxpayer certifies to the Secretary of the Treasury that, at the beginning of the rehabilitation, the taxpayer was in good faith not aware of the certification requirements at (b) above.[[381]](#footnote-382)
4. Any expenditure in connection with the rehabilitation of a building which is allocable to the portion of such property which is, or may reasonably be expected to be, tax-exempt use property [[382]](#footnote-383) within the meaning of I.R.C. § 168(h).[[383]](#footnote-384)
5. any expenditure of a lessee of a building if, on the date the rehabilitation is completed, the remaining term of the lease (determined without regard to any renewal periods) is less than the recovery period determined under I.R.C. § 168(c) (applicable recovery period).[[384]](#footnote-385)

As used above, a “certified rehabilitation” is any rehabilitation of a “certified historic structure” which the Secretary of the Interior has certified to the Secretary of the Treasury as being consistent with the historic character of such property or the district in which such property is located.[[385]](#footnote-386)

At a minimum, certification that a building is a “certified historic structure” must be applied for before the rehabilitation tax credit can be claimed on an income tax return. Certification by the National Park Service, or at least applying for certification, is a prerequisite to claiming the credit and not a mere procedural detail. One case makes that point convincingly as the government's motion for summary judgment was granted on that basis and the taxpayer was held not entitled to the credit. The taxpayer claimed the critical factor was whether it had performed the appropriate rehabilitation work, not whether it filed for certification with the Department of the Interior. I.R.C. § 48(g)(2)(C) describes a certified rehabilitation as one “which the Secretary of Interior has certified to the Secretary [of the Treasury] as being consistent with the historic character of the property … .” Pursuant to Treasury Regulations § 1.48-12(d)(7)(ii), if the final certification has not been issued before the tax return is filed, the taxpayer need only attach a copy of the application with proof that it was received by the Department of the Interior in order to claim the credit. The taxpayer must then attach a copy of the final certification on the first tax return filed after the certification is received. The government stated that if the taxpayer had applied for certification and had merely forgotten to attach a copy of the application to the return, then plaintiff might have claimed substantial compliance with the statute. But when the taxpayer failed to even apply for certification before claiming the credit, and “can point to nothing more than inadvertence for its failure to do so,” the taxpayer cannot argue that it has substantially complied with the statute.[[386]](#footnote-387)

**[b] Certified Historic Structure**

“Certified Historic Structure” refers to any building (and its structural components) which: (1) is listed in the National Register; or (2) is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.[[387]](#footnote-388)

A “registered historic district” is:

1. any district listed in the National Register; or
2. any district—
   1. which is designated under a statute of the appropriate State or local government, if such statute is certified by the Secretary of the Interior to the Secretary of the Treasury as containing criteria which will substantially achieve the purpose of preserving and rehabilitating buildings of historic significance to the district; and
   2. which is certified by the Secretary of the Interior to the Secretary as meeting substantially all of the requirements for listing of districts in the National Register.[[388]](#footnote-389)

**[c] Qualified Rehabilitated Building**

A qualified rehabilitated building is defined as meaning any building (and its structural components) if:

1. such building has been substantially rehabilitated;
2. such building was placed in service prior to the beginning of the rehabilitation;
3. in the case of any building *other* than a certified historic structure, in the rehabilitation process—
   1. fifty percent or more of the existing *external* walls of such building are retained in place as *external* walls;
   2. seventy-five percent or more of the existing *external* walls of such building are retained in place as *internal or external* walls; and
   3. seventy-five percent or more of the existing internal structural framework of such building is retained in place; and
4. depreciation (or amortization in lieu of depreciation) is allowable with respect to the building.[[389]](#footnote-390)

A building is “substantially rehabilitated” only if the qualified rehabilitation expenditures (previously discussed), which are incurred during any 24-month period selected by the taxpayer (at the time and in the manner prescribed by Regulation) that ends with or within the taxable year, exceed the greater of: (1) the adjusted basis of such building (and its structural components); or (2) $5,000.[[390]](#footnote-391) For this purpose, the adjusted basis of the building (and its structural components) is determined as of the beginning of the first day of the 24-month period selected by the taxpayer, or of the holding period of the building, whichever is later.[[391]](#footnote-392) The beginning of the holding period is determined without regard to any reconstruction by the taxpayer in connection with the rehabilitation.

This is an interesting application of the statute because it allows the taxpayer to choose the 24-month period which best suits his or her needs. The fixed point in this equation is the placed in service date; the taxpayer can choose any 24-month period *ending* in the year in which the rehabilitated property is placed in service.

There is a special rule which allows a longer measuring period if a rehabilitation may reasonably be expected to be completed in phases that are set forth in architectural plans and specifications completed before the rehabilitation begins. In such a case, the measurement period is sixty months rather than twenty-four months.[[392]](#footnote-393)

Only qualified rehabilitation expenditures (QREs) made within the 60-month period *ending* on the last day of the taxable year for which the credit is claimed may be considered in determining whether QREs exceed the building's adjusted basis for purposes of determining whether a building undergoing a phased rehabilitation is substantially rehabilitated in a taxable year. For example, in Ford v. United States,[[393]](#footnote-394) the court rejected the taxpayers' argument that their total projected expenditures over a subsequent 60-month rehabilitation period should be used to determine whether a building was substantially rehabilitated in a taxable year.

**[3] Low-Income Housing Credit (LIHC)[[394]](#footnote-395)**

**[a] In General**

The low-income housing credit (LIHC) is a federal income tax credit claimed by owners of residential rental properties which are rented to low-income tenants at below-market rental rates. It is available for qualified low income housing projects.[[395]](#footnote-396) The LIHC is an indirect federal subsidy of low-income housing. To claim the subsidy, eligible taxpayers claim a tax credit on their federal income tax returns. However, the total amount of credit available is limited on a state-by-state basis. Therefore, before claiming the credit on their federal income tax returns, taxpayers must first apply to the applicable state allocation agency to “reserve” a portion of the credit available to the state.

Form 8609 is used by owners of LIHC projects to obtain a housing credit allocation from the housing credit agency and to certify certain necessary information under the LIHC provision. Once allocated and earned, the credit is actually taken pro-rata over a ten-year period. It can be used in connection with both new and existing buildings. The LIHC is an extremely technical area of income tax law.

Once a project is placed in service, it is generally eligible for the credit every year for ten years. To continue generating the credit and to avoid tax credit recapture, an LIHC building must satisfy specific low-income housing compliance rules for a full fifteen-year period. The LIHC can be combined with the rehabilitation tax credit if a particular project meets the requirements of both statutes.

**[b] Economics**

The credit is generally designed to subsidize either thirty percent or seventy percent of the costs of the low-income units in a project, depending upon whether the project is new, existing, or uses federal subsidies. The thirty percent subsidy is for: (1) new construction using additional federal subsidies; and (2) the cost of acquisition of existing buildings.[[396]](#footnote-397) The seventy percent subsidy is for new construction without using additional federal subsidies. “New construction” includes the cost of rehabilitating an existing building if a minimum per unit expenditure threshold is exceeded. In such case, the rehabilitation expenditures are treated as a separate new building.[[397]](#footnote-398)

Because the credit is claimed over a ten-year period but is intended to equal thirty percent or seventy percent of allowable costs, the actual credit rate used for each year of the ten-year period is an amount which will yield a present value of thirty percent or seventy percent of allowable costs, based on the month the project is placed in service.

The rates are based on applicable federal rates (AFR). At their inception, the seventy percent credit rate was set at nine percent and the thirty percent credit rate was set at four per cent.[[398]](#footnote-399) Current low-income housing credit rates are published by the Treasury Department monthly in Revenue Rulings.[[399]](#footnote-400) For example, the rates for projects placed in service in July 2007 were: (1) 8.18 percent for the seventy percent credit rate; and (2) 3.50 percent for the thirty percent credit rate.

The operation of the credit mechanism practically ensures that taxpayers participating in low-income housing projects placed in service in different months will use different credit percentages on their returns. However, once a credit percentage is established, it remains constant for the duration of the period the credit is claimed.

The credit is claimed on Form 8586 (Low-Income Housing Credit). In exchange for receiving this credit, the project owner must agree to rent units to low-income individuals at reduced rental rates. Theoretically, the credit is designed to provide the additional return that is necessary to compensate low-income building owners for their reduced rental income. The effect of the reduced rental income stream must be factored into the project analysis.

In addition to the fifteen-year compliance period, a credit is denied unless an otherwise qualified project is also subject to a low-income use agreement with the housing agency for fifteen years after the close of the compliance period. Such an “extended low-income housing commitment” is intended to ensure the continued availability of the property for low-income use.[[400]](#footnote-401)

Economic principles influence where tax credit subsidized low-income housing projects will be built. Such housing is generally located where the land costs are low (because the credit is not allowable on land costs) and the LIHC allowable rents (discussed later) are closest to market rate rents.

Consequently, it is generally more difficult to build low-income tax credit housing in major cities because land costs are higher and allowable low-income rents are substantially below market rate rents. However, other federal and state programs may make development in major cities feasible. For example, the federal Section 8 program[[401]](#footnote-402) subsidizes tenant rents but does not limit the building owner's ability to claim the LIHC.

When reviewing whether or not to apply for a LIHC allocation, building owners should consider four major criteria: (1) the economic value of the credit; (2) the economic value of additional government subsidies; (3) the economic cost of the reduced rents; and (4) the administrative burden of complying with the LIHC program.

The credit is most valuable if it can be used in the year in which it is generated; *i.e.*, the building owner has sufficient current income tax liability to absorb the credit in full (*e.g.,* it is not an organization exempt from income taxation, part of the credit need not be carried forward, etc.). If a building owner cannot use the credit currently, then he or she may be able to re-market it to investors who are able to use the credit on a current basis. Such remarketing, or syndication, usually does not come without a (sometimes significant) cost.

**[c] Taxpayers Who Can Use the Credit**

The low-income housing credit, like many other areas of the tax law, involves limitations which come from other sections of the Internal Revenue Code and which apply differently to different types of taxpayers. For example, credits generated from rental real estate are generally subject to the passive activity loss and credit limitation rules.[[402]](#footnote-403)

The LIHC is calculated as a percentage of the tax basis of eligible low-income housing rental properties. Because they involve rental properties, LIHC activities are usually deemed to be passive activities.[[403]](#footnote-404) Generally, the passive activity rules provide that taxpayers can only claim passive activity credits to the extent that their regular tax liability is attributable to passive income.[[404]](#footnote-405) However, the LIHC cannot reduce a taxpayer's alternative minimum tax liability.[[405]](#footnote-406) Accordingly, both the passive activity and the alternative minimum tax rules limit the number of taxpayers who can benefit from the LIHC.

Because the LIHC can be claimed against regular income tax that is attributable to passive income, taxpayers with net passive income are ideal investors for LIHC projects.[[406]](#footnote-407) Under the general rental real estate exception to the passive loss rules, qualifying individual taxpayers may deduct up to $25,000 of losses from rental real estate activities.[[407]](#footnote-408) To fully qualify for this exception, the taxpayer must actively participate in the rental real estate activity and have less than $100,000 of adjusted gross income (AGI). If the taxpayer actively participates but the taxpayer’s AGI exceeds $100,000, then the $25,000 allowance is reduced by fifty cents for every dollar by which the taxpayer's AGI exceeds $100,000. The allowance is completely phased out when the taxpayer's adjusted gross income reaches $150,000.[[408]](#footnote-409)

To actively participate in an activity under this rule, an investor must: (1) own at least ten percent of the rental real estate project; and (2) participate in the property management in a significant and bona fide sense. Limited partners are generally treated as not actively participating, regardless of their percentage ownership.[[409]](#footnote-410) However, the active participation requirement does not apply in the case of the low-income housing credit (or the rehabilitation tax credit).[[410]](#footnote-411) Therefore, an individual can use the $25,000 offset for rental real estate activities associated with a low-income housing project even if she has a less than ten percent interest or participates as a limited partner.

However, this exception to the general rule applies only with respect to the credit and not to any losses generated by an LIHC project. Consequently, the active participation of investors with respect to operating losses from a LIHC project is determined under the general rules. As LIHC investments are generally owned by individuals through limited partnership interests, investors in LIHC projects will normally not qualify as active participants. Consequently, operating losses from LIHC projects will generally not qualify for the rental real estate exception.

If the LIHC is allowable because of the exception to the active participation rule, it is only allowable to the extent of the “deduction equivalent” of the passive activity credit.[[411]](#footnote-412) The deduction equivalent is the amount which (if allowed as a deduction) would reduce the regular tax liability for such taxable year by an amount equal to such credits.[[412]](#footnote-413)

Once an individual taxpayer meets the hurdle of “active participation,” there is another obstacle to overcome before a deduction (or deduction equivalent in the case of a passive activity credit) is allowed. This obstacle is the phase-out of the allowable $25,000 offset for taxpayers whose adjusted gross incomes exceed $100,000. For these taxpayers, the $25,000 amount is reduced (but not below zero) by fifty percent of the amount by which the adjusted gross income of the taxpayer for the taxable year exceeds $100,000. [[413]](#footnote-414) The full $25,000 offset amount will disappear when a taxpayer's adjusted gross income reaches $150,000. However, there is another benefit in this area for participants in LIHC projects. Specifically, the phase out does not apply to a credit (as opposed to a loss) from a LIHC project.[[414]](#footnote-415)

There is an ordering rule which prescribes how allowable losses and credits will offset the $25,000 offset amount.[[415]](#footnote-416)

With respect to S corporations, the LIHC will be passed through to the corporation’s shareholders.[[416]](#footnote-417) Since most S corporation shareholders are individuals, the limitations discussed above will apply. Similarly, because personal service corporations are subject to the general passive loss provisions,[[417]](#footnote-418) they can only use the credit against tax attributable to passive income, as discussed above.

“Closely held C corporations” (those where five or fewer shareholders who own fifty percent or more by value of the corporate stock at any time during the last half of the taxable year),[[418]](#footnote-419) that are not personal service corporations, enjoy a liberalized passive activity limitation rule. Under the liberalized rule, passive activity losses and credits can offset income and tax attributable to both passive and active income.[[419]](#footnote-420) The only limitation is that loss or credit cannot offset income or tax attributable to portfolio income, such as interest and dividends.

C corporations other than closely held corporations or personal service corporations are not subject to the passive loss rules.[[420]](#footnote-421)

**[d] Technical Overview of the Operation of the LIHC**

**[i] In General**

Determining the LIHC is a two-part calculation: the initial year calculation and succeeding year calculations. The initial year calculation has four components: (1) qualified low-income building; (2) credit percentage; (3) low-income occupancy percentage; and (4) eligible basis. Each of these is discussed below.

**[ii] Qualified Low-Income Building**

To qualify for the credit, a building must be a qualified low-income building.[[421]](#footnote-422) A “qualified low-income building” is one which is part of a qualified low-income housing project at all times during the fifteen-year compliance period.[[422]](#footnote-423) In order to be a qualified low-income building, a building must be subject to the depreciation rules that were enacted as part of the Tax Reform Act of 1986.[[423]](#footnote-424) These rules generally require that residential rental property be depreciated on a straight-line basis over 27.5 years.

A qualified low-income housing project is generally any residential rental property that satisfies one of two minimum set-aside tests,[[424]](#footnote-425) so-called because they refer to the minimum number of units which must be “set aside” for occupancy by low-income tenants. The two minimum set-aside tests are known as: (1) the 20–50 test; and (2) the 40–60 test.[[425]](#footnote-426) Under the 20–50 test, at least twenty percent of the residential units in the project must be both “rent-restricted” and occupied by tenants whose gross income is fifty percent or less of the area median gross income.[[426]](#footnote-427) Under the 40–60 test, at least forty percent of the residential units in the project must be both rent-restricted and occupied by tenants whose gross income is sixty percent or less of the area median gross income.[[427]](#footnote-428)

A residential unit is rent-restricted only if the “gross rent” charged with respect to such unit does not exceed thirty percent of the income limitation applicable under the elected minimum set-aside test.[[428]](#footnote-429) For example, if the 20–50 minimum set-aside test is elected, then gross rent for a particular unit is limited to thirty percent of fifty percent (*i.e.,* fifteen percent) of the area gross median income. If the 40–60 minimum set-aside test is elected, then gross rent is limited to thirty percent of sixty percent (*i.e.,* eighteen percent) of the area median gross income.

Gross rent includes the cost of any utilities that are paid for by the tenant*,* excluding the cost of a telephone, in determining if a unit is rent restricted.[[429]](#footnote-430) Gross rent also includes a utility allowance as determined by the Secretary of the Treasury after taking into account such determinations under Section 8 of the United States Housing Act of 1937.[[430]](#footnote-431) Such a utility allowance effectively reduces the cash rent which may be charged for a particular unit and still have the unit meet the minimum set-aside test. Gross rent does not include any rental assistance payments made on behalf of a tenant, such as through Section 8 of the United States Housing Act of 1937.[[431]](#footnote-432)

Obviously, all rental units are not the same size and it would not be equitable to subject different size units to a single minimum set-aside requirement. As a result, a complicated set of rules exists to determine allowable rent for different sized rental units in order to meet the minimum set-aside requirements. Similar rules exist with respect to the income limitations of the set-aside requirements.

When projecting income levels for a project, building owners should generally use imputed income levels based on the number of bedrooms rather than the size of the family that occupies the unit. Specifically, for purposes of determining the maximum gross rent that may be charged to a tenant, a studio apartment is deemed occupied by one individual. Apartments with one or more separate bedrooms are deemed occupied by 1.5 individuals per bedroom. [[432]](#footnote-433)

In contrast, actual family size is used to determine family income for purposes of the minimum set-aside test. A family consists of all occupants of a unit; no ancestral or marital relationship is required for an individual to be included in the determination of family size.[[433]](#footnote-434)

Revenue Ruling 90–89[[434]](#footnote-435) well illustrates the point. It, involves a situation in which two unrelated adults individually meet the low-income test, *i.e.*, each has income less than (in this case) sixty percent of the area median gross income for a family of one. They wish to rent a single two-bedroom apartment in a (potential) low-income housing project. However, together their combined incomes exceed the area median gross income for a family of two. If they rent this apartment together, the apartment does not qualify toward satisfying the minimum set-aside requirement. A unit occupied by multiple adults, with no relationship to each other, constitutes a family. Such a family will generally find it difficult to satisfy the low-income test if each adult tenant is employed.

The U.S. Department of Housing and Urban Development (HUD) releases its calculation of an area's median gross income annually in late January or early February. HUD releases three income calculations: (1) median income; (2) low income; and (3) very low income. Income levels for each calculation are presented for family sizes from one to eight persons. Very low income is the level used for the 20–50 test. To obtain the income level for the 40–60 minimum set-aside test, the very low income level is multiplied by 1.2 (*i.e.,* 50% times 1.2 equals 60%). Building owners should closely monitor the release of these statistics and review rent levels during the early months of every year. If the area median gross incomes increase, then rents can also be increased. Gross income for this purpose is not the same as gross income for federal income tax purposes. For example, gross income for LIHC purposes includes welfare assistance and child support payments and excludes employment income of children.[[435]](#footnote-436)

The determination of whether a tenant qualifies as low-income for purposes of the minimum set-aside test is made on a continuing basis throughout the project compliance period, both with regard to tenant income and area median gross income. The test is applied annually and not just on the date the tenant initially occupies the unit.

Obviously, both tenant income and area median gross income can change over time. All other things being equal, if either tenant income for a unit increases (*e.g.,* through considering increased or new income for a family member, adding a working family member or losing a non-working family member) or area median gross income decreases*,* the low-income unit can fall out of compliance with the applicable minimum set-aside test.

Increases in tenant's income (and presumably decreases in area median gross income) will not disqualify the tenant (and therefore the low-income unit) if the changes are *de minimis.* There are two *de minimis* rules: (1) the general rule; and (2) the elective deep rent skewing set-aside.

Under the general rule, the initially qualified tenant is treated as continuing to satisfy the applicable income test if his or her income (or, in the case of a family, the family's income) does not increase to a level more than forty percent above the otherwise applicable income limit. If a tenant's income does increase above forty percent of the applicable income limit, then that tenant is no longer a low-income tenant for purposes of determining whether the set-aside test has been met. However, a penalty is not assessed and a unit will continue to be treated as a low-income unit if during the period of noncompliance each unit of a comparable or smaller size as the occupied/nonqualifying unit that becomes vacant is rented to tenants that do satisfy the applicable income test.[[436]](#footnote-437)

The “deep rent skewing set-aside” is an elective provision. The election must be made when the project is placed in service. However, administratively, the election is not reported to the IRS until the tax return that includes the year the property is place in service is filed. Under this special set-aside rule, a low-income tenant will continue to qualify for purposes of the applicable income test as long as the tenant's income does not increase above seventy percent of qualifying income.[[437]](#footnote-438) If projects electing this provision have one or more tenants whose income exceeds the 170 percent limit (*i.e.*, qualifying income equals 100 percent plus 70 percent excess equals 170 percent), then no penalties are imposed if, during the period of noncompliance, each unit that becomes vacant is rented to tenants having incomes of forty percent or less of area median gross income*.*

Projects can qualify for this elective provision only if fifteen percent or more of all low-income units are occupied by tenants having incomes equal to forty percent or less of area median gross income.[[438]](#footnote-439) In addition, the average rent that is charged to tenants in any market rate units in the project must be at least 200 percent of the average rent that is charged to low-income tenants for comparable units.[[439]](#footnote-440)

The IRS has issued a revenue procedure to provide guidance to owners of low-income buildings on electing to satisfy the 200-percent gross-rent restriction for a rent skewed project.[[440]](#footnote-441)

If a unit is disqualified, recapture of the LIHC may result. Generally, if any noncompliance is corrected within a reasonable period of time after learning of the noncompliance, then recapture will not be triggered. Also, Congress did not intend that tenants should be evicted in order to return projects to compliance. Rather, Congress intended that while a low-income housing project is in noncompliance, each available unit of a comparable or smaller size that becomes available must be rented to a tenant having qualifying income until the project is returned to compliance. Therefore, recapture will generally not occur during periods of noncompliance unless vacant rental units are rented to market rate tenants.[[441]](#footnote-442)

**[iii] Qualified Basis**

Once it is determined that a building is a qualified low-income building, the building owner must determine the building's qualified basis to calculate the LIHC for the year. A building's “qualified basis” is the product of the building's low-income occupancy percentage multiplied by the building's eligible basis.[[442]](#footnote-443)

The LIHC which a building owner can claim with respect to a qualified low-income building is based on the percentage of the building that is occupied by low-income tenants: the applicable fraction. The applicable fraction is determined as of the close of the taxable year and is the smaller of the: (1) unit fraction, or (2) the floor space fraction.[[443]](#footnote-444) Both fractions are computed—and the smaller used—to prevent developers from manipulating the definition of low-income units to maximize the credit without providing low-income units comparable in number and size to any market rate units in a project.

The term “unit fraction” represents the number of low-income units in the building divided by the number of total residential rental units in the building.[[444]](#footnote-445) The number of residential rental units in the building includes units that are not occupied.[[445]](#footnote-446) The term “floor space fraction” represents the ratio of total floor space of low-income units in the building divided by the total floor space of all residential rental units in the building.[[446]](#footnote-447) The floor space of residential rental units in the building includes units that are not occupied.[[447]](#footnote-448) For purposes of determining the applicable fraction, the term “low-income unit” represents a unit that satisfies the same rent restriction and income limitations used for the minimum set-aside test.[[448]](#footnote-449)

In addition to these two general requirements, there are other specific requirements which will be listed but not further detailed here. These requirements address:

1. transient occupancy;[[449]](#footnote-450)
2. suitability for occupancy;[[450]](#footnote-451)
3. availability to the general public;[[451]](#footnote-452)
4. buildings with four or fewer units;[[452]](#footnote-453)
5. provision of supportive services;[[453]](#footnote-454) and
6. owner-occupied buildings.[[454]](#footnote-455)

Generally, the credit period, with respect to any building, is the ten-year period beginning with: (1) the taxable year in which the building is placed in service; or (2) at the election of the taxpayer, the succeeding taxable year but only if the building is a qualified low-income building as of the close of the first year of such period. (This election, once made, is irrevocable.)[[455]](#footnote-456)

However, there is a special rule for the first year of the credit period. For the first year of the credit period, the applicable fraction is determined on a monthly basis.[[456]](#footnote-457) The credit that is disallowed in the first year due to this monthly calculation may be claimed in the eleventh year.[[457]](#footnote-458) This calculation begins with the first full month in which the property is placed in service. The occupancy of the units for each month is determined as of the last day of the month.[[458]](#footnote-459)

**EXAMPLE:**

If one-half the units in a low-income housing project were first occupied for the full month of November and the balance were occupied in December, then a calendar year taxpayer would treat the building has having been in service for 1.5 / 12 of the year. This first year adjustment does not affect the determination of qualified basis in subsequent years. In the eleventh year, the credit disallowed in the first year is allowed. In this example, 10.5 / 12 of the credit should be claimed.

**[iv] Eligible Basis**

In general, “eligible basis” is the acquisition cost of the property plus the cost of any improvements to the property. The determination of eligible basis is similar to the determination of cost basis used for other purposes of the tax law. Under the general rule, the eligible basis for the entire compliance period is determined as of the close of the first day of the credit period. [[459]](#footnote-460)

The “credit period” is the period of ten taxable years beginning with: (1) the taxable year in which the building is placed in service, or (2) at the election of the taxpayer, the succeeding taxable year but only if the building is a qualified low-income building as of the close of the first year of such period. The election to use the succeeding taxable year, once made, is irrevocable.[[460]](#footnote-461)

To be included in eligible basis, the property must be depreciable. This rule precludes taxpayers from claiming the LIHC with respect to land costs. Taxpayers are also required to make adjustments with respect to: (1) disproportionate standard units;[[461]](#footnote-462) (2) mixed-use property; (3) common areas;[[462]](#footnote-463) (4) depreciation expense; (5) federal grants;[[463]](#footnote-464) (6) rapid amortization provisions; (7) build-out costs; and (8) developer fees.

**[e] Additional Tax Issues**

**[i] In General**

Many other areas of the Code have direct and indirect application to LIHC projects. These areas include the tax shelter filing requirements, profit motive rules, and capital recovery allowances.

**[ii] Tax Shelter Filing Requirements**

The former tax shelter registration requirements of I.R.C. § 6111[[464]](#footnote-465) were repealed by the American Jobs Creation Act of 2004[[465]](#footnote-466) and replaced by a regime requiring certain reporting requirements for “reportable transactions.” Under these requirements, each “material advisor”[[466]](#footnote-467) must file an information return for any reportable transactions, identifying and describing the transaction, including any potential tax benefits expected to result.[[467]](#footnote-468) In addition, each material advisor must keep a list identifying each person for whom the advisor acted as a material advisor for the transaction. “Reportable transactions” as those that Secretary of the Treasury has determined as having a potential for tax avoidance or evasion.[[468]](#footnote-469) The penalties for failure to comply with these requirements have been substantially increased.[[469]](#footnote-470)

**[iii] Profit Motive**

Taxpayers are not allowed to deduct losses with respect to activities that are not engaged in for profit.[[470]](#footnote-471) However, the Treasury Department has issued a regulation which provides that the profit motive basis will not disallow losses, deductions, or credits generated by a qualified low-income building for which tax credits are allowable.[[471]](#footnote-472)

**[iv] Capital Recovery**

Capital recovery is the term applied to the process by which taxpayers recover their capital expenditures for income tax purposes. Generally this occurs via depreciation or amortization over a period of time. The LIHC has two interesting interactions in the area of capital recovery: (1) cost segregation studies; and (2) basis adjustments.

By utilizing cost segregation studies, the LIHC can be claimed with respect to both personal and real depreciable property. The LIHC differs in this respect from the rehabilitation tax credit, which is generally only allowable on real property. Therefore a taxpayer utilizing only the LIHC has no incentive to allocate basis to real property. Consequently, for depreciation purposes, such a taxpayer does have an incentive to allocate basis to personal property in order to obtain a faster recovery of his or her capital expenditures (tax basis) via accelerated depreciation deductions.

Cost segregation studies are used to document the allocation of costs among different categories of property. For depreciation purposes, there are generally five different categories of property. In descending order by general lengths of depreciable lives, they are: (1) land; (2) improved real property; (3) land improvements; (4) seven-year property; and (5) five-year property.

A taxpayer can use a cost segregation study to aggressively allocate costs away from land and to personal property. The benefits of a cost segregation study can be substantial. Cost segregation studies can also yield substantial property tax savings, particularly with respect to low-income housing properties. Taxpayers should scrutinize the benefits of a cost segregation study before filing their income tax returns for the year property is placed in service. [[472]](#footnote-473)

With respect to basis adjustments, the basis of LIHC property does not need to be reduced by a portion of the LIHC claimed. This feature also distinguishes the LIHC from other tax credits such as the rehabilitation tax credit. This feature allows the taxpayer to claim tax credits with respect to qualifying basis as well as to depreciate the full basis. Thus the taxpayer is allowed to recover a portion of his capital expenditure twice: once via tax credits and a second time via depreciation deductions.

**[f] Tax-Exempt Bonds**

Interest on obligations of states and local governments generally is exempt from federal income tax.[[473]](#footnote-474) Such tax-exempt loans do constitute a federal subsidy. If any portion of the eligible basis attributable to new construction or to rehabilitation expenditures is financed with federal subsidies, the qualified basis is eligible only for the thirty percent present value credit, unless such federal subsidies are excluded from eligible basis.[[474]](#footnote-475)

**[4] Disabled Access Credit**

Many businesses have to comply with the Americans with Disabilities Act (ADA). The ADA generally prohibits employers from discriminating against a qualified individual with a disability because of that disability, requires private employers to make their facilities accessible to job applicants and employees, and requires places of public accommodation, such as banks, retail stores, theaters, hotels and restaurants to make their goods and services accessible to all people with disabilities.[[475]](#footnote-476)

In order to defray the cost of complying with the ADA, certain taxpayers can claim a credit or take a deduction for the expense of making their business more accessible to the disabled. Specifically, there are three business tax incentives available to offset some of the financial cost of ADA compliance: a credit for the cost of providing access for persons with disabilities (I.R.C. § 44); a special deduction for the cost of removing architectural and transportation barriers (I.R.C. § 190); and a credit for hiring members of certain targeted groups, including those who have disabilities (I.R.C. § 51).

The I.R.C. § 44 credit, with certain limitations, is worth fifty percent of the expenses of making business premises more accessible by removing barriers, providing qualified interpreters, or buying and modifying equipment. To qualify, a business must have either gross receipts of $1 million or less for the tax year before the credit is elected, or no more than thirty full-time employees during the tax year before the credit is elected.[[476]](#footnote-477) The credit is claimed on Form 8826 (Disabled Access Credit) and equals 50 percent of the amount of annual eligible access expenditures that exceed $250 but do not exceed $10,250.[[477]](#footnote-478) The credit cannot exceed the tax liability of the business for the year. Eligible expenses are those that allow the business to comply with the ADA, including: (1) removing architectural, communication, physical or transportation barriers that prevent a business from being accessible to, or usable by, individuals with disabilities; (2) providing interpreters or other effective methods of making aurally delivered materials available to hearing-impaired persons; and (3) acquiring or modifying equipment or devices for disabled individuals.[[478]](#footnote-479)

The disabled access credit is part of the general business credit,[[479]](#footnote-480) so it is subject to the carryback and carryforward rules.[[480]](#footnote-481) Any unused credit remaining at the end of the carryforward period is lost.[[481]](#footnote-482) No other or deduction or credit is allowed for any amount for which the disabled access credit is allowed.[[482]](#footnote-483)

Under I.R.C. § 190, a taxpayer may elect to treat qualified architectural and transportation barrier removal expenses paid or incurred during the taxable year as deducted rather than capitalizable expenses.[[483]](#footnote-484)

I.R.C. § 51 allows employers a credit equal to 40% of first-year wages (up to $6,000) paid to individuals who are members of a targeted group.[[484]](#footnote-485)

**§ 2.07 At-Risk Rules**[[485]](#footnote-486)

**[a] In General**

The “at-risk” rules of I.R.C. § 465 serve to limit a taxpayer’s ability to deduct losses generated from a business or investment activity. In 1976, Congress enacted the “at-risk” rules of I.R.C. § 465 in an effort to defeat some of the tax shelters of the time. Those investments typically used inflated valuation and creative financing that involved no economic liability on the part of the investors, but resulted in substantial loss deductions far exceeding the investors’ total investment risk. Under the “at-risk” rules of I.R.C. § 465, deductions from covered activities are limited to the amount that the taxpayer economically has “at-risk” in the venture. To be considered “at-risk” under I.R.C. § 465, a taxpayer must generally either commit personal funds or property to the investment or incur personal liability for borrowed funds (or pledge property other than property used in that activity as security for the borrowed amount).[[486]](#footnote-487)

Taxpayers covered by the at-risk rules include individuals, estates, trusts, and certain closely-held C corporations.[[487]](#footnote-488) Individual partners, LLC members, or shareholders of S corporations are subject to the at-risk rules on the amount of any losses that flow through to them from the partnership (or LLC) or S corporation. The at-risk rules of I.R.C. § 465 apply to virtually any business or profit-making activity.[[488]](#footnote-489)

The at-risk rules of I.R.C. § 465 limit losses to the extent that a taxpayer is at-risk with respect to any “activity.” Thus, the limitations are applied on an activity-by-activity basis, and a taxpayer’s at-risk amount with respect to one activity cannot be used to allow deductions generated from another “activity” for which the taxpayer is not at-risk. Except with respect to certain activities,[[489]](#footnote-490) regulations have not been issued to address the definition of separate “activities.”[[490]](#footnote-491)

The loss limitation of I.R.C. § 465 applies only when deductions incurred in an activity exceed the income generated by that activity, and the taxpayer desires to use that loss against income from other sources.[[491]](#footnote-492) The taxpayer must be “at-risk” in order to deduct that loss. Any disallowed loss is carried forward to the next taxable year for use against income, if any, from that activity or from additional amounts invested in the activity for which the taxpayer is at-risk.[[492]](#footnote-493)

The amount that a taxpayer has at risk in an activity will generally vary from year to year. The income from the activity in question increases the at-risk amount each year, as do payments of nonrecourse debt principal, and cash distributions will decrease the at-risk amount.[[493]](#footnote-494) However, a taxpayer will not be considered to be at risk to the extent that the taxpayer’s investment is protected against loss by guarantees, stop-loss agreements, or other similar arrangements.[[494]](#footnote-495)

If a taxpayer’s at-risk amount drops below zero due to distributions from the activity,[[495]](#footnote-496) the amount by which it falls below zero must be recaptured and included in gross income.[[496]](#footnote-497) That amount is then treated as a deduction with respect to that activity, and may be deducted in subsequent years when there is a sufficient at-risk amount available. Thus, this recapture rule will recapture deductible losses if over time they exceed the taxpayer’s at-risk amount from that activity.

**[2] Qualified Non-Recourse Financing**

Under the general at-risk rule, a taxpayer would not be “at-risk” to the extent that a venture is funded with non-recourse debt, and would not be able to take losses against the basis created by purchasing the investment with nonrecourse debt. The taxpayer would only be able to take losses to the extent that taxpayer invested cash or borrowed funds for which the taxpayer is personally liable.[[497]](#footnote-498) However, the at-risk debt rules are relaxed for real estate ventures, which are traditionally funded with nonrecourse debt, to enable such investors to deduct a greater portion of their losses. I.R.C. § 465(b)(6) provides that, in the case of real property activities, the taxpayer’s at-risk amount includes the taxpayer’s share of any “qualified nonrecourse financing.”

Qualified nonrecourse financing is defined by the I.R.C.[[498]](#footnote-499) as any financing:

1. Which is borrowed by the taxpayer with respect to the activity of holding real estate and is secured by such real estate;
2. Which is borrowed from a qualified person, defined as a person actively or regularly engaged in the business of lending money, or borrowed from or guaranteed by any Federal, State, or local government;[[499]](#footnote-500)
3. Which is not borrowed from a person from whom the taxpayer acquired his or her interest, or a person who received a fee in connection with the sale of the interest to the taxpayer, or a person who is related to such seller or promoter;[[500]](#footnote-501)
4. Except to the extent provided in regulations, with respect to which no person is personally liable for repayment;[[501]](#footnote-502) and
5. Which is not convertible debt.[[502]](#footnote-503)

Treas. Reg. § 1.465-27 provides that qualified nonrecourse financing must be secured only by real property used in the activity of holding real property, except that (i) property that is incidental to the activity of holding real property, and (ii) property that is neither real property used in the activity of holding real property nor incidental property if the aggregate gross fair market value of such property is less than 10% of the aggregate gross fair market value of all the property securing the financing, may also secure the financing.

Note that in an LLC, generally entity-level debt is not recourse to the members, even if the loan is recourse to the LLC. For purposes of the at-risk rules, such debt will not violate the requirement that no person is personally liable for repayment even if the debt is recourse to the LLC itself, provided certain conditions are met. Under the Regulations, the personal liability of any partnership is disregarded, and the debt, if otherwise qualified, will be treated as qualified nonrecourse financing, if (i) the only persons personally liable to repay the financing are partnerships; (ii) each partnership with personal liability holds only real property used in the activity of holding real property, incidental property, or property that meets the 10% aggregate gross fair market value test described above, and (iii) in the event of a default, the lender may proceed only against the property that is described in (ii) and that is held by the partnership.[[503]](#footnote-504)

**§ 2.08 Passive Activity Rules**

**[1] In General**

In order to curb tax shelters, the Tax Reform Act of 1986 imposed yet another limitation on the deduction of losses from the ownership or operation of real estate and other investments. The passive activity rules are another means of deferring the recognition of certain losses and credits. Losses or credits disallowed in the current year due to the passive activity rules are suspended for reconsideration and possible utilization in each succeeding tax year.

The passive activity rules of I.R.C. § 469 apply to individuals, estates, trusts, closely-held C corporations, and personal service corporations.[[504]](#footnote-505) Losses that flow through from partnerships and S corporations will be limited at the individual partner or shareholder level.[[505]](#footnote-506)

I.R.C. § 469 disallows the deduction of net passive activity losses against other types of non-passive income, which are characterized as either active income or portfolio income.[[506]](#footnote-507) The characterization of income as either “active” or “passive” depends on whether the taxpayer “materially participates” in the activity.[[507]](#footnote-508) Note that losses generated by one passive activity can be used to offset income or gain generated by another passive activity. However, portfolio income (*e.g.,* interest, dividend, and royalty income not derived in the ordinary course of a trade or business) is not treated as income from a passive activity.[[508]](#footnote-509) Thus, passive activity losses cannot shelter portfolio income. In addition, portfolio income earned in connection with a passive activity retains its character as portfolio income and will be taken into account separately from other items related to that activity.[[509]](#footnote-510)

Suspended passive activity losses and credits can be carried forward indefinitely. They are treated as deductions or credits in each succeeding tax year.[[510]](#footnote-511) Unused suspended losses from an activity are allowed in full when the taxpayer disposes of his or her entire interest in the activity in a taxable transaction. However, the loss must first be applied against net income or gain from all passive activities for the taxable year before it can offset nonpassive income or gain.[[511]](#footnote-512)

The key to the application of the passive loss limitations is whether the taxpayer “materially participates” in the activity. Material participation, as well as other aspects of the passive activity loss rules, is determined on an “activity” by activity basis. For example, a partner might materially participate in one activity conducted by a partnership but not in another, so that his or her share of losses from the first activity would be active (not limited by the passive loss rules) while his or her share of losses in the other activity would be limited by the passive loss rules and could not be deducted against the taxpayer’s active income.[[512]](#footnote-513) Thus, it is necessary first to determine the scope of the taxpayer’s “activities.”

**[2] What Constitutes an Activity**

The Treasury Regulations adopt a facts and circumstances approach to defining the scope of an “activity.”[[513]](#footnote-514) Multiple enterprises or business can be considered a single “activity” if “the activities constitute an appropriate economic unit for the measurement of gain or loss.”[[514]](#footnote-515) The Regulations list the following factors in making this determination:

1. similarities and differences in the type of business;
2. the extent of common control;
3. the extent of common ownership;
4. geographical location; and
5. business interdependency, such as the extent to which the activities purchase or sell goods between themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or share a single set of books and records.[[515]](#footnote-516)

Taxpayers generally have significant flexibility in determining the scope of an activity. A taxpayer may use any reasonable method in applying the relevant facts and circumstances to group his or her activities.[[516]](#footnote-517) An example given in the Regulations involves a taxpayer owning a bakery and a movie theater in Baltimore and a bakery and a movie theater in Philadelphia. The taxpayer could treat all these investments as one activity, or could group the Baltimore bakery and theater together and the Philadelphia bakery and theater together, or could group the two bakeries together and the two theaters together, or could treat them as four separate activities.[[517]](#footnote-518)

**[3] Material Participation Standards**

Whether or not a taxpayer materially participates in an activity is based on the personal involvement of the individual taxpayer in the activity. The Code defines material participation as involvement by the taxpayer on a “regular, continuous, and substantial basis.”[[518]](#footnote-519) The Treasury Regulations provide seven detailed mechanical tests to determined material participation, based on the amount of hours the taxpayer devotes to the activity.[[519]](#footnote-520) For example, an individual will be treated as materially participating in an activity for a taxable year if the individual’s participation exceeds 500 hours during the year.[[520]](#footnote-521) Participation may be established by any reasonable means. Maintaining contemporaneous daily records of participation is not necessary. An approximate number of hours of participation may be based on appointment books, calendars or narrative summaries.[[521]](#footnote-522)

The determination of material participation differs somewhat based on the type of entity. Under the regulations,[[522]](#footnote-523) a general partner in a partnership must comply with one of seven tests to determine if that individual materially participates in an activity of the partnership. Under I.R.C. § 469(h)(2), a limited partner is presumed not to materially participate in the partnership and is therefore generally limited by the passive loss rules. However, a limited partnership interest held by a general partner is not treated as a limited partnership interest in applying I.R.C. § 469.[[523]](#footnote-524) Whether or not the taxpayer in that situation materially participates is determined under the general material participation tests for both interests together. Also, a limited partner may meet the material participation test if he or she meets one of three tests: (i) the 500-hour test; (ii) the material participation in five out of the past ten years test; or (iii) the material participation in a personal service activity during the past three years test.[[524]](#footnote-525)

The application of these material participation rules becomes more complicated when the investor is a member in an LLC or LLP. Since different material tests are available for limited and general partners, the question arises whether a partner in an LLP or LLP is treated as a general or limited partner for these purposes. The regulations define limited partner for this purpose with reference to the partner’s liability for the entity’s debts under state law.[[525]](#footnote-526) However, at least one court has held that an LLC member should be able to establish material participation by using the seven tests available to general partners.[[526]](#footnote-527)

**[4] Rental Activity is Per Se Passive Activity**

Rental activities, whether or not the taxpayer materially participates, are treated as passive activities.[[527]](#footnote-528) Thus, the passive loss provisions may be particularly harsh for general partners of leveraged real estate rental activities. Since all partnership losses will be passive losses, regardless of the partner’s level of participation, the general partner’s share of partnership losses will be passive activity losses, which may not be offset by management fees received by the general partner for services rendered to the partnership.[[528]](#footnote-529)

Pursuant to Treasury Regulations, however, some rental operations are essentially considered “active” and are excluded from the definition of rental activity. Rental operations which fall outside the definition of rental activity (and which are therefore trade or business activities subject to the material participation rules) include rentals where:

(1) the average period of customer use for such property is seven days or less (*e.g.,* a hotel or motel);[[529]](#footnote-530)

(2) the average period of customer use for such property is thirty days or less and significant personal services are provided on behalf of the owner in connection with making such property available for use by customers;[[530]](#footnote-531)

(3) without regard to the average period of customer use, extraordinary personal services are provided on behalf of the owner in connection with making such property available for use by customers;[[531]](#footnote-532)

(4) the rental of such property is incidental to a nonrental activity of the taxpayer;[[532]](#footnote-533)

(5) the taxpayer makes the property available during defined business hours for nonexclusive use by various customers (*e.g.,* a golf course);[[533]](#footnote-534) or

(6) the taxpayer provides property for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.[[534]](#footnote-535)

**[5] Special Rule for Rental Activities: Active Participation**

The general rule is that rental activities are passive activities, without regard to whether the taxpayer materially participates in the activity. An exception to the general rule permits an individual to annually offset up to $25,000 of losses or equivalent credits from real estate activities, with respect to which such individual “actively participates,” against other forms of income such as salary or portfolio income.[[535]](#footnote-536) In this manner, the statute operates to not subject this type of rental activity to the passive activity loss and credit disallowance rule of I.R.C. § 469(a).

The $25,000 amount will be reduced, but not below zero, by fifty percent of the taxpayer's adjusted gross income over $100,000.[[536]](#footnote-537) Thus, the allowance is completely phased out when adjusted gross income reaches $150,000. Adjusted gross income for this purpose is determined without regard to net losses from passive activities.[[537]](#footnote-538)

The taxpayer “actively participates” in an activity if he or she participates in a significant and bona fide sense, such as making management decisions. Management decisions that are relevant in determining whether a taxpayer actively participates include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.[[538]](#footnote-539)

A limited partner will generally not be treated as satisfying the active participation requirement.[[539]](#footnote-540) Further, a taxpayer will not be treated as actively participating in an activity if he owns less than ten percent (by value) of all interests in such activity at any time during the taxable year.[[540]](#footnote-541)

**[6] Special Rules for Real Estate Professionals**

There is an additional exception in the passive loss rules which will benefit those individuals engaged in real estate businesses. Since rents are per se passive income,[[541]](#footnote-542) those engaged in the real estate business as their profession would be disadvantaged. Therefore, for certain eligible taxpayers, rents will not be deemed per se passive income, and will be active income if the taxpayer meets the material participation test with respect to that activity.[[542]](#footnote-543) An individual is eligible for this exception if (i) the taxpayer performs more than 750 hours of service during the taxable year in real property trades or businesses in which the taxpayer materially participates, and (ii) these services amount to more than one-half of all personal services the taxpayer performs in all trades or businesses during the year.[[543]](#footnote-544) A “real property trade or business” means any real property development, redevelopment, construction, acquisition, conversion, rental, management, leasing, or brokerage trade or business.[[544]](#footnote-545) A closely held C corporation will meet the eligibility requirements if more than 50% of its gross receipts for the taxable year are earned from real property trades or businesses in which the corporation materially participates.[[545]](#footnote-546) Personal services performed by the taxpayer as an employee are not treated as performed in a real property trade or business unless the taxpayer has more than a five percent ownership interest in the employer.[[546]](#footnote-547) In the case of a joint return, the eligibility requirements are met only if either spouse separately satisfies the requirements. In determining material participation, however, the participation of the spouse is taken into account.[[547]](#footnote-548)

**§ 2.09 Basis for Loss Limitation**

**[1] Partner’s Basis in Partnership Interest**

**[a] In General**

A partner’s basis in his or her partnership interest plays two major roles for tax purposes: (1) it determines how much of the loss, which flows through to the partner from the partnership, may be deducted in a particular tax year; and (2) it is used to compute gain or loss on a disposition of the partnership interest or a distribution from the partnership. For simplicity, the partner’s basis in his or her partnership interest is referred to as the “outside basis,” as contrasted with the basis of the assets in the hands of the partnership, which is referred to as “inside basis.”

A partner's outside basis will initially be determined by reference to the amount of money and the adjusted basis of any property that the partner contributed to the partnership, or the cost basis of a purchased partnership interest.[[548]](#footnote-549)

A partner's original outside basis in his or her partnership interest will be increased by:

(1) any additional capital contributions made by the partner;[[549]](#footnote-550)

(2) the partner’s distributive share of partnership taxable income;[[550]](#footnote-551)

(3) the partner’s distributive share of partnership income which is exempt from tax;[[551]](#footnote-552) and

(4) the partner’s proportionate share of the increases in partnership liabilities.[[552]](#footnote-553)

A partner's basis in his or her partnership interest will be decreased (but not below zero) by:

(1) distributions made to the partner by the partnership;[[553]](#footnote-554)

(2) the partner’s distributive share of the partnership losses and deductions;[[554]](#footnote-555)

(3) the partner’s distributive share of nondeductible partnership expenditures which are not properly chargeable to capital account;[[555]](#footnote-556) and

(4) the partner’s proportionate share of the decreases in partnership liabilities.[[556]](#footnote-557)

**[b] Effect of Debt on Basis**

With partnerships, or any entity taxed as a partnership (i.e., an LLC), the partner’s basis in his or her partnership interest includes that partner’s share of partnership level debt. This is accomplished under I.R.C. § 752(a), which provides that an increase in a partner's share of partnership liabilities,[[557]](#footnote-558) or an increase in a partner's individual liabilities due to the assumption of partnership liabilities, is treated as a contribution of money to the partnership. This deemed contribution of money results in an increased basis for the partner in his or her partnership interest.[[558]](#footnote-559) Conversely, under I.R.C. § 752(b), a decrease in a partner's share of partnership liabilities, or a decrease in a partner's individual liabilities by reason of the assumption of such individual liabilities by the partnership, is treated as a distribution of money to the partner. This deemed cash distribution will reduce the partner's basis for his or her partnership interest.[[559]](#footnote-560) I.R.C. § 731(a) will require gain to be recognized when a partner receives an actual or constructive cash distribution from the partnership that is in excess of the adjusted basis of his or her partnership interest. A partner’s share of liabilities for purposes of I.R.C. § 752 is determined under the Treasury Regulations, and will depend on whether the liability is a recourse liability or a nonrecourse liability.

This inclusion of entity-level debt in the partner’s basis is a benefit of partnerships and LLCs. An increased basis will allow partners to deduct a greater amount of losses that flow through from the entity.[[560]](#footnote-561) However, partners must be careful of liability shifts and reductions, which produce a deemed cash distribution under I.R.C. §752(b), and perhaps gain if the reduction in the partner’s share of debt exceeds the partner’s basis in his or her partnership interest.[[561]](#footnote-562)

The determination of a partner’s share of the partnership liabilities depends on whether the liability is recourse or nonrecourse to the partner, which in turn requires an analysis of both the nature of the liability and the nature of the partnership entity (general partnership, limited partnership, or limited liability company). A recourse liability is any liability for which one or more of the partners bears an economic risk of loss with regard to the obligation.[[562]](#footnote-563) To the extent that any partner bears the burden of discharging that liability, should the partnership be unable to do so, it is a recourse liability of the partnership. Each partner’s share of that liability is then determined under the rules for sharing recourse liabilities.[[563]](#footnote-564) A nonrecourse liability is any liability with respect to which none of the partners bears an economic risk of loss (i.e., has any personal liability), and is shared among the partners under the nonrecourse debt rules.[[564]](#footnote-565)

In determining a partner’s share of a recourse liability, the §752 regulations employ an economic risk of loss analysis for each partner. That is done by determining the extent to which a partner would have to make a contribution to the partnership to pay a creditor in the event that all partnership assets were disposed of for no consideration, gain or loss was allocated among the partners, the partnership was liquidated, and the liability was due and payable.[[565]](#footnote-566) This “deemed liquidation scenario” assumes that all of the partnership assets are worthless, including cash, and that all assets are sold in a taxable transaction for no consideration (or sold for the amount of any nonrecourse liability attached to an asset). In determining the amount that a partner would have to contribute, the regulations take into account arrangements such as additional capital contribution requirements, deficit restoration obligations, guarantees, assumptions, and indemnities. This deemed liquidation scenario will use the partners’ loss ratios and capital accounts to determine the amount of the liability for which each partner is responsible. A partner’s negative capital account after computing this deemed liquidation will dictate that partner’s share of the recourse liability.[[566]](#footnote-567)

In determining a partner’s share of nonrecourse liabilities, the regulations use a three-tier analysis, which ultimately looks to the manner in which the partners will share profits.[[567]](#footnote-568) The three tiers consist of (i) the partner’s share of the partnership minimum gain determined under the I.R.C. § 704(b) regulations;[[568]](#footnote-569) (ii) the amount of gain that would be allocated to a partner under I.R.C. § 704(c) upon a disposition of the property for the amount of the liability; and (iii) the partner’s interest in partnership profits.[[569]](#footnote-570)

In an LLC, where no member has personal liability for debts of the entity, all liabilities will be treated as nonrecourse liabilities for purposes of the I.R.C. § 752 regulations, even if the debt is nominally recourse to the entity itself. Consequently, debt in an LLC will generally be allocated to all the members under the rules for allocating nonrecourse debt. However, since a partner bears the economic risk of loss for a partnership liability to the extent that he or she personally guarantees the liability,[[570]](#footnote-571) such a guarantee can convert a nonrecourse liability into a recourse liability for the guaranteeing partner. Consequently, an LLC member (or any partner in a general partnership with nonrecourse debt) can create additional basis in his or her LLC/partnership interest by guaranteeing all or a portion of the debt, at the cost of less debt (and consequently less basis) allocated to other members/partners.

**[c] Effect of Distributions on Basis**

Distributions can often be made tax-free out of a partnership, because the partner is initially taxed on his or her distributive share of partnership income, gain, deductions, losses, credits, and similar items, regardless of whether such items are actually distributed.[[571]](#footnote-572) This allocation of income, whether or not distributed, increases a partner’s basis in his or her partnership interest.[[572]](#footnote-573) Therefore, these “previously taxed amounts,” along with any initial capital contributed, can generally be withdrawn tax free under I.R.C. § 731, which provides that distributions of cash are not taxable except to the extent that the cash distributed exceeds the partner’s basis in his or her partnership interest. Loss can only be recognized upon the liquidation of a partnership in certain events.[[573]](#footnote-574)

Distributions of cash will reduce the partner’s basis in his or her partnership interest, but not below zero.[[574]](#footnote-575) These basis adjustments for distributions of cash are made after basis is increased for profits for the year or decreased for losses for the year.[[575]](#footnote-576) The partnership does not receive a deduction for any distributions made to a partner, unless they are characterized as guaranteed payments.[[576]](#footnote-577)

One of the important advantages of an entity taxed as a partnership is the ability to distribute appreciated property from the partnership (or LLC) to a partner/member without triggering a taxable event and consequently without gain recognition of the appreciation in that asset. Under I.R.C. § 731(b), no gain or loss is recognized to a partnership upon the distribution of appreciated or depreciated property.[[577]](#footnote-578) Similarly, a partner does not recognize gain upon the distribution of an appreciated asset from the partnership to the partner. Loss could be recognized to a partner on a distribution but only if the distribution is in liquidation of the partner’s interest in the partnership and the partner receives no property other than money, unrealized receivables, and inventory.[[578]](#footnote-579)

The unrecognized gain in the property distributed will remain with the property due to the carryover basis rules. The tax basis for the property received by the partner will be the adjusted basis for that property in the hands of the partnership immediately before the distribution.[[579]](#footnote-580) Such basis may not exceed, however, the adjusted basis of the partner’s interest in the partnership, reduced by any money distributed in the same transaction.[[580]](#footnote-581) The holding period of the property received will include the period held by the partnership.[[581]](#footnote-582) The partner’s basis in his or her partnership interest will be reduced by the basis of the asset received in the distribution.[[582]](#footnote-583)

The rules are slightly different for a liquidating distribution. In that case, the partner’s basis in his or her partnership interest is allocated among all the assets received in the liquidation, under rules set forth in I.R.C. § 732(c). However, both the current and liquidating distribution rules allow a partner to receive appreciated property from a partnership and defer the taxable event until the partner sells that property.

**[2] Shareholder’s Basis in S Corporation**

A shareholder's pro rata share of S corporation losses and deductions can be deducted in computing the shareholder's income only to the extent of: (1) the shareholder's basis in his or her stock; and (2) loans by the shareholder to the S corporation (*i.e.,* debt owed to the shareholder by the S corporation.[[583]](#footnote-584) Losses and deductions in excess of basis can be carried over to a later time when the shareholder has basis against which the carried-over losses can be offset.[[584]](#footnote-585)

Increases in basis for loss recognition purposes can result from additional equity contributions, shareholder loans to the S corporation, and income realized by the corporation, whether separately or nonseparately computed and whether taxable or non-taxable to the shareholder.[[585]](#footnote-586) Debt incurred by the S corporation from other than the taxpayer does not increase a shareholder's basis for loss purposes. Thus, unlike a partnership, entity level debt does not increase a shareholder’s basis in his or her stock.[[586]](#footnote-587)

Similar to a partnership, a distribution of money by an S corporation can reduce the shareholder’s stock basis.[[587]](#footnote-588)

Since shareholders only receive debt basis for loans made directly by the shareholder to the S corporation, and not for any loans of the entity from any other source, shareholders have tried to obtain debt basis through methods that do not require a direct outlay of money to the corporation. Generally these methods have been unsuccessful. For example, if the S corporation borrows funds from a creditor and the shareholder guarantees the loan, the shareholder will not receive debt basis due simply to the guarantee.[[588]](#footnote-589) Shareholders have also tried creative circular transfers of cash in order to claim debt basis, which are generally ignored.[[589]](#footnote-590) However, a shareholder can structure a back-to-back loan from a lender to the shareholder and then from the shareholder to the S corporation. These are generally respected as creating debt basis to the shareholder.[[590]](#footnote-591)

**§ 2.10 Tax-Exempt Use Property**

**[1] In General**

Tax-exempt use property is an interesting aspect of the topic of limitations placed on tax credits and deductions. The general premise is that renting or leasing property to a tax-exempt entity may limit the landlord/owner's ability to use rehabilitation tax credits and to claim the most rapid depreciation available.

In the case of depreciation, the adjustment is a timing difference, as the full amount of allowable depreciation will be realized, albeit over a longer period of time than would otherwise have been the case. However, when one factors in the time value of money, there is a real dollar cost to this adjustment. Moreover, the adjustment to the rehabilitation tax credit is a loss of the credit relating to the portion of the property leased to the tax-exempt entity. Clearly, a landlord/owner (or the taxpayer’s representative) must pay particular attention to the tenant mix in a property and to the tax-exempt entity rules.

The term “tax-exempt use property” is defined in I.R.C. § 168(h). It is referred to, for rehabilitation tax credit purposes, at I.R.C. § 47(c)(2)(B)(v)(I). In short, the term applies to certain leases of certain property to tax-exempt entities. A more precise definition follows.

In general, for property other than nonresidential real property, tax-exempt use property is the portion of any tangible property leased to a tax-exempt entity.[[591]](#footnote-592) For nonresidential real property, tax-exempt use property includes (1) only the portion of the property leased to a tax-exempt entity in a “disqualified lease;”[[592]](#footnote-593) (2) where more than 35-percent of the property is leased to tax-exempt entities;[[593]](#footnote-594)

Tax-exempt use property does not include property leased under a short-term lease.[[594]](#footnote-595) Tax-exempt use property also does not include any portion of property predominantly used by the tax-exempt entity (directly or through a partnership of which such entity is a partner) in an unrelated trade or business the income of which is subject to tax under I.R.C. § 511.[[595]](#footnote-596)

**EXAMPLE:**

*X* has just completed rehabilitating an historic downtown property. Several tenants are interested in occupying the highly visible space. The City Dental Association, a tax-exempt entity, would like to lease thirty percent of the total property for its headquarters operations. It will only lease the property if it can secure a lease term of at least thirty years. Museum *Y* would like to rent some ground floor space, ten percent of the total property, for a satellite book store and retail outlet. Such an outlet would publicize the museum which is located elsewhere and cater to the downtown audience. Museum *Y* just fought and lost an Internal Revenue Service audit which concluded that its book and retail store sales are unrelated business taxable income. Museum *Y* also wants to make sure it can secure the location on a long-term basis and will insist on at least a twenty-five year initial lease term, plus options. The balance of the tenants will be professional and back office operations.

*X* can rent to both exempt organizations without sacrificing any tax benefits. The long-term lease to City Dental Association is not tax-exempt use property because the portion of the property leased to tax-exempt entities in taxable leases does not exceed thirty-five percent of the property. Museum *Y*'s lease is not included in the thirty-five percent threshold test because Museum *Y*'s use of the leased property is predominantly (in fact, totally) used in an unrelated trade or business, the income from which is subject to tax. In this respect, Museum *Y* is, from a tax perspective, no different than the other for-profit tenants of the building.

**[2] Tax-Exempt Entity**

A tax-exempt entity includes:

1. the United States, any state or political subdivision thereof (*e.g.,* county, city, etc.), any possession of the United States, or any agency or instrumentality of such government;
2. an organization (other than a cooperative described in I.R.C. § 521) which is exempt from income tax (*e.g.,* a non-profit hospital, charitable organization, business league, etc.);
3. any foreign person or entity;[[596]](#footnote-597) or
4. any Indian tribal government.[[597]](#footnote-598)

**[3] Treatment of Property Leased to Partnerships**

In the case of any property which is leased to a partnership (and other pass-through entities),[[598]](#footnote-599) the determination of whether any portion of such property is tax-exempt use property is made by treating each tax-exempt entity partner's proportionate share of such property as being leased directly to the partner.[[599]](#footnote-600) A tax-exempt entity's proportionate share of any property leased by a partnership is determined on the basis of the entity's share of partnership items of income or gain, whichever results in the larger proportionate share.[[600]](#footnote-601)

**[4] Treatment of Property Owned by Partnerships**

Generally, tax-exempt use property is the portion of property leased to a tax-exempt entity. However, a portion of property owned by a partnership (or other pass-through entity) may be treated as tax-exempt use property. The general rule is that an amount equal to the tax-exempt entity's proportionate share of the property is treated as tax-exempt use property if: (1) the property is owned by a partnership (or other pass-through entity) which has both a tax-exempt entity and a person who is not a tax-exempt entity as partners; and (2) any allocation to the tax-exempt entity is not a “qualified allocation.”[[601]](#footnote-602)

As discussed above, determination of proportionate share is based on the entity's share of income or gain, whichever produces the largest proportionate share. The term “qualified allocation” means any allocation to a tax-exempt entity which: (1) is consistent with the entity's being allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis and such share remains the same during the entire period the entity is a partner in the partnership, and (2) has substantial economic effect within the meaning of I.R.C. § 704(b)(2).[[602]](#footnote-603)

**EXAMPLE:**

Partners *X*, a for-profit corporation, and *Y*, a non-profit corporation, are partners in Partnership *XY.* The partners agree in the partnership agreement to share income and gain 50/50. Because *Y* is tax-exempt and has no use for depreciation deductions or rehabilitation tax credits, the partners also agree to allocate all depreciation deductions and rehabilitation tax credits 100% to *X.* All other items of loss, deduction, credit, and basis are allocated 50/50 between the partners. The partnership does not lease any property to a tax-exempt entity. Because the allocation of depreciation deductions (0%) and rehabilitation tax credits (0%) to *Y* (the tax-exempt entity) are not consistent with *Y*'s allocation of the same distributive share of each item of deduction (50%) and credit (50%), the allocation is not a qualified allocation, even before the consideration of substantial economic effect. Consequently, an amount equal to *Y*'s proportionate share (50%) of the property will be treated as tax-exempt use property.

**[5] Depreciation Limitations**

I.R.C. § 168(g) requires the use of the alternative depreciation system for tax-exempt use property.[[603]](#footnote-604) As previously discussed, the alternative depreciation system requires use of the straight-line method of depreciation over a longer recovery period than ordinary MACRS.[[604]](#footnote-605)

**[6] Credit Limitations**

The term “qualified rehabilitation expenditure” does not include any expenditure in connection with the rehabilitation of a building which is allocable to the portion of the property which is tax-exempt use property.[[605]](#footnote-606) However, this limitation is not applicable in the determination of whether a building has been substantially rehabilitated.[[606]](#footnote-607)

**EXAMPLE:**

*A* buys a building for $100,000 and incurs $200,000 of rehabilitation expenditures to rehabilitate it. *A* has planned from the outset of the project to lease 60% of the rehabilitated property to a tax-exempt entity, *X.* Thus, $120,000 (*i.e.* 60% x $200,000) is allocable to the portion of the property which is tax-exempt use property and therefore is not a qualified rehabilitation expenditure eligible for the credit.

However, the $120,000 is a qualified rehabilitation expenditure for purposes of determining whether the building has been substantially rehabilitated. Thus, the qualified rehabilitation expenditure for purposes of the substantial rehabilitation test in this example is not $80,000 (the $200,000 total rehabilitation expenditure less the $120,000 non-qualifying rehabilitation expenditure). Had it been that amount, the property would not be “substantially rehabilitated” because the $80,000 qualifying rehabilitation expenditure fails to exceed the greater of $5,000 or the $100,000 adjusted basis of the building.

Instead, the qualified rehabilitation expenditure for purposes of the substantial rehabilitation test is the full $200,000 rehabilitation expenditure. This amount does exceed the greater of $5,000 or the $100,000 adjusted basis of the building. Consequently, *A* is entitled to a credit on $80,000 of qualified rehabilitation expenditures.

There is no similar limitation on use of the low-income housing credit if property is leased to a tax-exempt entity.

**[9] Illustration of Principles**

The following illustrates several of the principles presented in this section of the chapter.

**EXAMPLE**:

*A*, *B*, and *E* are members of a partnership formed on July 1. On that date the partnership places in service a building and Section 1245 class property. *A* and *B* are taxable entities; *E* is a tax-exempt entity. The partnership agreement provides that during the first five years of the partnership, *A* and *B* are each allocated forty percent of each item of income, gain, loss, deduction, credit, and basis; *E* is allocated 20 percent. Thereafter, *A*, *B*, and *E* are each allocated 33 1/3 percent of each item of income, gain, loss, deduction, credit, and basis.

Assume that these allocations meet the substantial economic effect test of I.R.C. § 704(b)(2) and *E*'s distributive share of the partnership's income is not unrelated trade or business income subject to tax under I.R.C. § 511. The allocations to *E* are not qualified allocations under I.R.C. § 168(h)(6)(B) because *E*'s distributive share of partnership items does not remain the same during the entire period that *E* is a partner in the partnership. Thus, 33 1/3 percent of the building and 33 1/3 percent of the I.R.C. § 1245 class property are tax-exempt use property from the time each is placed in service by the partnership and are thus subject to the cost recovery rules of I.R.C. § 168(g)(1) and (2) (alternative MACRS).

In addition, no tax credit is allowed for 33 1/3 percent of any “qualified rehabilitation expenditures” with respect to the building because of I.R.C. § 47(c)(2)(B)(v).

With better planning, *A* and *B* in the above example might have consented to the lower (33 1/3 ) percentage interest from the outset and realized a greater benefit, with respect to depreciation deductions and the rehabilitation tax credit. Otherwise, when *A* and *B* are each allocated their 40% share of qualified rehabilitation expenditures), they each are actually realizing a benefit of only 26.68% (*i.e.*, 40% x 66 2/3 %) of the total rehabilitation expenditures incurred during the year. Had they consented to the lower (33 1/3) percentage, all the rehabilitation expenditures would have been qualified rehabilitation expenditures in this example, and each would have realized a benefit of 33 1/3 percent of the total rehabilitation expenditures incurred during the year. As it is, the difference is permanently lost.

**§ 2.11 Original Issue Discount and Unstated Interest**

**[1] Background**

I.R.C. §§ 1274 and 483 are somewhat outdated and unnecessary weapons in the Internal Revenue Service's arsenal. To continue the analogy, the wrongs these sections were intended to right have been largely eradicated by other weapons. Nonetheless, the sections are still in effect and can apply to real property transactions.

I.R.C. § 483, which predates I.R.C. § 1274, was originally enacted in 1964 to give the I.R.S. authority to characterize as interest a portion of a deferred payment made under the terms of a debt instrument, irrespective of the fact that the parties to the debt instrument treated the payment as principal. Very generally, the difference between the present value of the deferred payments and the stated sales price was called the total unstated interest.

The original abuse was perceived to be the seller's ability to convert ordinary income (*i.e.,* a payment received as interest income) into capital gain (*i.e.,* a payment received as principal).[[607]](#footnote-608)

I.R.C. § 483 also did not address the issue of when recharacterized interest income would be recognized. In fact, a cash basis seller could defer recognition of interest on a deferred payment until receipt, even though an accrual basis buyer would be currently deducting the interest “payments,” each in accordance with his or her respective accounting method.[[608]](#footnote-609)

Congress wanted to correct this abuse as well and essentially did so in the Tax Reform Act of 1984[[609]](#footnote-610) by expanding the scope of the original issue discount (OID) rules to treat unstated interest as OID for debt instruments involving significant amounts. As a result, the I.R.C. § 483 rules took a “back seat” to the revised OID rules, specifically I.R.C. § 1274 dealing with the determination of sales price in the case of certain debt instruments issued for property. Now, I.R.C. § 483 applies only to those debt instruments to which I.R.C. § 1274 does not apply.

**[2] Section 1274 Original Issue Discount**

**[a] In General**

I.R.C. § 1274 applies the original issue discount (OID) rules to debt instruments that are not publicly traded and that are given as consideration for the sale or exchange (after December 31, 1984) of property that is not publicly traded if:

1. some or all of the payments under the instrument are due more than six months after the sale; and
2. the stated redemption price at maturity of the instrument exceeds:
   1. the instrument’s stated principal amount if there is adequate stated interest; or
   2. its imputed principal amount if there is not adequate stated interest.[[610]](#footnote-611)

There are several specific statutory exclusions from Section 1274, including:

1. sales involving total payments of $250,000 or less;[[611]](#footnote-612)
2. sales of principal residences;[[612]](#footnote-613)
3. sales of farms by individuals, estates, trusts, and small businesses for $ 1 million or less;[[613]](#footnote-614)
4. certain land transfers between related parties that are covered by I.R.C. § 483;[[614]](#footnote-615)
5. sales or exchanges of annuity contracts governed by I.R.C. § 72;[[615]](#footnote-616)
6. debt instruments which are publicly traded or issued for publicly traded property;[[616]](#footnote-617) and
7. sales of patents for amounts that are contingent on the productivity, use, or disposition of the property transferred.[[617]](#footnote-618)

Probably the best place to start in a potential OID analysis of a transaction is with the exemptions. If none apply, one can look at statutory provisions regarding adequately stated interest and, if necessary, compute the OID amount. One should also keep in mind that the I.R.C. § 483 rules may apply if the OID rules do not. If none of the statutory exemptions apply, the following definitions will be relevant.

The “stated redemption price at maturity” is the principal amount of the debt instrument and all other amounts payable at that time, excluding interest which is based on a fixed rate and payable unconditionally at fixed periodic intervals of one year or less during the entire term of the debt instrument.[[618]](#footnote-619) Therefore, if the instrument provides for all principal and interest to be paid at maturity, then the entire amount is the stated redemption price at maturity. On the other hand, if the instrument provides for annual interest to be paid monthly, then the final payment of interest will not be part of the “stated redemption price at maturity.”

The “imputed principal amount” is the sum of the present values of all payments due under the instrument (interest and principal), discounted at the applicable federal rate, and compounded semi-annually.[[619]](#footnote-620) There will be adequate stated interest if the stated principal (*i.e.,* face) amount of the instrument is less than or equal to the imputed principal amount.[[620]](#footnote-621)

**EXAMPLE:**

Assume a note provides for interest only payments at a rate of 9%, with a balloon payment (stated principal amount) of $4,500,000 of principal due after five years. The stated principal amount is therefore $4,500,000. Assume the applicable federal rate is 10% and that the present value of all payments due under the note discounted at 10% equals $4,200,000. The imputed principal amount is therefore $4,200,000. Because the stated principal amount ($4,500,000) is not less than the imputed principal amount ($4,200,000), there is not adequate stated interest with respect to the underlying debt instrument. Therefore, the issue price of this debt instrument for purposes of the original issue discount rules is the imputed principal amount, or $4,200,000. As the stated redemption price at maturity is the same as the stated principal amount in this example, original issued discount is $4,500,000 - $4,200,000 = $300,000.

**[b] Applicable Federal Rate (AFR)**

The Applicable Federal Rates (AFR) are determined and announced monthly by the Treasury Department in a Revenue Ruling.[[621]](#footnote-622) There are three Applicable Federal Rates (AFR), depending on the term of the debt instrument.[[622]](#footnote-623) They are the short term rate (for instruments with a term of not over three years), the mid-term rate (for instruments over three but not over nine years), and the long-term rate (for instruments over nine years). The AFR may also be used in a variety of real estate contexts, including: (1) rental agreements for tangible property which involve either deferred payments (where at least one amount, allocable to the use of property in one calendar year, is to be paid after the close of the calendar year) or stepped rents (where there are increases in the amount to be paid as rent under the agreement); (2) deferred payment sales where some or all of the payments are due more than one year after the sale and there is unstated interest; (3) private placement of debt instruments; and (4) loans with below market interest rates.

In the case of a sale or exchange, the AFR used is the lowest rate in effect for any month in the 3-calendar-month period ending with the 1st calendar month in which there is a binding contract in writing for such sale or exchange.[[623]](#footnote-624)

**[c] Special Rates**

If a debt instrument is given in exchange for property and the stated principal (face) amount of the debt instrument does not exceed $2,800,000, then the debt instrument is a “qualified debt instrument” and the discount rate used for both I.R.C. §§ 483 and 1274 purposes will not exceed nine percent, compounded semi-annually. In other words, the discount rate used for a qualified debt instrument will be the AFR or nine percent, whichever is lower.[[624]](#footnote-625)

A discount rate of 110 percent of the federal rate, compounded semiannually, applies to sale and leaseback transactions.[[625]](#footnote-626)

There is also a provision to “elect out” of I.R.C. § 1274 treatment if: (1) both parties elect to use the cash receipts and disbursements method of accounting with respect to interest on the debt instrument; and (2) the stated principal amount of the debt instrument does not exceed $2,000,000.[[626]](#footnote-627) This election applies to successors of the holder (lender) and the obligor (debtor), and ceases to apply if the instrument is transferred to an accrual basis taxpayer.[[627]](#footnote-628) Both the $2,800,000 and $2,000,000 limits above are indexed for inflation after 1989.[[628]](#footnote-629)

**[d] Character of Gain on Retirement of Debt Obligation**

Under I.R.C. § 1271(a)(1), amounts received on the retirement of any debt obligation are treated as amounts received in exchange therefore. Gain on the sale or exchange of a debt instrument with OID generally is treated as ordinary income to the extent of its OID if there was intent at the time of its issuance to call the debt instrument before maturity.[[629]](#footnote-630)

**[e] Assumption of Mortgages**

If in connection with a sale or exchange of property, debt is either assumed or the property is taken subject to the debt, the original issue discount rules do not apply unless the terms of the debt instrument were modified.[[630]](#footnote-631)

The issuance of a wraparound mortgage, however, is not treated as an assumption and will be subject to the original issue discount rules.[[631]](#footnote-632)

**[3] Section 483 Unstated Interest**

If the original issue discount rules do not apply, the unstated interest rules set forth in I.R.C. § 483 may. The I.R.C. § 483 unstated interest rules apply under the following circumstances:

1. there is a sale or exchange of property in which at least one payment is due more than one year after the sale;[[632]](#footnote-633)
2. there is unstated interest (*i.e.,* the interest rate provided for in the instrument is less than the applicable federal rate);[[633]](#footnote-634)
3. the transaction is not subject to the original issue discount rules;[[634]](#footnote-635) and
4. the sales price exceeds $3,000.[[635]](#footnote-636)

The discount rate cannot exceed six percent, compounded semiannually, for transfers of land between family members. However, this rule applies only if the total sales price of all prior land sales between the family members during the calendar year does not exceed $500,000. If any party to the sale is a nonresident alien, the limit on the discount rate does not apply.[[636]](#footnote-637)

**§ 2.12 Tax-Exempt Interest on Qualified Bonds**

**[1] In General**

State and local bonds, the proceeds of which are used for nongovernmental, private purposes, are generally not tax-exempt.[[637]](#footnote-638) These bonds, known as “private activity bonds” (formerly “industrial development bonds”), however, may be tax-exempt if they are “qualified bonds” and meet certain requirements, including a volume cap.[[638]](#footnote-639) Qualified bonds are: (1) exempt facility bonds; (2) qualified mortgage bonds; (3) qualified veterans mortgage bonds; (4) qualified small issue bonds; (5) qualified student loan bonds; (6) qualified redevelopment bonds; and (7) qualified 501(c)(3) bonds.[[639]](#footnote-640) Those most related to real estate are discussed below.

**[2] Exempt Facility Bonds**

“Exempt facility bonds” are bonds at least ninety-five percent of the proceeds of which are used to provide certain enumerated public facilities, including airports, mass commuting facilities, utility facilities, and qualified residential rental projects.[[640]](#footnote-641) Regulations list the rules for determining whether a facility comes within the exemption.[[641]](#footnote-642) The qualified residential rental projects require a set-aside for a certain number of low-income tenants, similar to the requirements for the low-income housing credit.[[642]](#footnote-643)

**[3] Qualified Mortgage Bonds**

Tax-exempt status is available for certain state and local bonds used to finance mortgages (“qualified mortgage bonds” and “qualified veteran’s mortgage bonds”).[[643]](#footnote-644) A “qualified mortgage bond” is part of a “qualified mortgage issue,”[[644]](#footnote-645) which is an issue by a state or political subdivision where the proceeds of the issue are used to finance owner-occupied residences within a specified period. The issue must meet certain requirements relating to residence,[[645]](#footnote-646) “first-time home buyers,”[[646]](#footnote-647) purchase price,[[647]](#footnote-648) mortgagor’s income,[[648]](#footnote-649) repayment restrictions,[[649]](#footnote-650) placement of loan proceeds in targeted areas,[[650]](#footnote-651) and other miscellaneous requirements.[[651]](#footnote-652)

**§ 2.13 Disposition of Real Estate**

**[1] General Concepts Concerning Sale and Exchanges of Real Estate**

**[a] In General**

Real estate can generally be disposed of either in a taxable or non-taxable manner. In addition, the Internal Revenue Code provides for some permanent gain elimination provisions, such as with the disposition of a principal residence[[652]](#footnote-653) or upon death.[[653]](#footnote-654) A “sale” or disposition of real estate can take many forms. For example, the seller may receive cash, notes, other property, or debt discharge in exchange for the real estate transferred, all of which can carry unique tax consequences. Whether a “sale” occurs is a question of fact, and the I.R.C. may consider all circumstances, including side agreements or related contracts.[[654]](#footnote-655) For example, a sale to an entity may be recharacterized as a contribution and distribution, or a sale and leaseback may be recharacterized as a financing transaction.[[655]](#footnote-656)

**[b] Adjusted Basis**

To arrive at the adjusted basis of the property, the original basis must be increased for capital expenditures, including the cost of improvements, and reduced by allowed or allowable depreciation and amortization deductions incurred during the period the property was owned by the taxpayer.[[656]](#footnote-657) The adjusted basis of the property must be determined prior to sale in order to calculate gain or loss on sale. The seller's original basis is the starting point for computing the adjusted basis. The original basis of the property is the amount paid for the property in cash or in other property,[[657]](#footnote-658) the basis of property acquired in a carryover or substituted basis transaction,[[658]](#footnote-659) or the fair market value of property acquired from a decedent.[[659]](#footnote-660)

**[c] Gain Determination**

The amount of gain or loss on a sale or exchange equals the “amount realized” minus the “adjusted basis” of the property sold.[[660]](#footnote-661) The amount realized on a sale generally equals the money received plus the fair market value of any other property received.[[661]](#footnote-662)

In addition, if the property sold is subject to a mortgage, the face amount of the mortgage is included in the amount realized regardless of whether the seller was personally liable on the mortgage, whether the buyer assumes the mortgage or merely acquires the property subject to the mortgage, or whether the property's fair market value is less than the amount of indebtedness. [[662]](#footnote-663) Selling expenses, such as sales commissions and title costs, reduce the amount realized.[[663]](#footnote-664)

It is important to remember gain “realized” is a “paper” gain and may not represent the gain to be currently “recognized” and taxed. Realized gain is always greater than or equal to recognized gain. Gain realized is recognized unless some non-recognition rule (*e.g.,* installment sale or like-kind exchange treatment) applies. Therefore, for an outright sale, realized gain will generally be recognized.

To determine the manner in which this income will be recognized, certain other concepts must be considered. These include the seller's holding period in the property, whether the property is eligible for capital gains treatment and whether any depreciation must be recaptured on the sale.

**[d] Holding Period**

The length of time that a capital asset is held before its sale or exchange is its “holding period.” The holding period will determine whether the asset is eligible for favorable long-term capital gain rates. If the taxpayer holds a capital asset for one year or less (the “short term” holding period), the gain or loss from its sale or exchange is short-term.[[664]](#footnote-665) If the taxpayer holds a capital asset for more than one year (the “long term” holding period), the gain or loss from its sale or exchange is long-term.[[665]](#footnote-666) Generally holding periods are measured in months, rather than days,[[666]](#footnote-667) and the taxpayer must exclude the acquisition date but include the disposition date (i.e., the seller is deemed the owner on the day of sale).[[667]](#footnote-668)

A holding period does not always commence just on the date a taxpayer acquires property. For example, the holding period may include the period the property was held by a previous owner if the taxpayer acquired the property in a non-income recognition event.[[668]](#footnote-669)

**[2] Capital Gains**

**[a] Property Qualifying for Capital Gains Treatment**

Under I.R.C. § 1221, a “capital asset” is any property held by a taxpayer, whether or not connected with a trade or business, with several exceptions, including the following:

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business; and

(2) property used in a trade or business, of a character which is subject to the allowance for depreciation provided in I.R.C. § 167, or real property used in the trade or business.

With regard to real estate, the issue often is whether the taxpayer’s real estate is “property held by the taxpayer primarily for sale to customers in the ordinary course of business,” thus removing it from the capital asset category and resulting in ordinary income for any gain on disposition. Thus, if the taxpayer is a “dealer” in real estate, the property is essentially considered like inventory and the taxpayer will not be entitled to capital gain treatment.[[669]](#footnote-670)

In determining whether a piece of property is held primarily for sale in the ordinary course of business, the word “primarily” has been interpreted by the Supreme Court to mean “of first importance” or “principally.”[[670]](#footnote-671) Under this definition, if the taxpayer's sales purpose is substantial but not dominant, capital gains treatment will be available.

The determination of a taxpayer's dominant purpose requires an evaluation of the taxpayer's intent at the time the property was acquired and throughout the period when it was held. Significant factors evidencing that the property was held primarily for sale include advertising, listing with brokers, placing signs on the property, improvements and other sales-related activities.

Even in the absence of such factors, frequent and continuous sales efforts may result in ordinary income treatment. Although no one factor is controlling, the frequency of sales efforts may be the most important single factor.[[671]](#footnote-672)

**[b] Capital Gain Rates**

For individual taxpayers, capital gains (from the disposition of capital assets) are generally taxed at more favorable tax rates than ordinary income. Taxpayers must first determine whether their capital gains and losses are long term or short term, based on their holding period.[[672]](#footnote-673) For noncorporate taxpayers, the favorable capital gain rate is imposed on “net capital gain”, which is the excess of net long-term capital gain over net short-term capital loss.[[673]](#footnote-674) For corporate taxpayers, capital gains are included in full in gross income to the extent that they exceed capital losses.[[674]](#footnote-675) However, the deduction for capital losses is limited. Excess capital losses of corporations may be carried back three years and forward five years.[[675]](#footnote-676) Noncorporate taxpayers may deduct up to $3,000 of excess capital losses (after offsetting first by capital gains) against ordinary income each year with an indefinite carryover.[[676]](#footnote-677)

The current capital gain tax rate for noncorporate taxpayers is 15 percent (but only five percent for taxpayers in the 10- or 15-percent bracket; this 5-percent rate is replaced by a rate of zero percent for tax years beginning after 2007).[[677]](#footnote-678) However, the I.R.C. imposes a 25-percent tax rate on “unrecaptured section 1250 gain” (discussed below) and a 28-percent tax rate on “collectibles” and I.R.C. § 1202 gain.[[678]](#footnote-679)

**[c] Unrecaptured Section 1250 Gain**

As discussed in § 2.05[6] above, there is generally no depreciation recapture (taxed as ordinary income) on the disposition of real estate. However, the capital gain rate structure imposes a 25-percent capital gain rate on gain from the disposition of real estate to the extent of prior depreciation deductions taken. Thus, for example, if a taxpayer purchased a building for $100,000, took $25,000 of depreciation deductions, and then sold the building for $150,000, the taxpayer’s capital gain of $75,000 (amount realized of $150,000 less adjusted basis of $75,000) will be taxed $25,000 at a 28-percent rate (to the extent of prior depreciation deductions taken) and the balance of $50,000 at the 15-percent rate.

**[3] Sale of Principal Residence**

Individuals may exclude from income up to $250,000 ($500,000 for most joint returns) of gain realized on the sale or exchange of a principal residence.[[679]](#footnote-680) The exclusion automatically applies unless the taxpayer elects not to have it apply.[[680]](#footnote-681) The taxpayer must have owned and occupied the residence as a principal residence for a total of at least two of the five years before the sale or exchange.[[681]](#footnote-682) Short temporary absences or seasonal absences are counted as periods of use, even if the property is rented out during the period of absence.[[682]](#footnote-683) The ownership and use tests may be met during nonconcurrent periods, as long as both tests are met in the five-year period that ends on the date of sale.[[683]](#footnote-684) In addition, the taxpayer may generally only take advantage of this gain exclusion once every two years.[[684]](#footnote-685)

The amount of excludable gain is increased to $500,000 for married individuals filing jointly if:

(1) either spouse meets the two-year ownership test;

(2) both spouses meet the two-year use test, and

(3) neither spouse is ineligible for exclusion by virtue of a sale or exchange of a residence within the last two years.[[685]](#footnote-686)

Married individuals may still be eligible for the $250,000 exclusion even if they do not qualify under the requirements above for the $500,000 exclusion. For example, assume Wife owned her principal residence and lived in it for several years before marriage. Husband moved into that residence after the marriage. If they sell the residence before Husband has “used” the residence as his principal residence for two years, they are not entitled to the $500,000 exclusion. However, Wife satisfies the two-year ownership and use requirement and is eligible to exclude up to $250,000 of the gain from the sale of the residence on their joint return.[[686]](#footnote-687) This rule will also allow a single individual whose spouse has used the exclusion within two years before the marriage to be eligible for a $250,000 exclusion.

If a residence is transferred to a taxpayer incident to a divorce, the time during which the taxpayer's spouse or former spouse owned the residence is added to the taxpayer's period of ownership.[[687]](#footnote-688) In addition, a taxpayer who owns a residence is deemed to use it as a principal residence while the taxpayer's spouse or former spouse is given use of the residence under the terms of a divorce or separation.[[688]](#footnote-689)

The two-out-of-five-year rule does not prevent a taxpayer from converting a principal residence to a rental property for several years before selling and yet still excluding gain on sale.[[689]](#footnote-690) However, the gain exclusion does not apply and gain is recognized to the extent of any depreciation allowable with respect to the rental or business use of the principal residence after May 6, 1997.[[690]](#footnote-691)

The exclusion from income does not apply for any part of the gain that is allocable to that portion of the property that is separate from the actual residence (dwelling unit) and not used as a residence.[[691]](#footnote-692) Thus, if a portion of the property was used for residential purposes and a portion of the property (separate from the dwelling unit) was used for non-residential purposes, only the gain allocable to the residential portion is excludable under section 121. No allocation is required if both the residential and non-residential portions of the property are within the same dwelling unit.

**EXAMPLE:**

Taxpayer D, an attorney, buys a house in 2003. The house constitutes a single dwelling unit but D uses a portion of the house as a law office. D claims depreciation deductions of $2,000 during the period that she owns the house. D sells the house in 2006, realizing a gain of $13,000. D has no other section 1231 or capital gains or losses for 2006. Under I.R.C. § 121(d)(6), D must recognize $2,000 of the gain as unrecaptured section 1250 gain within the meaning of I.R.C. § 1(h). D may exclude the remaining $11,000 of the gain from the sale of her house because, under Treas. Reg. § 1.121-1(e)(1), she is not required to allocate gain to the business use within the dwelling unit.[[692]](#footnote-693)

There are special hardship rules for taxpayers who do not meet the two-year ownership and use requirement or the two-year minimum period for claiming the full exclusion. Such taxpayers may be eligible for a partial exclusion if the sale of the residence is due to a change in the place of employment, health reasons or unforeseen circumstances.[[693]](#footnote-694) The individual's primary reason for the sale must be related to one of these three reasons unless a safe harbor in the regulations applies.[[694]](#footnote-695)

*Change of employment—* A sale or exchange is by reason of a change in place of employment if the primary reason for the sale or exchange is a change in the location of the individual's employment.[[695]](#footnote-696) However, the Treasury Regulations provide a safe harbor where the taxpayer will be eligible for the partial exclusion if his or her new place of employment is 50 miles or more from the residence sold or exchanged than was the former place of employment. If there was no former place of employment, the distance between the new place of employment and the residence sold or exchanged must be at least 50 miles.[[696]](#footnote-697)

*Health reasons—*The partial exclusion is also available to a taxpayer if the reason for the sale is to obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of disease, illness or injury. Providing or obtaining medical or personal care for a qualified individual suffering from a disease, illness or injury will also qualify. A qualified individual includes the owner's spouse, children, siblings and parents.[[697]](#footnote-698) Under the safe harbor of the Treasury Regulations, a physician's recommendation for a change of homes for health reason will qualify.[[698]](#footnote-699)

*Unforeseen circumstances—*A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. However, a sale or exchange by reason of unforeseen circumstances does not qualify for the reduced maximum exclusion if the primary reason for the sale or exchange is a preference for a different residence or an improvement in financial circumstances.[[699]](#footnote-700) The Regulations provide specific event safe harbors that will be considered to be unforeseen circumstances for this purpose. They are: (1) involuntary conversion of the home; (2) natural or man made disasters or acts of war or terrorism; (3) death; (4) a period of unemployment that allows the taxpayer to be eligible for unemployment compensation; (5) change of employment that results in the inability to pay the cost of housing and basic living expenses and (6) divorce or separation; and (7) multiple births.[[700]](#footnote-701) The I.R.S. has also issued private rulings granting the use of the exclusion within the two-year period for various unforeseen circumstances.[[701]](#footnote-702)

If a taxpayer is entitled to the benefits of I.R.C. § 121 under the exceptions above, despite not meeting the two-year requirements, a reduced gain exclusion is allowable. The $250,000 or $500,000 exclusion amount is prorated by multiplying the applicable exclusion amount by a ratio equal to the period the property was actually owned and used as a principal residence (or the period since the last sale under I.R.C. § 121 if that is the failed requirement) over two years. Thus, if a single taxpayer owned and used a residence for one year as a principal residence before having to sell due to unforeseen circumstances, the taxpayer would be entitled to exclude up to $250,000 of gain.

The $250,000 or $500,000 exclusion from income eliminates the need for many homeowners to keep records of capital improvements that increase the basis of their residences. However, records of capital improvements should be kept if there is any possibility that income might be required to be recognized on the sale of the principal residence. That situation might arise if: (1) the individuals intend to live in the residence for a long period of time; (2) the residence is quickly appreciating in value; (3) there is a possibility that the owners may claim a depreciation deduction for a home office or rental use of the residence; or (4) there is a possibility that the owners may not use or own the residence long enough to qualify for the exclusion.

**[4] Involuntary Conversions**

**[a] In General**

A property owner who receives insurance proceeds or other compensation for property lost by fire, theft, or condemnation ordinarily must report as income any excess of the compensation received over his or her adjusted basis of the property lost. However, gain realized by a taxpayer from these “involuntary conversions” of property can be deferred if the taxpayer purchases property “similar or related in service or use” to the converted property within a specified replacement period.[[702]](#footnote-703) Gain will have to be recognized if the amount realized on the conversion exceeds the cost of the replacement property.[[703]](#footnote-704)

**[b] Similar or Related in Service or Use Requirement**

It is essential that the replacement property be “similar or related in service or use.” As opposed to the “like kind” standard of I.R.C. § 1031,[[704]](#footnote-705) the similar or related in service or use requirement is a functional use test from the point of the taxpayer. For example, reinvesting the proceeds from the involuntary conversion of unimproved real estate into improved real estate is not considered an investment in property that is similar or related in service or use.[[705]](#footnote-706) Likewise, where a taxpayer purchased a billiard center with the proceeds of an involuntary conversion of a bowling alley, the replacement was not “similar or related in service or use.”[[706]](#footnote-707) The test for this analysis looks to whether the physical characteristics and end uses of the converted and replacement property are closely similar, at least where the taxpayer is an owner-user.

When the taxpayer is the owner-lessor of converted property, the test is not what end use is made of the property but “similar or related in service or use” is based on the similarity of the investment to the owner-lessor. The Second, Fourth, and Ninth Circuits have held that where leased property is replaced by other leased property, the similarity of the replacement is based on the nature of the owner’s relation to the properties rather than on the actual use of the properties by the lessees.[[707]](#footnote-708) The I.R.S. has adopted this approach, holding that where the property owners are lessor-investors, a replacement will qualify if the original and replacement property are similar in the services or uses to the owner. Among the factors the I.R.S. will consider are the nature of the business risks connected with the properties and what kind of management and services the owner must provide to the lessee.[[708]](#footnote-709)

In lieu of the “similar or related in service or use” requirement, I.R.C. § 1033(g) provides a more lenient “like kind” standard for replacement property in certain circumstances. Where real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, replacement may be made in property that is of a like kind to the converted property.[[709]](#footnote-710)

**[c] Replacement Period**

To qualify for the gain deferral of I.R.C. § 1033, qualifying replacement property must be purchased during the period that begins on the earlier of the date of disposition or the earliest date of the threat or imminence of requisition or condemnation of the converted property and ends two years after the close of the first tax year in which any part of the gain from conversion is realized.[[710]](#footnote-711) This two-year period is extended in certain situations,[[711]](#footnote-712) including the condemnation of real property held for productive use in a trade or business or for investment, which has a three-year replacement period.[[712]](#footnote-713)

**[d] Reporting Deferral or Gain Recognition**

In the year in which the taxpayer receives proceeds from an involuntary conversion, the taxpayer must report all of the details of the involuntary conversion, including those relating to the replacement of the converted property, or a decision not to replace (in which case the gain will be reported). If, after making the election under I.R.C. § 1033(a)(2), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than the amount realized on the conversion, the tax liability for the year in which the election was made must be recomputed, and an amended return filed for that year.[[713]](#footnote-714)

If the taxpayer fails to appropriately reinvest all the proceeds from an involuntary conversion, the taxpayer will recognize part or all of the gain on the converted property. Gain must be recognized to the extent that the amount realized on the conversion exceeds the cost of the replacement property.[[714]](#footnote-715) If there is a debt on the property that is paid from the condemning authority or insurance company directly to the mortgagee, that amount is included in the taxpayer’s amount realized, regardless of whether the taxpayer was personally liable on the mortgage debt. Thus, if a taxpayer has acquired property worth $100,000 subject to a $50,000 mortgage (regardless of whether or not the taxpayer was personally liable for the mortgage debt) and, in a condemnation proceeding, the Government awards the taxpayer $60,000 and awards the mortgagee $50,000 in satisfaction of the mortgage, the entire $110,000 is considered to be the “amount realized” by the taxpayer. [[715]](#footnote-716)

**[e] Basis of Replacement Property**

Where property is acquired as a result of an involuntary or compulsory conversion, and the taxpayer qualifies under I.R.C. § 1033 to not recognize any part of the gain on the converted property, the basis of the replacement property is its cost, reduced by the amount of gain that is not recognized. If more than one piece of property is purchased for replacement, the basis is allocated to each in proportion to their respective costs.[[716]](#footnote-717)

**[5] Foreclosures**

A foreclosure sale is generally a taxable sale of property by the taxpayer. Where property is transferred to a lender in exchange for relief of the debt, the taxpayer will have a taxable exchange. The consequences of the exchange may depend on whether the debt is recourse or nonrecourse.

If property is transferred in satisfaction of a recourse debt, the transaction is treated as a sale on which gain is recognized to the extent that the fair market value of the property exceeds the taxpayer’s adjusted basis in the property.[[717]](#footnote-718) Any balance of the debt still owed by the taxpayer, if cancelled by the lender, will be discharge of indebtedness income,[[718]](#footnote-719) unless excluded under the provision of I.R.C. § 108. Where the taxpayer transfers property subject to a nonrecourse debt in full satisfaction of that debt, the taxpayer will recognize gain to the extent that the amount of the debt exceeds the taxpayer’s adjusted basis in the property.[[719]](#footnote-720) In this case, the taxpayer does not have cancellation of indebtedness income, but only gain from the sale of property.

**[6] Reporting Requirements**

**[a] In General**

Most sales or exchanges of real estate (with gross proceeds of $600 or more) are reportable on Form 1099–S (Proceeds from Real Estate Transactions).[[720]](#footnote-721) The information return and statement must include the name, address, and taxpayer identification number of the seller, and the gross proceeds of the real estate transaction.[[721]](#footnote-722) Gross proceeds means the total amount of cash received by the transferor in the transaction, plus any debt of the transferor assumed by the buyer or any obligation to deliver cash to the seller in the future.[[722]](#footnote-723) The person responsible for reporting must also furnish a statement to the payee showing the name and contact information of the person required to make the return, and the information required to be on the form, with a statement that the information is being reported to the I.R.S. This must be furnished to the taxpayer on or before January 31 of the year following the calendar year for which the information return was required to be made.[[723]](#footnote-724) However, it is not necessary to report the transaction if the transferor is a corporation.[[724]](#footnote-725)

The person responsible for closing the transaction (including an attorney or title company) is required to file Form 1099–S. If there is no such person, then the form must be filed by the mortgage lender, the seller's broker, the buyer's broker, or the transferee/buyer, in that order.[[725]](#footnote-726) The participants in a real estate transaction may, by an agreement executed at or before the closing, designate one of the parties as the reporting person for purposes of these rules. It is not required that all parties to the transaction be parties to the designation agreement.[[726]](#footnote-727)

**[b] Exception for Sales of Principal Residences**

There is an exception to the reporting requirement for sales or exchanges of certain principal residences. The reporting requirement does not apply to a sale or exchange of a residence for $250,000 (or $500,000 for married taxpayers) or less if the seller provides certain written assurances to the real estate reporting person.[[727]](#footnote-728) The I.R.S. has issued guidance on the assurances to be provided. Pursuant to Rev. Proc. 2007-12,[[728]](#footnote-729) the real estate reporting person must obtain from the seller[[729]](#footnote-730) a written certification, signed by the seller under penalties of perjury, that the following six assurances are true:

1. The seller owned and used the residence as the seller’s principal residence for periods aggregating two years or more during the five-year period ending on the date of the sale or exchange of the residence;
2. The seller has not sold or exchanged another principal residence during the two-year period ending on the date of the sale or exchange of the residence;
3. No portion of the residence has been used for business or rental purposes after May 6, 1997, by the seller (or by the seller’s spouse or former spouse, if the seller was married at any time after May 6, 1997);
4. At lease one of the following three statements applies:
   1. The sale or exchange is of the entire residence for $250,000 or less; or
   2. The seller is married, the sale or exchange is of the entire residence for $500,000 or less, and the gain on the sale or exchange of the entire residence is $250,000 or less; or
   3. The seller is married, the sale or exchange is of the entire residence for $500,000 or less, and
      1. The seller intends to file a joint return for the year of the sale or exchange,
      2. The seller’s spouse also used the residence as his or her principal residence for periods aggregating two years or more during the five-year period ending on the date of the sale or exchange of the residence, and
      3. The seller’s spouse also has not sold or exchanged another principal residence during the two-year period ending on the date of the sale or exchange of the residence.
5. During the five-year period ending on the date of the sale or exchange of the residence, the seller did not acquire the residence in an exchange to which I.R.C. § 1031 applied.
6. In cases where the seller’s basis in the residence is determined by reference to the basis in the hands of a person who acquired the residence in an exchange to which I.R.C. § 1031 applied, the exchange to which I.R.C. § 1031 applied occurred more than five years prior to the date of the seller’s sale or exchange of the residence.

Rev. Proc. 2007-12 also provides a sample certification form that may be used by a real estate reporting person to obtain the applicable assurances from the seller, although use of the sample form is not required. The real estate reporting person may obtain the certification at any time on or before January 31 of the year following the year of the sale or exchange of the residence. The certification must be retained by the real estate reporting person for four years after the year of the sale or exchange of the residence.

**[c] Failure to File Information Returns or Payee Statements**

Taxpayers required to file information returns and file payee statements are subject to a $50 penalty for failure to file the appropriate return[[730]](#footnote-731) or furnish the statement.[[731]](#footnote-732) This applies to real estate reporting persons described above.[[732]](#footnote-733) However, a real estate reporting person who relies on a certification made in compliance with Rev. Proc. 2007-12,[[733]](#footnote-734) regarding the information reporting exception for sale of principal residences, will not be liable for the penalty for failing to file an information return unless the real estate reporting person has actual knowledge that any assurance is incorrect.

The failure to file an information return or a payee statement can be waived if the failure is due to reasonable cause and not to willful neglect, which are defined in the regulations.[[734]](#footnote-735)

**§ 2.14 Installment Sales of Real Estate**[[735]](#footnote-736)

**[1] In General**

Absent a specific nonrecognition provision, a seller of real estate must recognize all of the realized gain in the year of sale.[[736]](#footnote-737) I.R.C. § 453 sets forth an alternative method of recognizing gain (not loss) realized from an installment sale of property. An “installment sale,” for tax purposes, is a disposition of property in which at least one payment is to be received after the close of the taxable year in which the disposition occurs.[[737]](#footnote-738) Also for tax purposes, income from an installment sale is taken into account under the installment method.[[738]](#footnote-739)

The primary advantage of the installment method of reporting is that it allows a taxpayer to defer payment of tax until the actual receipt of sales proceeds. Accordingly, the use of the installment method avoids the need of the seller to raise capital to satisfy a tax obligation on amounts not yet received. Because they allow a selling taxpayer to recognize income and therefore pay taxes on the installment method, the installment reporting rules also allow for greater flexibility in structuring the underlying terms of a transaction.

Dealers in real and personal property may not use the installment method to report gain from “dealer dispositions.”[[739]](#footnote-740) All such payments are treated as received in the year of disposition, even if the dealer expects to receive payments in future years. A “dealer disposition” is (1) any disposition of personal property by a person who regularly sells or otherwise disposes of such property on an installment plan, and (2) any disposition of real property that is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business. There are exceptions for dispositions of farm property, residential lots and timeshares.[[740]](#footnote-741)

An election under I.R.C. § 453 is not required to use the installment method of reporting. In fact, a special election is only needed if a taxpayer chooses to opt out of installment treatment. Such election must be made on the taxpayer's timely filed return, including extensions, for the taxable year of a sale.[[741]](#footnote-742) In general, a taxpayer who elects not to report an installment sale on the installment method must recognize gain on the sale in accordance with the taxpayer's method of accounting. The fair market value of an installment obligation is treated as the receipt of property, subject to valuation.[[742]](#footnote-743)

Generally, an election out of installment reporting is irrevocable once made. An election may be revoked only with the consent of the Internal Revenue Service and is retroactive. A revocation will not be permitted when one of its purposes is the avoidance of federal income taxes, or when the taxable year in which any payment was received has closed.[[743]](#footnote-744)

**[2] Determination of Taxable Gain**

The amount of gain recognized each year on the installment method is determined by applying the gross profit percentage (*i.e.,* the ratio of the gross profit to the total contract price) to the amount received in a particular year.[[744]](#footnote-745) The total contract price is the selling price reduced by liabilities “assumed” or taken “subject to” by the purchaser to the extent such liabilities do not exceed the seller's adjusted basis in the property.[[745]](#footnote-746) Selling price is the gross selling price without reduction for the seller's liabilities or selling expenses.[[746]](#footnote-747)

The term “gross profit” means the selling price less the taxpayer’s adjusted basis in the property.[[747]](#footnote-748)

In determining the taxable gain reportable each year, the gross profit percentage is applied to the amount received in such year. The following are some of the rules to determine whether and when payments are received:

(1) cash and property (other than the purchaser's evidence of indebtedness) are reportable in the year actually or constructively received;[[748]](#footnote-749)

(2) the purchaser's evidence of indebtedness (*i.e.,* the installment note) is excluded from the definition of amount received even if guaranteed by another person;[[749]](#footnote-750)

1. receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment;[[750]](#footnote-751)
2. receipt of a bond or other evidence of indebtedness which is payable on demand or is readily tradable is treated as receipt of payment;[[751]](#footnote-752)
3. if the taxpayer sells property to a creditor of the taxpayer and indebtedness of the taxpayer is cancelled in consideration of the sale, such cancellation shall be treated as payment;[[752]](#footnote-753)
4. refinancing the property immediately prior to a sale may be treated as the receipt of a payment[[753]](#footnote-754)
5. if the taxpayer sells property which is encumbered by a mortgage or other indebtedness on which the taxpayer is not personally liable, and the person acquiring the property is the obligee, the taxpayer shall be treated as having received payment in the amount of such indebtedness.[[754]](#footnote-755)

Notwithstanding the general installment sale rules, 100 percent of the depreciation recapture must be recognized as income in the year of sale, without regard to whether any payments are actually received.[[755]](#footnote-756) The adjusted basis of the property is then increased to the extent of such recapture so that the usual installment sale rules for determining and reporting gain can be applied.

The following are examples of installment reporting:

**EXAMPLE 1:**

*A*, a calendar year taxpayer, sells Blackacre, an unencumbered capital asset in *A*'s hands, to *B* for $100,000: $10,000 down and the remainder payable in equal annual installments over the next 9 years, together with adequate stated interest. *A*'s basis in Blackacre, exclusive of selling expenses, is $38,000. Selling expenses paid by *A* are $2,000. Therefore, the gross profit is $60,000 ($100,000 selling price − $40,000 basis inclusive of selling expenses). The gross profit ratio is 3/5 (gross profit of $60,000 divided by $100,000 contract price). Accordingly, $6,000 3/5 of $10,000) of each $10,000 payment received is gain attributable to the sale and $4,000 ($10,000 − $6,000) is recovery of basis. The interest received in addition to principal is ordinary income to *A*.[[756]](#footnote-757)

**EXAMPLE 2:**

C sells Whiteacre to D for a selling price of $160,000. Whiteacre is encumbered by a longstanding mortgage in the principal amount of $60,000. D will assume or take subject to the $60,000 mortgage and pay the remaining $100,000 in 10 equal annual installments together with adequate stated interest. C's basis in Whiteacre is $90,000. There are no selling expenses. The contract price is $100,000, the $160,000 selling price reduced by the mortgage of $60,000 assumed or taken subject to. Gross profit is $70,000 ($160,000 selling price less C's basis of $90,000). C's gross profit ratio is 7/10 (gross profit of $70,000 divided by $100,000 contract price). Thus, $7,000 (7/10 of $10,000) of each $10,000 annual payment is gain attributable to the sale, and $3,000 ($10,000 − $7,000) is recovery of basis.[[757]](#footnote-758)

**[3] Installment Sales of Property Between Related Parties**

There are certain limitations on the use of installment reporting with regard to sales between related parties. If any person disposes of property to a related person or entity and, before the person making the first disposition receives all payments due him or her with respect to such disposition, the related party disposes of the property, the amount realized on the second disposition is treated as received at the time of the second disposition by the initial seller.[[758]](#footnote-759)

Except in the case of marketable securities, the related party rule does not apply if the related entity holds the property for at least two years, subject to the normal risks of ownership, before making the second disposition. In contrast, holding marketable securities for at least two years does not cure the related party taint. [[759]](#footnote-760)

Dispositions by a related party are excluded from the rule if it is established that neither the first disposition not the second disposition had as one of its principal purposes the avoidance of federal income tax. Certain other dispositions, including involuntary conversions and dispositions after the death of either the first or second seller, are also excluded from this related party rule.[[760]](#footnote-761)

The constructive ownership rules of I.R.C. § 318 (as modified) and § 267 are used in determining who is a related party for purposes of I.R.C. § 453(e). By operation of such sections, an individual will be deemed to be related to his or her spouse, children, grandchildren, parents, brothers and sisters. If there is the requisite commonality of ownership interest, an individual may also be related to a partnership, estate, trust, or corporation, and such entities may also be related to each other.[[761]](#footnote-762)

The Internal Revenue Code contains a more restrictive rule in the case of the sale of depreciable property between a taxpayer and a 50%-owned entity with respect to such taxpayer. In such case, installment reporting is not available and all gain must be recognized in the year of sale, unless it is established that the transaction did not have the avoidance of federal income tax as one of its principal purposes.[[762]](#footnote-763)

**[4] Pledging of Installment Obligations**

The proceeds of a secured indebtedness may be treated as a payment received on an installment obligation if the installment obligation is pledged. Under I.R.C. § 453A(d), indebtedness is secured by an installment obligation to the extent that the payment of principal or interest on the indebtedness is directly secured, under the terms of the indebtedness or any underlying arrangement, by any interest in that installment obligation. A payment is treated as directly secured by an interest in an installment obligation to the extent an arrangement allows the taxpayer to satisfy all or a portion of the indebtedness with the installment obligation.[[763]](#footnote-764)

**EXAMPLE:**

Taxpayer disposes of property in exchange for an installment note. The disposition is properly reported using the installment method. Taxpayer only recognizes gain upon receiving deferred payments. If the installment note is pledged as security for a loan, however, Taxpayer must treat the proceeds of the loan as a payment on the installment note and recognize the appropriate amount of gain. Similarly, if Taxpayer has the right to “put” or repay a loan by transferring the installment note to the creditor, Taxpayer must treat the proceeds of the loan as payment on the installment note to that extent.

**§ 2.15 Like-Kind Exchanges**

**[1] In General[[764]](#footnote-765)**

I.R.C. § 1031 provides an exception to the general rule that a taxpayer must recognize all the gain realized on the sale or exchange of property. Section 1031 provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment, provided the property is exchanged solely for property of like-kind which is also to be held either for productive use in a trade or business or for investment. Real estate which is held primarily for sale in the ordinary course of a taxpayer's trade or business is not eligible for non-recognition treatment under I.R.C. § 1031.

In order to fit within the parameters of I.R.C. § 1031, both the property transferred and received by the taxpayer must be “property held for productive use in a trade or business or for investment,” there must be an “exchange,” and the properties exchanged must be of “like-kind.” Accordingly, each of these requirements is discussed below.

**[2] Property Held For Productive Use in a Trade or Business or for Investment**

There is no requirement that business property be exchanged for other business property or investment property be exchanged for other investment property.[[765]](#footnote-766) However, both the property transferred and the property received by the taxpayer must be “held” for either business or investment use. If a taxpayer acquires property in an exchange which is immediately transferred, or acquires the relinquished property shortly before relinquishing it in an exchange, the I.R.S. may take the position that the property received (in the first case) or the property exchanged (in the second case) was not “held” for either productive use in a trade or business or for investment. While the Internal Revenue Service has taken a narrow view of the holding requirement, several decisions have been favorable to the taxpayer.

Numerous cases have held that the taxpayer’s intent at the time of the exchange to liquidate or dispose of an interest in property acquired in the exchange disqualifies the exchange for nonrecognition under section 1031.[[766]](#footnote-767) For example, nonrecognition has been denied when the taxpayer had a binding contract to sell the property received in the exchange. The court held that the binding contract prevented the possibility of meeting any holding requirement at the time of the exchange.[[767]](#footnote-768) The holding period will also not be met if the taxpayer at the time of the exchange intends to sell the property,[[768]](#footnote-769) give it to relatives as a gift,[[769]](#footnote-770) or donate it to charity.[[770]](#footnote-771)

According to the I.R.S., nonrecognition is not available if property acquired on the exchange is immediately disposed of in a prearranged transaction. Specifically, the I.R.S. has taken the position that like-kind treatment was not available in a situation in which the replacement property was transferred in a prearranged I.R.C. section 351 transaction to the taxpayer's newly formed corporation.[[771]](#footnote-772) The basis for the ruling was that the property was not held for productive use in a taxpayer's trade or business or for investment. Apparently, the corporation's use of the property is not imputed to the taxpayer. The IRS has also ruled that property that was immediately exchanged after being received upon the liquidation of a corporation was not held for investment or business.[[772]](#footnote-773) Presumably property contributed to a corporation that immediately exchanges it will also not satisfy section 1031 based on these rulings.

However, the courts have sometimes been more lenient. The Tax Court has held that the holding requirement was met when a corporation engaged in a like-kind exchange and several days later liquidated under former I.R.C. § 333, distributing the property received in the exchange to its controlling shareholders.[[773]](#footnote-774) The shareholders continued to hold the property for investment purposes. The court rejected the I.R.S. argument that the intent to liquidate the asset at the time of the exchange by distributing it to shareholders caused the exchange to fail the holding requirement. The court found the necessary continuity of investment and attributed the corporate holding purposes to the shareholders.

In another pro-taxpayer decision, the 9th Circuit in Bolker v. Commissioner[[774]](#footnote-775) approved an exchange where a taxpayer received property in a liquidating distribution from his wholly-owned corporation. Three months later he exchanged the property in a like-kind exchange pursuant to an executory contract that was entered into the same day of the liquidating distribution. The I.R.S. claimed that the taxpayer could not have the requisite holding intent because of the almost immediate contractual obligation to exchange it. The Ninth Circuit held that the holding requirement was met if a taxpayer owned property that he or she did not intend to liquidate or use for personal pursuits.

The Ninth Circuit has also been lenient with post-exchange contributions to partnerships. In Magneson v. Commissioner,[[775]](#footnote-776) the taxpayers exchanged an apartment building for a 10 percent undivided fee interest in another property. On the same day, they transferred their interest in the new property to a partnership. The court held that the taxpayers met the holding requirement with respect to property received in the exchange. Its rationale was that contributing the property to a partnership in return for a partnership interest was “holding” the property for investment within the meaning of I.R.C. § 1031. The court found that the conversion of a tenant-in-common interest to that of a general partner did not involve a substantial change in the form of the taxpayer’s investment. The court distinguished the transfer to a partnership from the transfer to a corporation in Revenue Ruling 75-292, noting that the taxpayers retain management control over property transferred to a general partnership, but relinquish ownership and control of property transferred to a corporation.

Practitioners should be cautioned, however, that section 1031 was amended after the date of the Magneson case to exclude any exchange of partnership interests.[[776]](#footnote-777) The Magneson facts could easily be collapsed under the step transaction doctrine whereby the taxpayer would be considered to receive a partnership interest in exchange for his or her property.

**[3] Exchange Requirement**

To qualify for deferral, the transaction must constitute an exchange.[[777]](#footnote-778) Generally, a transaction constitutes an exchange if there is a reciprocal transfer of property, rather than a transfer solely for cash, although the receipt of boot along with other property will not destroy a transaction's characterization as an exchange.[[778]](#footnote-779)

Although intent is considered by the courts, what actually happened during the entire transaction is the most important consideration.[[779]](#footnote-780) For example, if the taxpayer intended an exchange to occur, but received, or had control over, the sale proceeds from the relinquished property, the tax-deferred exchange will be disallowed.[[780]](#footnote-781)

**[4] Like-Kind Property**

In order to qualify for nonrecognition treatment, the properties exchanged must be of like kind. “Like-kind” refers to the nature or character of the properties exchanged and not to their grade or quality. The fact that any real estate involved is or is not improved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.[[781]](#footnote-782) Thus, real estate that differs in location, style, size, or profitable use may be exchanged. For example, a vacant lot can be exchanged for a commercial building. However, an exchange of real property for personal property does not qualify for nonrecognition treatment because the nature or character of the property is not of like kind.

Certain assets are statutorily excluded from the nonrecognition treatment provided by I.R.C. § 1031. These assets are:

• stock in trade or other property held primarily for sale;

• stocks, bonds, or notes;

• other securities or evidences of indebtedness or interest;

• interests in a partnership;

• certificates of trust or beneficial interests;

• choses in action; and

• livestock of different sexes.[[782]](#footnote-783)

In addition, exchanges of real property located in the United States for real property located outside the United States are also excluded.[[783]](#footnote-784)

**[5] Operation of I.R.C. § 1031**

An exchange of properties not qualifying under I.R.C. § 1031 will be a taxable exchange.[[784]](#footnote-785) However, compliance with the requirements of § 1031 will defer the gain inherent in the relinquished property,[[785]](#footnote-786) provided only like-kind property is received by the taxpayer in the exchange. Since it is unusual for the exchanged properties to have equal amounts of equity, typically money or other non-like kind property is also exchanged to equal the equities in the transaction. This money or other non-like kind property is called “boot.” The receipt of boot will not disqualify an exchange from the benefit of § 1031, but the taxpayer’s gain on the relinquished property will be recognized to the extent of the boot received.[[786]](#footnote-787)

Because the § 1031 exchange is only a tax-deferred exchange, the taxpayer’s basis in the property received in the exchange will reflect the deferred gain. In general, the basis of like kind property received in a § 1031 exchange is equal to the adjusted basis of the property transferred, decreased by the amount of money received by the taxpayer (including any liability of the taxpayer which was assumed or which attached to the property transferred by the taxpayer) and increased by any gain recognized on the exchange, and increased by any additional amounts paid by the taxpayer.[[787]](#footnote-788)

**[6] Treatment of Non-Qualifying Property (“Boot”) and Liabilities**

To the extent of the cash and the fair market value of any other property the taxpayer receives in the exchange, the taxpayer’s gain on the relinquished property must be recognized.[[788]](#footnote-789) In addition to cash or other property, boot received will also include the assumption (or the buyer’s taking subject to) of a taxpayer’s liability on the relinquished property.[[789]](#footnote-790)

The regulations contain a netting rule where boot is both received and paid by a taxpayer. In determining the amount of boot received by a taxpayer in an exchange, any boot *given* by the taxpayer, including the assumption (or taking subject to) of a mortgage on the replacement property, is netted against boot *received* in the form of the other party assuming a mortgage on the taxpayer’s relinquished property. However, cash received by the taxpayer cannot be offset by liabilities assumed by the taxpayer.[[790]](#footnote-791)

**[7] Examples of Like-Kind Exchanges**

**[a] Two-Party Exchange**

A simple exchange involves two parties exchanging their respective properties directly. To equalize the exchange, one party may receive cash or other “boot” for the difference between the properties' values.[[791]](#footnote-792) If the exchange occurs simultaneously, both deeds and any boot are simultaneously exchanged at closing. If the exchange does not occur simultaneously, then the deferred exchange requirements of I.R.C. § 1031(a)(3)[[792]](#footnote-793) must be satisfied.

**[b] Three-Party Exchange**

Two party exchanges are rare, since a taxpayer must find another taxpayer with whom he or she wants to trade properties. More likely, one party (the “Buyer”) may wish to purchase property from the taxpayer, while the taxpayer wishes to acquire property from a third party (the Seller”) through an exchange. The Buyer may accommodate the taxpayer by purchasing the Seller's property and exchanging the deed to that property for the deed to the taxpayer's property. Alternatively, the Seller can accommodate the taxpayer by exchanging the Seller’s property for the taxpayer’s property, and the Seller will then sell the taxpayer’s property to the Buyer.

Clearly this structure requires the cooperation of other parties, including taking title to property that they do not ultimately want. Therefore, more frequently an independent intermediary[[793]](#footnote-794) will be placed in between the Buyer, Seller, and taxpayer. Typically a taxpayer will transfer his or her relinquished property to an intermediary who will sell the relinquished property to a Buyer. The intermediary will use the cash proceeds to purchase replacement property from a Seller, and then transfers the relinquished property to the taxpayer.

The key for a simultaneous exchange is that no matter how many parties and properties are involved, all of the transactions must be interdependent and close through the same escrow on the same day. Obviously with several parties involved, a simultaneous exchange will be difficult to accomplish. Thus, a deferred exchange is more likely.

**[c] Deferred Exchanges**

As indicated above, a three or four-party exchange will be hard to accomplish simultaneously. Even with a direct two-party exchange, the parties may not be able to transfer both properties simultaneously. The taxpayer may need to close on the sale of his or her property before suitable replacement property is found. Thus, deferred exchanges, sometimes referred to as “Starker exchanges,” can be structured, subject to statutory limitations.[[794]](#footnote-795)

For a deferred exchange to qualify as a like-kind exchange, two conditions must be satisfied:

(1) the like-kind property to be received in the exchange must be identified on or before the forty-fifth day after the date on which the taxpayer transfers the property relinquished in the exchange; and

(2) the like-kind property must be received on or before the earlier of

(i) the one-hundred-eightieth day after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extensions) for the transferor's return for the taxable year in which the transfer of the relinquished property occurred.[[795]](#footnote-796)

Failure to properly identify the replacement property within the 45-day period will result in a total disallowance of the tax-deferred exchange. The regulations contain detailed rules on the procedure used to identify properties, and the number of properties that can be identified.[[796]](#footnote-797) The maximum number of replacement properties that the taxpayer may identify is:

(a) three properties without regard to their fair market value (the “three-property rule”), or

(b) any number of properties as long as their aggregate fair market value at the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties are transferred by the taxpayer (the “200 percent rule”)[[797]](#footnote-798).

The regulations provide rules for determining whether the identified replacement property is received before the end of the exchange period.[[798]](#footnote-799) The regulations also provide special rules for the identification and receipt of replacement property where the replacement property is not in existence or is being produced or constructed at the time the identification is made.[[799]](#footnote-800)

In order for a deferred exchange to work, the taxpayer cannot have any control or constructive receipt over the proceeds of the sale of the relinquished property. If the taxpayer is in constructive receipt of the sale proceeds, then the transaction will be treated as a taxable sale and reinvestment instead of a tax-deferred exchange.[[800]](#footnote-801) However, a taxpayer who has transferred the relinquished property is typically unwilling to rely on the transferee's unsecured promise to transfer the like-kind replacement property. Accordingly, taxpayers often structure deferred exchanges so that the transferee's obligation to transfer the like-kind replacement property to the taxpayer is guaranteed or secured. In order to clarify the application of the constructive receipt doctrine to deferred exchanges, the regulations provide four safe harbors; the use of these safe harbors will avoid treating the taxpayer as being in actual or constructive receipt of money or other property.[[801]](#footnote-802)

The most frequently used safe harbor is that of a qualified intermediary.[[802]](#footnote-803) The I.R.S. will require strict adherence to the rules regarding qualified intermediaries.[[803]](#footnote-804)

**[d] Reverse Exchanges**

The deferred exchange provisions of I.R.C. § 1031(a)(3) apply where the taxpayer identifies replacement property within 45 days (and acquires it within 180 days) after the taxpayer transfers the relinquished property. However, the taxpayer may want or need to acquire the replacement property prior to disposing of the relinquished property. This is referred to as a “reverse exchange” or sometimes a “reverse Starker exchange.”[[804]](#footnote-805) In a preamble to the final regulations in deferred exchanges, the Internal Revenue Service stated that those regulations do not apply to reverse exchanges.[[805]](#footnote-806)

In 2000, the Service finally issued guidance on reverse exchanges. Rev. Proc. 2000-37[[806]](#footnote-807) provides a safe harbor (discussed below) for reverse exchanges, which merely allows a reverse deferred exchange under circumstances similar to a forward deferred exchange under I.R.C. § 1031(a)(3); that is, the acquisition of the replacement property and the transfer of the relinquished property must occur within 180 days of each other.[[807]](#footnote-808)

**§ 2.16 Holders of Timeshare Interests**

For tax years beginning after December 31, 1996, qualifying timeshare associations may elect to be taxed under I.R.C. § 528 at a rate of 32 percent on their “timeshare association income.” Electing associations would be treated similarly to homeowners associations, except at a higher rate (homeowners associations are taxed at 30 percent).

To qualify under I.R.C. § 528, the timeshare association must meet all of the following conditions:

(1) It must receive at least 60 percent of its gross income from membership dues, fees, or assessments from owners of either (a) timeshare rights to use or (b) timeshare ownership interests in timeshare association property;

(2) At least 90 percent of its expenditures for the tax year must be for the acquisition, management, maintenance or care of association property and activities provided by the association to, or on behalf of, members of the timeshare association;

(3) No part of the net earnings of the association may inure to the benefit of any private shareholder or individual;[[808]](#footnote-809) and

(4) The association properly elects to be treated as a timeshare association.[[809]](#footnote-810)

A member of a qualified timeshare association must hold a timeshare right to use, or timeshare ownership in, real property of the association.[[810]](#footnote-811) If the election is made, tax is imposed on the timeshare association's taxable income.[[811]](#footnote-812)

**§ 2.17 Estate Tax**

**[1] In General**

Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax was repealed effective for estates of decedents dying after December 31, 2009.[[812]](#footnote-813) The gradual tax rate reduction and phase-out of the tax began in 2002, as did the increase in the gift tax unified credit exemption. The generation skipping tax was repealed, effective for generation skipping transfers after December 31, 2009.

In 2002, the 5% surtax, which phased out the benefit of the graduated rates, and the rates in excess of 50%, were repealed. In addition, in 2002, the unified credit effective exemption amount was increased to $1 million. In 2003, the estate and gift tax rates in excess of 49% are repealed. In 2004, the estate and gift tax rates in excess of 48% are repealed and the unified credit effective exemption amount for estate tax purposes is increased to $1.5 million. In 2004, the family-owned business deduction is repealed. In 2005, the estate and gift tax rates in excess of 47% are repealed. In 2006, the estate and gift tax rates in excess of 46% are repealed, and the unified credit effective exemption amount is increased for estate tax purposes to $2 million. In 2007, the estate and gift tax rates in excess of 45% are repealed. In 2009, the unified credit effective exemption amount is increased to $3.5 million. In 2010, the estate and generation transfer taxes are repealed.[[813]](#footnote-814)

It is important to note that the phase out of the estate tax is scheduled to expire after December 31, 2010. This means that after the one year repeal in 2010, the old I.R.C. provisions that were in effect before the 2001 changes will apply again beginning in 2011, unless extended by subsequent legislation.

**[2] Special Use Valuation**

Although the estate tax is being gradually phased out under the Economic Growth and Tax Relief Reconciliation Act of 2001 (*see* § [1] above), the special use valuation rules continue to apply until the estate tax is eliminated.

Under I.R.C. § 2032A, an executor may elect to value certain qualified real property used in farming or other qualified trade or business at its current value rather than at its highest and best use value. There is a $750,000 ceiling on the total decrease in the value of qualified property. For decedents dying after 1998, the $750,000 ceiling is subject to annual adjustment for inflation. The indexing is rounded to the next lowest multiple of $10,000.[[814]](#footnote-815)

If special use valuation is elected, the qualified heir is subject to an additional tax if he or she disposes of any interest in qualified real property or ceases to use the property for its qualified use within ten years (15 years for individuals dying before 1982) following the decedent's death. A cessation of qualified use occurs if there is no material participation by the qualified heir or any member of the heir's family in the operation of the farm or other business. Leasing qualified real property on a net cash basis is generally considered a cessation of qualified use because the heir no longer bears the financial risk of the business.[[815]](#footnote-816) However, lineal descendants of the decedent may lease specially valued real property to a member of the lineal descendant's family on a net cash basis without subjecting such individual to the recapture tax.[[816]](#footnote-817)

According to Committee Reports of the Economic Growth and Tax Relief Reconciliation Act of 2001, the recapture tax imposed under I.R.C. § 2032A(c) will be retained after repeal of the estate tax. The retention of this provision ensures that those estates that claimed the benefit of special use valuation prior to repeal will be subject to recapture if a disqualifying event occurs after repeal.

**[3] Land Subject to Qualified Conservation Easement**

**[a] In General**

A charitable deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity exclusively for conservation purposes. In addition, I.R.C. § 2031(c) allows an exclusion from a decedent's gross estate of up to 40 percent of the value of land subject to a qualified conservation easement, reduced by the amount of any charitable deduction under I.R.C. § 2055(f) with respect to the land.

The election is made on an estate tax return on or before the due date, including extensions, and, once made, is irrevocable. For estates of decedents dying after December 31, 2000, a qualified conservation easement may be claimed for any land located in the United States or its possessions. In addition, the land must have been owned by the decedent or a member of the decedent's family during the three-year period ending on the date of the decedent's death. The land must also be subject to a qualified conservation easement granted by the decedent or a member of the decedent's family. [[817]](#footnote-818)

**[b] Definition of Qualified Conservation Easement**

A qualified conservation easement is a qualified conservation contribution, as defined in I.R.C. § 170(h)((1). It is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.[[818]](#footnote-819) A qualified real property interest means either the donor's entire interest in the real property, other than a qualified mineral interest, or a remainder interest. However, for purposes of the qualified conservation easement exclusion, the preservation of a historically important land area or a historic structure does not qualify as a conservation purpose.[[819]](#footnote-820) In addition, a de minimis commercial recreational activity that is consistent with the conservation purpose, such as the granting of hunting or fishing licenses, will not cause the property to fail to qualify for the exclusion.

**[c] Exclusion Amount**

The exclusion is calculated based on the value of the property after the conservation easement has been placed on the property. In addition, the exclusion amount does not extend to the value of any development rights retained by the decedent or the donor. Development rights are defined as any rights retained to use the land for any commercial purpose which is not subordinate to and directly supportive of the land as a farm or for farming purposes.[[820]](#footnote-821) However, if every person in being who has an interest in the land executes an agreement to extinguish permanently some or all of any development rights retained by the donor, on or before the estate tax return is due, the estate tax may be reduced accordingly. If the agreement is not implemented by the earlier of the date which is two years after the decedent's death or the date of the sale of the land, an additional tax is imposed in the amount of the tax which would have been due on the retained development rights that were subject to the agreement.

The maximum amount that can be excluded is the lesser of the applicable percentage or the exclusion limitation. The exclusion limitation is $500,000 for estates of decedents dying after 2001.[[821]](#footnote-822)

**[d] Applicable Percentages**

The applicable percentage means 40 percent reduced (but not below zero) by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land. For this purpose, the value of the land is determined without regard to the value of the easement, and reduced by the value of any retained development rights. As a result, if the value of the easement is ten percent or less of the value of the land before the easement, less the value of any retained development rights, the applicable percentage will be zero.[[822]](#footnote-823)

**[e] Limitation on post-mortem contribution**

An estate tax deduction is allowed for a qualified conservation easement contribution made after the decedent's death. However, no income tax deduction is allowed to the decedent's estate or to the decedent's qualified heirs with respect to such a post-mortem contribution.[[823]](#footnote-824)

**[f] Special Use Valuation Property**

The granting of a conservation easement does not affect specially valued property under I.R.C. § 2032A. Thus, the granting of such an easement is not treated as a disposition for purposes of I.R.C. § 2032A(c) and does not trigger an additional estate tax. Also, the existence of a qualified conservation easement does not prevent the property from subsequently qualifying for special use valuation.[[824]](#footnote-825)

**[g] Retained Mineral Rights**

A contribution of a permanent conservation easement on property qualifies for a charitable deduction for estate and income tax purposes where a mineral interest has been retained and surface mining is possible, but its probability is so remote as to be negligible.[[825]](#footnote-826)

**[4] Basis**

**[a] In General**

Under I.R.C. § 1014, property received from a decedent's estate generally takes what is commonly referred to as a “stepped-up” basis (although it could also be “stepped down”). This means that the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death, or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate. This step-up (or step-down) in basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death, and has the effect of eliminating the tax benefit from any unrealized loss. Special rules apply for community property.[[826]](#footnote-827)

**[b] Decedents Dying After 2009**

For decedents dying after 2009, after the repeal of the estate and generation skipping transfer taxes, the existing rules providing for a fair market value, that is, stepped-up basis, for property acquired from a decedent under I.R.C. § 1014 are repealed.[[827]](#footnote-828) It is important to note that the phase out of the estate tax is scheduled to expire after December 31, 2010. This means that after the one year repeal in 2010, the old I.R.C. provisions that were in effect before the 2001 changes will apply again beginning in 2011, unless future legislation changes this scheme.

Under I.R.C. § 1022, effective for estates of decedents dying after 2009, a modified carryover basis rule will take effect. Under the new rules, recipients of property transferred at the decedent's death receive a basis equal to the lesser of the adjusted basis of the decedent in the property or the fair market value of the property on the date of the decedent's death. Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the gain on the property received from a decedent's estate and its character is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

**[i] Property to Which the Rules Apply**

The modified carryover basis rules apply to property acquired from the decedent. Property acquired from a decedent is:

1. Property acquired by bequest, devise or inheritance;
2. Property acquired by the decedent's estate from the decedent;
3. Property transferred by the decedent during his or her lifetime to a qualified revocable trust and any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;
4. Any other property passing from the decedent by reason of death to the extent that such property passed without consideration; [[828]](#footnote-829) and
5. The surviving spouse's one-half share of certain community property held by the decedent and surviving spouse as community property.[[829]](#footnote-830)

**[ii] Basis Increase Permitted for Certain Property**

An executor may step up the basis of certain assets owned by the decedent and acquired by the beneficiaries at the decedent's death. Under this rule, each decedent's estate generally is permitted to increase the basis of assets transferred by up to a total of $1.3 million.[[830]](#footnote-831) The $1.3 million is increased by the amount of unused capital losses, net operating losses, and certain “built-in” losses of the decedent.[[831]](#footnote-832) In addition, the basis of property transferred to a surviving spouse can be increased by an additional $3 million.[[832]](#footnote-833) Thus, the basis of property transferred to surviving spouses can be increased by a total of $4.3 million.

Nonresidents who are not U.S. citizens will be allowed to increase the basis of property by up to $60,000, but may not increase that amount by any losses.[[833]](#footnote-834)

The $60,000, $1.3 million, and $3 million amounts are adjusted annually for inflation occurring after 2010.[[834]](#footnote-835)

Generally, the basis of property may be increased above the decedent's adjusted basis in that property only if the property is owned, or treated as owned, by the decedent at the time of the decedent's death.[[835]](#footnote-836) In the case of property held as joint tenants or tenants by the entireties with the surviving spouse, one-half of the property is treated as having been owned by the decedent and is thus eligible for the basis increase.[[836]](#footnote-837) In the case of property held jointly with a person other than the surviving spouse, the portion of the property attributable to the decedent's consideration furnished is treated as having been owned by the decedent and will be eligible for a basis increase.[[837]](#footnote-838)

The decedent is also treated as the owner of property eligible for a basis increase if the property was transferred by the decedent during his or her lifetime to a qualified revocable trust.[[838]](#footnote-839) The decedent is treated as having owned the surviving spouse's one-half share of community property if at least one-half of the property was owned by and acquired from the decedent.[[839]](#footnote-840) Thus, both the decedent's and surviving spouse's share of community property could be eligible for a stepped-up basis.

Property not eligible for stepped-up basis includes:

1. Property acquired by the decedent by gift or *inter vivos* transfer (other than from his or her spouse or for full consideration) during the three-year period ending on the date of the decedent's death;[[840]](#footnote-841)
2. Property that constitutes a right to receive income in respect of a decedent;[[841]](#footnote-842)
3. Stock or securities of a foreign personal holding company;[[842]](#footnote-843)
4. Stock of a domestic international sales corporation;[[843]](#footnote-844)
5. Stock of a foreign investment company;[[844]](#footnote-845)
6. Stock of a passive foreign investment company.[[845]](#footnote-846)

Basis increases will be allocable on an asset-by-asset basis. However, in no case can the basis of an asset be adjusted above its fair market value in the decedent's hands as of the date of the decedent's death.[[846]](#footnote-847)

**[iii] Income Tax Exclusion for Gain on Sale of Principal Residence Extended to Estates and Heirs**

The income tax exclusion of up to $250,000 ($500,000 on joint returns) of gain on the sale of a principal residence[[847]](#footnote-848) is extended to estates and heirs beginning in 2010.[[848]](#footnote-849)

If the decedent's estate or heir sells the decedent's principal residence, the I.R.C. § 121 gain exclusion will apply to the estate or heir and take into account the decedent’s ownership and use of the property as a principal residence. The exclusion for the gain on sale of a principal residence also applies to property sold by a trust that was a qualified revocable trust under I.R.C. § 645 immediately prior to the decedent's death.[[849]](#footnote-850)

**[iv] Transfers of Appreciated Carryover Basis Property to Satisfy Pecuniary Bequest**

For estates of decedents dying after 2009, if the executor satisfies the right of any person to receive a pecuniary bequest with appreciated property, then gain on such exchange shall be recognized to the estate only to the extent that, on the date of such exchange, the fair market value of such property exceeds such value on the date of death.[[850]](#footnote-851)

**§ 2.18 Home Purchase Distributions from Qualified Retirement Plans**

Amounts held in an individual retirement account (IRA) are includable in income when withdrawn, except to the extent that the withdrawal represents a return of nondeductible contributions. Amounts distributed from an IRA before age 59 1/2 are subject to an additional ten percent withdrawal tax, with certain exceptions.[[851]](#footnote-852) One of those exceptions allows early distributions from an IRA if used to pay expenses incurred by qualified first time home buyers, up to the first $10,000.[[852]](#footnote-853)

Qualified first time homebuyer distributions are withdrawals from an IRA of up to $10,000 during the individual's lifetime that are used within 120 days of withdrawal to buy, build or rebuild a “first” home that is the principal residence of the individual, his or her spouse, or any child, grandchild or ancestor of the individual or spouse. Acquisition costs are the costs of acquiring, constructing, or reconstructing a residence, and include any usual or reasonable settlement, financing or other closing costs.[[853]](#footnote-854)

To be considered a first time homebuyer, the individual (and spouse, if married) must not have had an ownership interest in a principal residence during the two-year period ending on the date that the new home is acquired.[[854]](#footnote-855)

1. \* This Chapter was rewritten and revised in 2007 by Patricia Hughes Mills, J.D., L.L.M., Associate Professor of Clinical Accounting, University of Southern California’s Leventhal School of Accounting. It is based on previous versions written and revised by Anne Lyons-Waldron, Esq., David J. Clark, Esq., and Sandra R. Bullington, Esq. [↑](#footnote-ref-2)
2. See § 2.13[2] below. [↑](#footnote-ref-3)
3. See § 2.01[3][f] below. [↑](#footnote-ref-4)
4. *See* I.R.C. § 168; *see* § 2.05 below. [↑](#footnote-ref-5)
5. *See* I.R.C. § 121; *see* § 2.12[3] below. [↑](#footnote-ref-6)
6. Additional limitations may apply on these types of property, such as the home office deduction or vacation home rental rules of I.R.C. § 280A. *See* § 2.04[8]. [↑](#footnote-ref-7)
7. *See* I.R.C. § 168. [↑](#footnote-ref-8)
8. I.R.C. § 121 allows the deferral of gain on a personal residence if the property was owned and used as a residence for at least two of the five years prior to sale. Thus, a rental of the property for three years or less will allow the taxpayers to take depreciation deductions on the property while still taking advantage of the personal residence gain exclusion (except that the gain can not be excluded to the extent of prior depreciation). *See* § 2.13[3] below. [↑](#footnote-ref-9)
9. Treas. Reg. § 1.167(g)-1. [↑](#footnote-ref-10)
10. Treas. Reg. § 1.165-9. [↑](#footnote-ref-11)
11. *See* § 2.08, 2.13[4] below. [↑](#footnote-ref-12)
12. I.R.C. § 1221(a)(1). [↑](#footnote-ref-13)
13. *See* Austin v. Commissioner, 263 F.2d 460 (9th Cir. 1959); *see also* Urick v. Commissioner, T.C. Memo 1983-60. [↑](#footnote-ref-14)
14. Gault v. Commissioner, 332 F.2d 94 (2nd Cir. 1964) [↑](#footnote-ref-15)
15. *See, e.g*., Rev. Rul. 57-565, 1957-2 C.B. 546; Turner v. Commissioner, 540 F.2d. 1249 (4th Cir. 1976). [↑](#footnote-ref-16)
16. *See* Powell on Real Estate, Chp 10A, *Choice of Entity for Acquiring, Holding, or Improving Real Property.* [↑](#footnote-ref-17)
17. For purposes of this discussion, for tax purposes it generally is not relevant whether the taxpayer is a sole owner or a joint tenant, provided the taxpayer is deemed to be the direct owner and not a “partner” with another owner. *See* § 2.02[2][d][ii] below. [↑](#footnote-ref-18)
18. I.R.C. § 1. [↑](#footnote-ref-19)
19. *See* § 2.01[3][f] above. [↑](#footnote-ref-20)
20. I.R.C. § 1(h). [↑](#footnote-ref-21)
21. *See* § 2.08 below. [↑](#footnote-ref-22)
22. *See* § 2.07 below. [↑](#footnote-ref-23)
23. I.R.C. § 11. Corporate capital gains are taxed at the corporation’s regular tax rate. I.R.C. § 1201. Corporations may also be subject to the alternative minimum tax (*see* I.R.C. § 55), the accumulated earnings tax (see I.R.C. § 531), and the personal holding company tax (*see* I.R.C. § 541). [↑](#footnote-ref-24)
24. I.R.C. § 301. While the double level of taxation problem is mitigated if corporate income and gains are intended to remain in the corporate and be reinvested, ultimate liquidation of the corporation will generate the second level of tax. [↑](#footnote-ref-25)
25. Although distributing a C corporation’s income as compensation to its shareholders may eliminate double taxation, distributing all the proceeds of a large real estate sale as compensation may be disallowed as “unreasonable compensation.” [↑](#footnote-ref-26)
26. *See* I.R.C. § 172. [↑](#footnote-ref-27)
27. Prior to the Tax Reform Act of 1986, I.R.C. § 311 allowed a corporation to distribute appreciated property to its shareholders without recognition of gain to the corporation. This was the so-called General Utilities doctrine, which took its name from General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), where the Supreme Court concluded that a corporation did not recognize gain upon distribution of assets to its shareholders. The shareholders would recognize income to the extent of the value of the property, but would take a basis in the property equal to that value. Therefore, the shareholders would not have any additional gain upon a subsequent sale of the property. The net result is that appreciated property could be distributed from a C corporation, prior to 1986, with one level of gain. [↑](#footnote-ref-28)
28. I.R.C. § 301(b)(1) specifies that the amount of a corporate distribution shall include the fair market value of property received. I.R.C. §301(b)(2) provides, however, that the amount of any distribution is reduced by (i) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and (ii) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution. [↑](#footnote-ref-29)
29. The distribution will be taxed as a dividend to the extent of earnings and profits, which will include the gain recognized upon the distribution. I.R.C. § 316. [↑](#footnote-ref-30)
30. *See* I.R.C. § 469(a)(2). [↑](#footnote-ref-31)
31. *See* I.R.C. § 1366. [↑](#footnote-ref-32)
32. *See* I.R.C. § 1363. [↑](#footnote-ref-33)
33. I.R.C. § 1361(b)(1). [↑](#footnote-ref-34)
34. I.R.C. § 1361(b)(1)(B), (C). [↑](#footnote-ref-35)
35. I.R.C. § 1361(a)(1)(A). [↑](#footnote-ref-36)
36. I.R.C. §§ 1361(b)(1)(D); 1361(c)(4). [↑](#footnote-ref-37)
37. I.R.C. § 1361(b)(2). [↑](#footnote-ref-38)
38. I.R.C. § 1361(b)(3). Before 1996 and the amendments made by P.L. 104-188, § 1308(a), an S corporation could not own 80% or more of the stock of a subsidiary corporation. [↑](#footnote-ref-39)
39. I.R.C. § 1361(b)(3). [↑](#footnote-ref-40)
40. I.R.C. 1 1362(d)(2). [↑](#footnote-ref-41)
41. I.R.C. § 1361(b)(1)(B). [↑](#footnote-ref-42)
42. *See* section [ii] below. [↑](#footnote-ref-43)
43. I.R.C. § 1361(b)(1)(C). [↑](#footnote-ref-44)
44. Treas. Reg. § 1.1361-1(g)(1)(i). [↑](#footnote-ref-45)
45. A corporate shareholder is only permitted in the case of qualified Subchapter S subsidiaries. *See* I.R.C. § 1361(b)(3). [↑](#footnote-ref-46)
46. I.R.C. § 1361(b)(1)(B). [↑](#footnote-ref-47)
47. I.R.C. §§ 1361(b)(1)(B), 1361(c)(6). [↑](#footnote-ref-48)
48. *Id*. [↑](#footnote-ref-49)
49. I.R.C. § 1361(c)(2)(A)(iii). [↑](#footnote-ref-50)
50. I.R.C. § 1361(c)(2)(A)(iv). [↑](#footnote-ref-51)
51. I.R.C. § 1361(c)(2)(A)(i), including where a person other than the grantor is treated as the owner under I.R.C. § 678. [↑](#footnote-ref-52)
52. I.R.C. § 1361(c)(2)(A)(ii). [↑](#footnote-ref-53)
53. I.R.C. §§ 1361(d), 1361(c)(2)(A)(v). [↑](#footnote-ref-54)
54. *See* I.R.C. §§ 1361(d)(3). [↑](#footnote-ref-55)
55. *See* I.R.C. § 1361(e)(1). [↑](#footnote-ref-56)
56. I.R.C. § 1361(b)(1)(A), as amended by the American Jobs Creation Act of 2004, § 232(a). [↑](#footnote-ref-57)
57. Former I.R.C. § 1371(a)(1), as in effect for taxable years starting before January 1, 1977. [↑](#footnote-ref-58)
58. Former I.R.C. § 1371(a)(1), as amended by P.L. 95-600 § 341, for taxable years starting after 1978. [↑](#footnote-ref-59)
59. Former I.R.C. § 1361(b)(1)(A) as revised by the Subchapter S Revision Act of 1982. [↑](#footnote-ref-60)
60. Established by the Small Business Job Protection Act of 1996, § 1301. [↑](#footnote-ref-61)
61. I.R.C. § 1361(c)(1)(A)(ii), adopted by the American Jobs Creation Act of 2004, § 231(a). [↑](#footnote-ref-62)
62. Id. Notice 2005-91, 2005-51 I.R.B. 1165, provides details on making this election. [↑](#footnote-ref-63)
63. I.R.C. § 1361(c)(1)(B). [↑](#footnote-ref-64)
64. Treas. Reg. § 1.1361-1(e)(1). [↑](#footnote-ref-65)
65. I.R.C. § 1361(c)(2)(B)(iv). [↑](#footnote-ref-66)
66. I.R.C. § 1361(c)(2)(B)(iii). [↑](#footnote-ref-67)
67. I.R.C. § 1361(c)(2)(B)(i). [↑](#footnote-ref-68)
68. I.R.C. § 1361(d)(1)(B). [↑](#footnote-ref-69)
69. I.R.C. § 1361(c)(2)(B)(v). [↑](#footnote-ref-70)
70. I.R.C. § 1361(b)(1)(D). [↑](#footnote-ref-71)
71. I.R.C. § 1361(c)(4). [↑](#footnote-ref-72)
72. *See* Treas. Reg. § 1.1361-1(l) [↑](#footnote-ref-73)
73. I.R.C. § 1366(d)(1). [↑](#footnote-ref-74)
74. I.R.C. § 1366(d)(2). [↑](#footnote-ref-75)
75. *See* discussion at § 2.02[2][d] below. [↑](#footnote-ref-76)
76. *See* Frederick G. Brown, TC Memo ¶ 81,608 (1981), *aff’d* 706 F.2d 755 (6th Cir. 1983); Leavitt Est. v. Commissioner, 875 F.2d 420 (4th Cir. 1989); Maloof v. Commissioner, T.C. Memo 2005-75. A shareholder will obtain debt basis if a payment is made on the guaranty, in which case the shareholder steps into the shoes of the creditor. [↑](#footnote-ref-77)
77. *See* Oren v. Commissioner, 357 F.3d 854 (8th Cir. 2004). [↑](#footnote-ref-78)
78. *See* Bolding v. Commissioner, 117 F.3d 270 (5th Cir. 1997); Michael A. Gurda, Jr. v. Commissioner, TC Memo ¶ 87,394 (1987); PLR 8747013. [↑](#footnote-ref-79)
79. I.R.C. §1366(a)(1). [↑](#footnote-ref-80)
80. I.R.C. § 1377(a)(2); Treas. Reg. § 1.1368-1(g). [↑](#footnote-ref-81)
81. *See* § 2.02[2][d] below. [↑](#footnote-ref-82)
82. I.R.C. § 1361(b)(1)(D). *See* § 10A.06[2][a][iii] above. [↑](#footnote-ref-83)
83. *See* I.R.C. § 704(c); § 10A.05[1][d][3] above. [↑](#footnote-ref-84)
84. I.R.C. § 351. [↑](#footnote-ref-85)
85. *See* I.R.C. § 1374. [↑](#footnote-ref-86)
86. I.R.C. § 1362(d)(3)(C)(i) [↑](#footnote-ref-87)
87. I.R.C. § 1375(b)(1)(B). [↑](#footnote-ref-88)
88. I.R.C. § 1362(c). [↑](#footnote-ref-89)
89. Treas. Reg. § 1.1362-6(a)(2)(i). The regulations indicate who must sign as a shareholder. *See* Treas. Reg. § 1.1362-6. [↑](#footnote-ref-90)
90. I.R.C. § 1362(b). A new corporation’s year starts on the day that it first has shareholders, assets, or starts doing business. Treas. Reg. § 1.1362-6(a)(2)(ii)(C). [↑](#footnote-ref-91)
91. I.R.C. § 1362(b)(5), added by the Small Business Job Protection Act of 1996. *See* Rev. Proc. 2003-43, 2003-1 C.B. 998, for an automatic relief procedure for filing late S corporation elections. [↑](#footnote-ref-92)
92. *See* § 2.02[2][b] above. [↑](#footnote-ref-93)
93. I.R.C. § 1363(a), unless the property is subject to the built-in-gain rules of I.R.C. § 1374. [↑](#footnote-ref-94)
94. I.R.C. § 1366. [↑](#footnote-ref-95)
95. *See* § 2.20[2][d] below. [↑](#footnote-ref-96)
96. I.R.C. § 1372. [↑](#footnote-ref-97)
97. I.R.C. § 761(a). [↑](#footnote-ref-98)
98. For detailed discussion of the different types of entities, *see* Powell on Real Estate, Chp 10A, Choice of Vehicle for Acquiring, Holding, and Improving Real Property. [↑](#footnote-ref-99)
99. I.R.C. § 721. [↑](#footnote-ref-100)
100. *See* I.R.C. § 351. [↑](#footnote-ref-101)
101. I.R.C. § 723. [↑](#footnote-ref-102)
102. I.R.C. § 722. [↑](#footnote-ref-103)
103. See Rev. Proc. 93-27, 1993-2 C.B. 343. However, Prop. Regs. §1.721-1(b) and Prop. Regs. §1.761-1(b) (REG-105346-03, 70 Fed. Reg. 29675 (5/24/05)) would eliminate the distinction between taxation of the receipt of a capital interest for services and the receipt of a profits interest for services. Notice 2005-43, 2005-24 I.R.B. 1221, released in connection with proposed regulations, sets forth a proposed revenue procedure that would revoke Rev. Proc. 93-27. [↑](#footnote-ref-104)
104. I.R.C. §§ 752(b), 731. [↑](#footnote-ref-105)
105. Id. [↑](#footnote-ref-106)
106. *See* § 707(a)(2)A); Regs. § 1.707-2 through 1.707-9, T.D. 8439, 57 Fed. Reg. 44974 (9/30/92). [↑](#footnote-ref-107)
107. I.R.C. §§ 704(c)(1)(B); 737. [↑](#footnote-ref-108)
108. Note that effective for liabilities incurred or assumed by a partnership on or after June 24, 2003, an obligation is considered a Treas. Reg. §1.752-1 liability to the extent the obligation creates or increases the basis of any of the obligor's assets (including cash), gives rise to an immediate deduction to the obligor, or gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. Treas. Reg. §1.752-1(a)(4)(i). T.D. 9207 (5/26/05). All remaining "obligations" (as defined in Treas. Reg. §1.752-1(a)(4)(ii)) are considered Treas. Reg. §1.752-7 liabilities and are subject to special rules. [↑](#footnote-ref-109)
109. I.R.C. §§ 721, 752(a). [↑](#footnote-ref-110)
110. I.R.C. § 705. [↑](#footnote-ref-111)
111. *See* § [ii] below. [↑](#footnote-ref-112)
112. I.R.C. § 704(d). [↑](#footnote-ref-113)
113. *See generally*, 714-2nd T.M., *Partnerships – Allocation of Liabilities; Basis Rules* [↑](#footnote-ref-114)
114. I.R.C. § 706(a). [↑](#footnote-ref-115)
115. I.R.C. § 703. [↑](#footnote-ref-116)
116. I.R.C. § 704(a), (b). [↑](#footnote-ref-117)
117. *See* I.R.C. § 1.704-1(b)(2). [↑](#footnote-ref-118)
118. *See* I.R.C. § 737, § 704(c)(1)(B). [↑](#footnote-ref-119)
119. Treas. Reg. § 1.704-3. [↑](#footnote-ref-120)
120. *See* generally 712-2nd T.M., *Partnerships – Taxable Income; Allocation of Distributive Shares; Capital Accounts* [↑](#footnote-ref-121)
121. *See* § 2.08 below. [↑](#footnote-ref-122)
122. *See* § 2.07 below. [↑](#footnote-ref-123)
123. I.R.C. §704(d). [↑](#footnote-ref-124)
124. I.R.C. § 752(a). [↑](#footnote-ref-125)
125. Note, however, that a partnership could recognize gain or loss if a distribution of money or property to a partner disproportionately changes the partner’s interest in I.R.C. § 751 “hot assets.” *See* I.R.C. § 751(b). [↑](#footnote-ref-126)
126. I.R.C. § 731. [↑](#footnote-ref-127)
127. I.R.C. § 732(a)(1). [↑](#footnote-ref-128)
128. I.R.C. § 732(a)(2). [↑](#footnote-ref-129)
129. I.R.C. § 1223(1). [↑](#footnote-ref-130)
130. I.R.C. § 733. [↑](#footnote-ref-131)
131. I.R.C. § 168(i)(7). [↑](#footnote-ref-132)
132. *Id.* [↑](#footnote-ref-133)
133. This section is adapted from Powell on Real Estate, Ch 10A, *Choice of Vehicle for Acquiring, Holding, and Improving Real Property,* § 10A.02[4]. [↑](#footnote-ref-134)
134. Treas. Reg. § 301.7701-1(a)(1). [↑](#footnote-ref-135)
135. The issue is important not simply for determining whether partnership tax returns are required to be filed, but in other areas as well. For example, a co-ownership interest may be exchanged in an I.R.C. § 1031 like-kind exchange, but a partnership interest may not. [↑](#footnote-ref-136)
136. Treas. Reg. § 301.7701-1(a)(2). [↑](#footnote-ref-137)
137. 1975-2 C.B. 261. [↑](#footnote-ref-138)
138. Rev. Proc. 2002-22, 2002-1 C.B. 733. This issue is key in the I.R.C. § 1031 like kind exchange area, since co-ownership interests may be exchanged tax-free under I.R.C. § 1031, but I.R.C. § 1031 does not apply to the exchange of partnership interests. See I.R.C. § 1031(a)(2)(D). [↑](#footnote-ref-139)
139. Rev. Proc. 2002-22, Sec. 3, 2002-1 C.B. 733. [↑](#footnote-ref-140)
140. 1975-2 C.B. 261. [↑](#footnote-ref-141)
141. Treas. Reg. § 1.512(b)-1(c)(5). [↑](#footnote-ref-142)
142. *See* PLR 200625009 (Mar. 1, 2006). [↑](#footnote-ref-143)
143. Treas. Reg. § 1.761-2. [↑](#footnote-ref-144)
144. Treas. Reg. § 1.761-2(a)(1). [↑](#footnote-ref-145)
145. Treas. Reg. § 1.761-2(a)(2). The ability to elect out of Subchapter K for investment partnerships is not as useful as it appears. For an investment organization to elect out of Subchapter K, it must not be engaged in the active conduct of a business. Therefore, if the organization meets the qualifications to be a partnership in the first place (i.e., the definition of a partnership under I.R.C. § 761(a) and § 7701(a)(2) involves carrying on a business), it is apparently unable to meet the qualifications to elect out of Subchapter K. If an organization meets the requirement that it is not engaged in the active conduct of a business, then it is unlikely to be defined as a partnership. [↑](#footnote-ref-146)
146. Treas. Reg. § 1.761-2(a)(3). The Regulations have not yet been amended to cover the third type of organization that may be excluded from Subchapter K – the dealer in securities. [↑](#footnote-ref-147)
147. Treas. Reg. § 1.6031-1. [↑](#footnote-ref-148)
148. Treas. Reg. § 1.761-2(b)(1). [↑](#footnote-ref-149)
149. Treas. Reg. § 1.761-2(b)(2)(i). [↑](#footnote-ref-150)
150. Wyoming was first state to adopt an LLC statute in 1978. However, it wasn’t until the IRS ruled that the LLC could be taxed as a partnership (Rev. Rul. 88-76, 1988-2 C.B. 360, obsoleted by Rev. Rul. 98-37, 1998-2 C.B. 133), that LLC statutes became prevalent. All states and the District of Columbia now have LLC statutes. The National Conference of Commissioners on Uniform State Laws has approved a Uniform Limited Liability Company Act, which was revised in 2006. [↑](#footnote-ref-151)
151. *See* § 2.02[3] below. [↑](#footnote-ref-152)
152. Treas. Reg. § 301.7701-3(a). [↑](#footnote-ref-153)
153. Unless the LLC elects to be taxed as a corporation. *See* Treas. Reg. § 301.7701-3(a). [↑](#footnote-ref-154)
154. I.R.C. § 752(a). [↑](#footnote-ref-155)
155. I.R.C. § 704(d). [↑](#footnote-ref-156)
156. I.R.C. § 731(a)(1). [↑](#footnote-ref-157)
157. Treas. Reg. § 1.704-1(b)(2). [↑](#footnote-ref-158)
158. I.R.C. § 731(a)(1). [↑](#footnote-ref-159)
159. I.R.C. § 311(b); § 1366(a)(1). [↑](#footnote-ref-160)
160. I.R.C. § 734 and § 734. [↑](#footnote-ref-161)
161. I.R.C. §§ 856-860. [↑](#footnote-ref-162)
162. I.R.C. § 856(a)(5). [↑](#footnote-ref-163)
163. *See* I.R.C. § 856. [↑](#footnote-ref-164)
164. *See, e.g*., I.R.C. § 857(b)(7), § 857(f). [↑](#footnote-ref-165)
165. I.R.C. § 857(a)(1). [↑](#footnote-ref-166)
166. I.R.C. § 4981. [↑](#footnote-ref-167)
167. I.R.C. §§ 856(c)(2), (3). [↑](#footnote-ref-168)
168. I.R.C. §§ 856(d)(2)(C), (d)(7). [↑](#footnote-ref-169)
169. I.R.C. §§ 856(d)(7)(C). *See* I.R.C. § 856(d)(3) for the definition of independent contractor. [↑](#footnote-ref-170)
170. Before the environmental remediation trust rules were issued, the IRS ruled privately that a trust under local law created by potentially responsible parties to clean up hazardous waste cites was a business entity that was treated as a partnership. PLR 9108025. [↑](#footnote-ref-171)
171. Treas. Reg. § 301.7701–4(e)(1). [↑](#footnote-ref-172)
172. Treas. Reg. § 301.7701–4(e)(1) [↑](#footnote-ref-173)
173. Treas. Reg. § 301.7701–4(e)(2). [↑](#footnote-ref-174)
174. Treas. Reg. § 301.7701–4(e)(2). See § 2.04[7] below for discussion of deduction of environmental clean-up costs under I.R.C. § 198. [↑](#footnote-ref-175)
175. Treas. Reg. § 301.7701-4(e)(3). [↑](#footnote-ref-176)
176. Treas. Reg. § 301.7701–4(e)(4) [↑](#footnote-ref-177)
177. See generally Powell on Real Estate Chp 10A “*Choice of Vehicle for Acquiring, Holding, or Improving Real Property*,” § 10A.04[1]. [↑](#footnote-ref-178)
178. While the regulations refer to non-corporate entities that are being taxed as a corporation as “associations taxed as a corporation,” for simplicity they will be referred to in this section as eligible entities being taxed as a corporation. [↑](#footnote-ref-179)
179. *See* TD 8697, Treas. Reg. §§ 301.7701-3. Revenue Rulings and Revenue Procedures applying the prior classification regulations were declared obsolete in Notice 97-1, 1997-1 C.B. 348 and Rev. Rul. 98-37, 1998-2 C.B. 133. [↑](#footnote-ref-180)
180. Treas. Reg. § 301.7701-1(a). [↑](#footnote-ref-181)
181. Treas. Reg. § 301.7701-2(a). [↑](#footnote-ref-182)
182. *Id*. [↑](#footnote-ref-183)
183. Treas. Reg. § 301.7701-2(b)(1). [↑](#footnote-ref-184)
184. Treas. Reg. § 301.7701-3(a) [↑](#footnote-ref-185)
185. *Id*. [↑](#footnote-ref-186)
186. Treas. Reg. § 301.7701-3(b)(1) [↑](#footnote-ref-187)
187. Treas. Reg. § 301.7701-3(c)(1)(i). [↑](#footnote-ref-188)
188. Treas. Reg. § 301.7701-3(c)(1)(iii). [↑](#footnote-ref-189)
189. 2002-2 C.B. 615. [↑](#footnote-ref-190)
190. Treas. Reg. § 301.7701-3(c)(2). [↑](#footnote-ref-191)
191. Treas. Reg. § 301.7701-3(c)(1)(iv). [↑](#footnote-ref-192)
192. Treas. Reg. § 301.7701-3(f)(1). [↑](#footnote-ref-193)
193. Treas. Reg. § 301.7701-3(f)(2). *See* discussion of the tax consequences of this conversion in § 2.02[3][c] below. [↑](#footnote-ref-194)
194. Treas. Reg. § 301.7701-3(g)(1)(i). [↑](#footnote-ref-195)
195. Treas. Reg. § 301.7701-3(g)(2)(i). [↑](#footnote-ref-196)
196. Treas. Reg. § 301.7701-3(g)(1)(ii). [↑](#footnote-ref-197)
197. I.R.C. §§ 311, 331. [↑](#footnote-ref-198)
198. I.R.C. § 336. [↑](#footnote-ref-199)
199. Treas. Reg. § 301.7701-3(g)(1)(iii). [↑](#footnote-ref-200)
200. Treas. Reg. § 301.7701-3(g)(1)(iv). *See* I.R.C. § 351 for the tax consequences of incorporation. [↑](#footnote-ref-201)
201. I.R.C. § 706(a). [↑](#footnote-ref-202)
202. I.R.C. § 706(b)(1) (entities taxed as partnerships) and I.R.C. § 1378 (S corporations). [↑](#footnote-ref-203)
203. I.R.C. § 706(b)(4)(A)(i). *See* Treas. Regs. §1.706-1(b)(4). [↑](#footnote-ref-204)
204. I.R.C. § 706(b)(1)(B)(ii); Treas. Regs. §1.706-1(b)(2)(i)(B). A principal partner is a partner having a 5% or greater interest in partnership profits or capital. I.R.C. §706(b)(3). *See* Regs. §1.706-1(b)(4) for guidance on measuring a partner's capital and profits interest. [↑](#footnote-ref-205)
205. I.R.C. § 706(b)(1)(B)(iii); Treas. Regs. §1.706-1(b)(2)(i)(C). *See* Treas. Regs. §1.706-1(b)(3) for guidance on determining the taxable year that produces the least aggregate deferral of income. [↑](#footnote-ref-206)
206. *See* Rev. Rul. 87-57, 1987-2 C.B. 117 for guidance on establishing a business purpose. The accepted reasons are extremely limited. [↑](#footnote-ref-207)
207. *See* I.R.C. §§ 444, 7519. [↑](#footnote-ref-208)
208. I.R.C. § 1378. *See* Rev. Rul. 87-57, 1987-2 C.B. 117 for guidance on establishing a business purpose to the satisfaction of the I.R.S. [↑](#footnote-ref-209)
209. *See* I.R.C. § 441(i). *See* Rev. Rul. 87-57, 1987-2 C.B. 117 for guidance on establishing a business purpose to the satisfaction of the I.R.S. [↑](#footnote-ref-210)
210. I.R.C. § 262(a) [↑](#footnote-ref-211)
211. *See* Anover Realty Corp v. Commissioner, 33 T.C. 671 (1960). [↑](#footnote-ref-212)
212. *See* IRS Pub 936. [↑](#footnote-ref-213)
213. Rev. Rul. 81-160, 1981-1 C.B. 312. [↑](#footnote-ref-214)
214. Rev. Rul. 69-188, 1969-1 C.B. 54. [↑](#footnote-ref-215)
215. I.R.C. § 461(g)(1). [↑](#footnote-ref-216)
216. I.R.C. § 461(g)(2). [↑](#footnote-ref-217)
217. *See* Schubel v. Commissioner, 77 T.C. 701 (1981). [↑](#footnote-ref-218)
218. Rev. Proc. 94-27, 1994-1 C.B. 613. [↑](#footnote-ref-219)
219. Rev. Rul. 87-22, 1987-1 C.B. 146. [↑](#footnote-ref-220)
220. Rev. Proc. 92-11, 1992-1 C.B. 662. [↑](#footnote-ref-221)
221. *See* Anover Realty Corp. v. Commissioner, 33 T.C. 671 (1960); Rev. Rev. 67-297, 1967-2 C.B. 87. [↑](#footnote-ref-222)
222. *See* § 2.03[3][a] above. [↑](#footnote-ref-223)
223. I.R.C. §§ 162, 212, 263. [↑](#footnote-ref-224)
224. I.R.C. § 217. [↑](#footnote-ref-225)
225. I.R.C. § 262. [↑](#footnote-ref-226)
226. *See* Treas. Reg. § 1.217-2. [↑](#footnote-ref-227)
227. *See* I.R.C. § 68. [↑](#footnote-ref-228)
228. I.R.C. § 280B. Note that since the expense is capitalized to the land, it will not be depreciable, and will be recovered when the land is sold only as an increase in basis. [↑](#footnote-ref-229)
229. De Cou v. Commissioner, 103 T.C. 80 (1994). [↑](#footnote-ref-230)
230. *See* Klein, Anticipatory Abandonment of Old Building: Deduction Allowed for Demolition When Building Retired From Use, *Journal of Real Estate Taxation* (Spring 1995). [↑](#footnote-ref-231)
231. Treas. Reg. § 1.190-2(a)(1). [↑](#footnote-ref-232)
232. Treas. Reg. § 1.190-2(a)(2). [↑](#footnote-ref-233)
233. Treas. Reg. § 1.190-2(b). [↑](#footnote-ref-234)
234. I.R.C. § 190(c). [↑](#footnote-ref-235)
235. I.R.C. § 164(d). [↑](#footnote-ref-236)
236. I.R.C. § 164(c)(2). [↑](#footnote-ref-237)
237. I.R.C. §§ 162, 212. [↑](#footnote-ref-238)
238. I.R.C. § 263. [↑](#footnote-ref-239)
239. Treas. Reg. § 1.162-4. [↑](#footnote-ref-240)
240. 39 T.C. 333 (1962). [↑](#footnote-ref-241)
241. 503 U.S. 79 (1992). [↑](#footnote-ref-242)
242. Rev. Rul. 94-12, 1994-1 C.B. 336. *See also*, Ingram Industries, Inc. & Subsidiaries, TC Memo 2000-323. [↑](#footnote-ref-243)
243. 14 T.C. 635 (1950). [↑](#footnote-ref-244)
244. TC Memo 1999-265. [↑](#footnote-ref-245)
245. I.R.C. § 262. [↑](#footnote-ref-246)
246. *See* U.S. v. Wehrli, 400 F.2d 686 (10th Cir. 1968). [↑](#footnote-ref-247)
247. Rev. Rul. 2001-4, 2001-1C.B. 295. [↑](#footnote-ref-248)
248. Paxton v. Commissioner, TC Memo 1991-217 [↑](#footnote-ref-249)
249. 108 T.C. 358 (1997). [↑](#footnote-ref-250)
250. I.R.C. §§ 162, 212. [↑](#footnote-ref-251)
251. I.R.C. § 263(a); *See* Indopco, Inc. v. Commissioner, 503 U.S. 79 (1992). [↑](#footnote-ref-252)
252. Burman v. Commissioner, 23 B.T.A. 639 (1931); *see also* Treas. Reg. § 1.263(a)-2(e). [↑](#footnote-ref-253)
253. Irma Jones Hunt v. Commissioner, 47 B.T.A. 829 (1942). [↑](#footnote-ref-254)
254. *See* Treas. Reg. § 1.263(a)-2(e). [↑](#footnote-ref-255)
255. *See* Prop. Reg. § 1.263(a)-1(c). [↑](#footnote-ref-256)
256. IRS Pub. No. 17. [↑](#footnote-ref-257)
257. Impact fees are one-time charges imposed by a state or local government on new developments to finance specific offsite capital improvements of public infrastructure. [↑](#footnote-ref-258)
258. Rev. Rul. 2002-9, 2002-1 C.B. 614. [↑](#footnote-ref-259)
259. Oriole Homes Corporation & Subsidiaries v. U.S, 64 AFTR 2d 89-5151 (S.D. Fla. 1989). [↑](#footnote-ref-260)
260. Rev. Rul. 81-161, 1981-1 C.B. 313. [↑](#footnote-ref-261)
261. Old Colony Railroad Co. v. Commissioner*,* 284 U.S. 552 (1932). [↑](#footnote-ref-262)
262. I.R.C. § 162(h)(2)(A). [↑](#footnote-ref-263)
263. I.R.C. § 162(h)(2)(B). [↑](#footnote-ref-264)
264. I.R.C. § 162(h)(2)(C). [↑](#footnote-ref-265)
265. I.R.C. § 162(h)(2)(D). [↑](#footnote-ref-266)
266. I.R.C. § 162(h)(2)(E). [↑](#footnote-ref-267)
267. I.R.C. § 162(h)(2)(F). [↑](#footnote-ref-268)
268. Rev. Rul. 69-290, 1969-1 C.B. 55. [↑](#footnote-ref-269)
269. Rev. Rul. 69-188, 1969-1C.B. 54. [↑](#footnote-ref-270)
270. Rev. Rul. 81-160, 1981-1 C.B. 312. [↑](#footnote-ref-271)
271. Rev. Rul. 69-188, 1969-1 C.B. 54. [↑](#footnote-ref-272)
272. Rev. Rul.76-413, 1976-2 C.B. 213. [↑](#footnote-ref-273)
273. *See* Linder v. Commissioner, 68 T.C. 792 (1977) [↑](#footnote-ref-274)
274. TAM 200116008. [↑](#footnote-ref-275)
275. Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960). [↑](#footnote-ref-276)
276. Erickson Post Acquisition, TC Memo 2003-218. [↑](#footnote-ref-277)
277. *See* U.S. v. Virgin, 230 F.2d 880 (5th Cir. 1956); Rev. Rul. 82-94, 1982-2 C.B. 31. [↑](#footnote-ref-278)
278. *See* I.R.C. § 163(a); B.B. Rider Corp. v. Commissioner, 725 F. 2d 945 (3rd Cir. 1984). [↑](#footnote-ref-279)
279. Abdalla v. Commissioner, 647 F.2d 487 (5th Cir. 1981). The nonrecourse nature of debt will not impact deductibility. Treas. Reg. § 1.163-1(b). [↑](#footnote-ref-280)
280. *See* Prendergast v. Commissioner, TC Memo 1983-413 [↑](#footnote-ref-281)
281. Treas. Reg. § 1.166-9. [↑](#footnote-ref-282)
282. Arrigoni v. Commissioner, 73 T.C. 792. [↑](#footnote-ref-283)
283. Treas. Reg. § 1.446-1(c)(i). [↑](#footnote-ref-284)
284. Treas. Reg. § 1.446-1(c)(ii). [↑](#footnote-ref-285)
285. I.R.C. § 267(a)(2). [↑](#footnote-ref-286)
286. Keith v. Commissioner, 139 F.2d 596 (2nd Cir. 1944); *see* Helvering v. Price, 309 U.S. 409 (1939). [↑](#footnote-ref-287)
287. *See* Rev. Rul. 70-647, 1970-2 C.B. 38; [↑](#footnote-ref-288)
288. Battlestein v. Internal Revenue Service, 631 F.2d 1182 (5th Cir. 1980), *cert. denied,* 451 U.S. 938 (1981); Wilkerson v. Commissioner, 655 F.2d 980 (9th Cir. 1981) [↑](#footnote-ref-289)
289. Burgess v. Commissioner, 8 T.C. 47 (1947). *See also,* Menz v. Commissioner, 80 T.C. 1174 (1983); Davison v. Commissioner, 107 T.C. 35 (1996), *aff’d* 141 F.3d 403 (2nd Cir. 1998). [↑](#footnote-ref-290)
290. 107 T.C. 35 (1996), *aff’d* 141 F.3d 403 (2nd Cir. 1998). [↑](#footnote-ref-291)
291. *See* footnote 287. [↑](#footnote-ref-292)
292. 141 F.3d 403 (2nd Cir. 1998). [↑](#footnote-ref-293)
293. Crown v. Commissioner, 77 T.C. 582 (1981). [↑](#footnote-ref-294)
294. I.R.C. § 461(g)(1). [↑](#footnote-ref-295)
295. I.R.C. § 461(g)(2). [↑](#footnote-ref-296)
296. Rev. Rul. 73-137, 1973-1 C.B. 68; Rev. Rul. 57-198, 1957-1 C.B. 94. [↑](#footnote-ref-297)
297. I.R.C. § 163(d)(1), (2). [↑](#footnote-ref-298)
298. I.R.C. § 163(d)(3)(A). [↑](#footnote-ref-299)
299. I.R.C. § 163((d)(3)(B)(i). [↑](#footnote-ref-300)
300. I.R.C. § 163(d)(3)(B)(ii). [↑](#footnote-ref-301)
301. I.R.C. § 163(d)(3)(C). [↑](#footnote-ref-302)
302. I.R.C. § 163(d)(5). [↑](#footnote-ref-303)
303. I.R.C. § 163(d)(4)(A), (C). [↑](#footnote-ref-304)
304. I.R.C. § 163(d)(4)(B). [↑](#footnote-ref-305)
305. I.R.C. § 163(d)(4)(B)(iii); § 1(h). [↑](#footnote-ref-306)
306. I.R.C. § 67(a). [↑](#footnote-ref-307)
307. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, p. 265. [↑](#footnote-ref-308)
308. I.R.C. § 163(d)(2). [↑](#footnote-ref-309)
309. I.R.C. § 163(h)(3)(A). [↑](#footnote-ref-310)
310. There is no official definition of the amount or extent of work that is required for a “substantial improvement.” [↑](#footnote-ref-311)
311. I.R.C. § 163(h)(3)(B). [↑](#footnote-ref-312)
312. I.R.C. § 163(h)(3)(B)(ii). [↑](#footnote-ref-313)
313. I.R.C. § 163(h)(3)(C). [↑](#footnote-ref-314)
314. I.R.C. § 163(h)(4)(A)(i). [↑](#footnote-ref-315)
315. A taxpayer is considered to use a residence for personal purposes on any day that it is used by the taxpayer, by family members, or by anyone paying less than fair market value for its use. I.R.C. § 280A(d)(2). [↑](#footnote-ref-316)
316. I.R.C. §§ 163(h)(4)(A)(i)(II), 280A(d)(1). [↑](#footnote-ref-317)
317. Treas. Reg. § 1.163-10T(p)(3)(iii). [↑](#footnote-ref-318)
318. Treas. Reg. § 1.163-10T(p)(3)(ii). [↑](#footnote-ref-319)
319. Notice 88-74, 1988-2 C.B. 385. [↑](#footnote-ref-320)
320. FSA 2001137033. [↑](#footnote-ref-321)
321. Pau v. Commissioner, TC Memo 1997-43. [↑](#footnote-ref-322)
322. I.R.C. § 110(c)(1). [↑](#footnote-ref-323)
323. I.R.C. § 110(c)(2). [↑](#footnote-ref-324)
324. I.R.C. § 110(c)(3). [↑](#footnote-ref-325)
325. I.R.C. § 110(d). [↑](#footnote-ref-326)
326. Treas. Reg. § 1.110-1(c)(2). [↑](#footnote-ref-327)
327. Treas. Reg. § 1.110-1(c)(3)(i). [↑](#footnote-ref-328)
328. Added by the Taxpayer Relief Act of 1997, P.L. 105-34, effective for expenditures paid or incurred after August 5, 1997, in tax years ending after that date. [↑](#footnote-ref-329)
329. I.R.C. § 198(h). The sunset date was extended by the 2006 Tax Relief and Health Care Act, P.L. 109-432. [↑](#footnote-ref-330)
330. This will also include the costs of demolition, which are otherwise capitalizable under I.R.C. § 280B. *See* I.R.C. § 198(f). [↑](#footnote-ref-331)
331. I.R.C. § 198(b)(1). [↑](#footnote-ref-332)
332. I.R.C. §198(c). [↑](#footnote-ref-333)
333. I.R.C. § 198(e). [↑](#footnote-ref-334)
334. I.R.C. §§ 262, 264, 163(h). [↑](#footnote-ref-335)
335. I.R.C. § 280A. [↑](#footnote-ref-336)
336. Home offices used for management or administrative activities may qualify as a taxpayer's principal place of business if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business I.R.C. § 280A(c). [↑](#footnote-ref-337)
337. I.R.C. § 280A(c)(1). [↑](#footnote-ref-338)
338. Hamacher v. Commissioner, 94 T.C. 348 (1990). [↑](#footnote-ref-339)
339. *See* Tokh v. Commissioner, TC Memo 2001-45, aff’d 88 AFTR2d 2001-7309. [↑](#footnote-ref-340)
340. Prop. Reg. § 1.280A-2(i)(3). [↑](#footnote-ref-341)
341. I.R.C. § 280A(c)(5). [↑](#footnote-ref-342)
342. Prop. Reg. § 1.280A-2(i)(2). [↑](#footnote-ref-343)
343. I.R.C. § 280A(c)(5)(B). [↑](#footnote-ref-344)
344. I.R.C. § 280A(c)(5)(A). [↑](#footnote-ref-345)
345. I.R.C. § 263. [↑](#footnote-ref-346)
346. I.R.C. § 179 allows a taxpayer to expense certain tangible personal property used in a trade or business, up to $125,000 for taxable years beginning after 2006 and before 2011. In addition, goodwill and certain other intangibles may be amortized under the rules of I.R.C. § 197. [↑](#footnote-ref-347)
347. Pub. L. No. 99–514, 99th Cong., 2d Sess. (Oct. 22, 1986). [↑](#footnote-ref-348)
348. Pub. L. No. 97–34, 97th Cong., 1st Sess. (Aug. 13, 1981). [↑](#footnote-ref-349)
349. Pub. L. No. 92–178, 92nd Cong., 1st Sess. (Dec. 10, 1971). [↑](#footnote-ref-350)
350. I.R.C. § 168(a). [↑](#footnote-ref-351)
351. Rev. Proc. 87-57, 1987-2 C.B. 687. [↑](#footnote-ref-352)
352. I.R.C. §§ 168(b)(1) – (3). [↑](#footnote-ref-353)
353. I.R.C. § 168(b)(3)(A), (B). [↑](#footnote-ref-354)
354. The term “residential rental property” includes a building, at least 80 percent of the gross rental income from which consists of rents from the rental of nontransient dwelling units. I.R.C. § 168(e)(2)(A). [↑](#footnote-ref-355)
355. I.R.C. § 168(e)(1). [↑](#footnote-ref-356)
356. *See* Ann. 99-82, 1999-2 C.B. 244. [↑](#footnote-ref-357)
357. Rev. Proc. 87-57, 1987-2 C.B. 687. [↑](#footnote-ref-358)
358. I.R.C. §168(d)(2). [↑](#footnote-ref-359)
359. Rev. Proc. 87-57, 1987-2 C.B. 687. [↑](#footnote-ref-360)
360. I.R.C. § 168(i)(6). [↑](#footnote-ref-361)
361. P.L. 107-147, § 101(a) added I.R.C. § 168(k) effective for property placed in service after 9/10/2001, in taxable years ending after 9/10/2001. The purpose was to encourage investment after the terrorist attacks of September 11, 2001. [↑](#footnote-ref-362)
362. I.R.C. § 168(k). [↑](#footnote-ref-363)
363. P.L. 108-27 added I.R.C. § 168(k)(4). [↑](#footnote-ref-364)
364. The placed in service deadline for certain types of property was extended to December 31, 2005 (*see* I.R.C. § 168(k)(4)(B)(iii)), which was further extended to December 31, 2006 for certain property in the Gulf region impacted by Hurricanes Katrina, Rita, or Wilma (*see* Ann 2006-29, 2006-19 I.R.B. 879). [↑](#footnote-ref-365)
365. *See* I.R.C. § 1400M which provides the definitions of areas or zones affected by Hurricanes Katrina, Rita or Wilma. [↑](#footnote-ref-366)
366. I.R.C. § 1400N(d)(2)(A)(i)(II) [↑](#footnote-ref-367)
367. I.R.C. § 168(g). [↑](#footnote-ref-368)
368. I.R.C. § 168(g)(2). [↑](#footnote-ref-369)
369. I.R.C. § 168(g)(7)(B). [↑](#footnote-ref-370)
370. I.R.C. § 168((g)(1)(A) – (D). [↑](#footnote-ref-371)
371. I.R.C. § 168(g)(2)(C). [↑](#footnote-ref-372)
372. I.R.C. § 168(d)(4)(B). [↑](#footnote-ref-373)
373. *See* I.R.C. § 1250. [↑](#footnote-ref-374)
374. *See* I.R.C. § 1245. [↑](#footnote-ref-375)
375. I.R.C. § 47(a). [↑](#footnote-ref-376)
376. I.R.C. § 47(c)(2). [↑](#footnote-ref-377)
377. I.R.C. § 47(c)(2)(B)(i). [↑](#footnote-ref-378)
378. I.R.C. § 47(c)(2)(B)(ii). [↑](#footnote-ref-379)
379. I.R.C. § 47(c)(2)(B)(iii). [↑](#footnote-ref-380)
380. I.R.C. § 47(d)(2)(B)(iv). [↑](#footnote-ref-381)
381. I.R.C. § 47(c)(2)(B)(iv)(I), (II), and (III). [↑](#footnote-ref-382)
382. *See* § 2.10 below for a discussion of tax-exempt use property. [↑](#footnote-ref-383)
383. I.R.C. § 47(c)(2)(B)(v). [↑](#footnote-ref-384)
384. I.R.C. § 47(c)(2)(B)(vi). [↑](#footnote-ref-385)
385. I.R.C. § 47(c)(2)(C). [↑](#footnote-ref-386)
386. Booker T. Washington Broadcasting Service, Inc. v. United States, 70 AFTR2d 92-5925 (N.D. Ala. 1992). [↑](#footnote-ref-387)
387. I.R.C. § 47(c)(3)(A). [↑](#footnote-ref-388)
388. I.R.C. § 47(c)(3)(B). [↑](#footnote-ref-389)
389. I.R.C. § 47(c)(1). [↑](#footnote-ref-390)
390. I.R.C. § 47(c)(1)(C). [↑](#footnote-ref-391)
391. I.R.C. § 47(c)(1)(C)(i). [↑](#footnote-ref-392)
392. I.R.C. § 47(c)(1)(C)(ii). [↑](#footnote-ref-393)
393. 989 F.2d 450 (11th Cir. 1993). [↑](#footnote-ref-394)
394. See Ch 8A, infra, for an in-depth discussion of the low-income housing credit.**Editor: is this correct?**  [↑](#footnote-ref-395)
395. I.R.C. § 42. [↑](#footnote-ref-396)
396. I.R.C. § 42(b). [↑](#footnote-ref-397)
397. I.R.C. § 42(e)(1). [↑](#footnote-ref-398)
398. I.R.C. § 42(b)(1). [↑](#footnote-ref-399)
399. *See, e.g.*, Rev. Rul. 2007-44, 2007-28 I.R.B. 47. [↑](#footnote-ref-400)
400. I.R.C. § 42(h)(6). [↑](#footnote-ref-401)
401. The Section 8 program is so-called because it was authorized by Section 8 of the United States Housing Act of 1937. It is discussed in Chapter 4, at § 4.03[6] *infra.* **Editor – is this still correct?** [↑](#footnote-ref-402)
402. I.R.C. § 469; *see* discussion at §2.08 below. [↑](#footnote-ref-403)
403. I.R.C. § 469(c)(2). [↑](#footnote-ref-404)
404. I.R.C. § 469(d)(2). [↑](#footnote-ref-405)
405. I.R.C. § 38(c)(1)(A). [↑](#footnote-ref-406)
406. *See* I.R.C. § 469. [↑](#footnote-ref-407)
407. I.R. C. § 469(i); *see* discussion at § 2.08[5] below. [↑](#footnote-ref-408)
408. I.R.C. § 469(i)(1), (3)(A). [↑](#footnote-ref-409)
409. I.R.C. § 469(i)(6)(A), (C). [↑](#footnote-ref-410)
410. I.R.C. § 469(i)(6)(B). [↑](#footnote-ref-411)
411. I.R.C. § 469(i)(1). [↑](#footnote-ref-412)
412. I.R.C. § 469(j)(5). [↑](#footnote-ref-413)
413. I.R.C. § 469(i)(3). [↑](#footnote-ref-414)
414. I.R.C. § 469(i)(3)(D). [↑](#footnote-ref-415)
415. *See* I.R.C. § 469(i)(3)(E). [↑](#footnote-ref-416)
416. I.R.C. § 1366. *See* discussion of S corporations at § 2.02[2][c] above. [↑](#footnote-ref-417)
417. I.R.C. § 469(a)(2)(C). [↑](#footnote-ref-418)
418. I.R.C. § 469(j)(1); § 542(a)(2). [↑](#footnote-ref-419)
419. I.R.C. § 469(e)(2)(A). [↑](#footnote-ref-420)
420. I.R.C. § 469(a)(2). [↑](#footnote-ref-421)
421. I.R.C. § 42(a)(2). [↑](#footnote-ref-422)
422. I.R.C. § 42(c)(2). [↑](#footnote-ref-423)
423. I.R.C. § 42(c)(2)(B). [↑](#footnote-ref-424)
424. I.R.C. § 42(g). [↑](#footnote-ref-425)
425. I.R.C. § 42(g)(1). [↑](#footnote-ref-426)
426. I.R.C. § 42(g)(1)(A). [↑](#footnote-ref-427)
427. I.R.C. § 42(g)(1)(B). [↑](#footnote-ref-428)
428. I.R.C. § 42(g)(2)(A). [↑](#footnote-ref-429)
429. Treas. Reg. § 1.42-10(a). [↑](#footnote-ref-430)
430. I.R.C. § 42(g)(2)(B)(ii) [↑](#footnote-ref-431)
431. I.R.C. § 42(g)(2)(B)(i). [↑](#footnote-ref-432)
432. *See* I.R.C. § 42(g)(2)(C). [↑](#footnote-ref-433)
433. Rev. Rul. 90-89, 1990-2 C.B. 8. [↑](#footnote-ref-434)
434. 1990-2 C.B. 8. [↑](#footnote-ref-435)
435. *See* excerpt from HUD Handbook 4350.3 for a complete list of income inclusions and exclusions. [↑](#footnote-ref-436)
436. I.R.C. § 42(g)(4) and § 142(d)(3)(B). [↑](#footnote-ref-437)
437. I.R.C. § 42(g)(4) and § 142(d)(4)(A). [↑](#footnote-ref-438)
438. I.R.C. § 142(d)(4)(B)(i). [↑](#footnote-ref-439)
439. I.R.C. § 142(d)(4)(B)(iii). [↑](#footnote-ref-440)
440. Rev. Proc. 94-10, 1994-1 C.B. 556. [↑](#footnote-ref-441)
441. I.R.C. § 42(j). [↑](#footnote-ref-442)
442. I.R.C. § 42(c). [↑](#footnote-ref-443)
443. I.R.C. § 42(c)(1)(B). [↑](#footnote-ref-444)
444. I.R.C. § 42(c)(1)(C). [↑](#footnote-ref-445)
445. I.R.C. § 42(c)(1)(C)(ii). [↑](#footnote-ref-446)
446. I.R.C. § 42(c)(1)(D). [↑](#footnote-ref-447)
447. I.R.C. § 42(c)(1)(D)(ii). [↑](#footnote-ref-448)
448. I.R.C. § 42(i)(3)(A)(i), (ii). [↑](#footnote-ref-449)
449. I.R.C. § 42(i)(3)(B)(i). [↑](#footnote-ref-450)
450. I.R.C. § 42(i)(3)(B)(ii). [↑](#footnote-ref-451)
451. *See* Treas. Reg. § 1.42-9. [↑](#footnote-ref-452)
452. I.R.C. § 42(i)(3)(C). [↑](#footnote-ref-453)
453. Treas. Reg. § 1.42-11. [↑](#footnote-ref-454)
454. I.R.C. § 42(i)(3)(E). [↑](#footnote-ref-455)
455. I.R.C. § 42(f)(1). [↑](#footnote-ref-456)
456. I.R.C. § 42(f)(2)(A). [↑](#footnote-ref-457)
457. I.R.C. § 42(f)(2)(B). [↑](#footnote-ref-458)
458. I.R.C. § 42(f)(2)(A). [↑](#footnote-ref-459)
459. I.R.C. § 42(d)(1), (2)(A)(i). [↑](#footnote-ref-460)
460. I.R.C. § 42(f). [↑](#footnote-ref-461)
461. I.R.C. § 42(d)(3). If a building has both market rate and low-income rental units and if the average quality of the building's market rate rental units exceeds the average quality of its low-income units, the building's eligible basis would not include costs attributable to the market rate rental units. Such exclusion would reduce the amount of LIHC available from the project. Rather than excluding the entire cost of a market rate rental unit, a taxpayer can elect to exclude only the disproportionate costs incurred. I.R.C. § 42(d)(3)(B)(i). [↑](#footnote-ref-462)
462. I.R.C. § 42(d)(4)(B). [↑](#footnote-ref-463)
463. I.R.C. § 42(d)(5)(A). [↑](#footnote-ref-464)
464. Former I.R.C. § 6111 required the registration of certain investments based on the ratio of the amount of deductions available compared to the amount invested. [↑](#footnote-ref-465)
465. P.L. 108-357. [↑](#footnote-ref-466)
466. A material advisor is generally defined in I.R.C. § 6111(b)(1)(A) as a person who provides certain assistance or advice regarding the transaction and receives more than certain prohibited threshold amounts of income. [↑](#footnote-ref-467)
467. I.R.C. § 6111(a). [↑](#footnote-ref-468)
468. I.R.C. § 6111(b)(2), § 6707A(c). See also I.R.C. § 6011. [↑](#footnote-ref-469)
469. *See* I.R.C. § 6707A. [↑](#footnote-ref-470)
470. I.R.C. § 183. [↑](#footnote-ref-471)
471. Treas. Reg. § 1.42-4. [↑](#footnote-ref-472)
472. *See* Bible and Hays, “Cost Segregation and Real Estate Investment Returns,” *Real Estate Tax’n* (4th Qtr 2005). [↑](#footnote-ref-473)
473. I.R.C. § 103. [↑](#footnote-ref-474)
474. I.R.C. § 42(b)(1)(B)(i), (d)(5)(A). [↑](#footnote-ref-475)
475. P.L. 101-336, 42 U.S.C. § 12111. [↑](#footnote-ref-476)
476. I.R.C. § 44(b). [↑](#footnote-ref-477)
477. I.R.C. § 44(a). [↑](#footnote-ref-478)
478. I.R.C. § 44(c)(2). [↑](#footnote-ref-479)
479. I.R.C. § 38(b)(7). [↑](#footnote-ref-480)
480. I.R.C. § 39. [↑](#footnote-ref-481)
481. *See* I.R.C. § 196. [↑](#footnote-ref-482)
482. I.R.C. § 44(d)(7). [↑](#footnote-ref-483)
483. *See* I.R.C. § 190(b) for definitions. [↑](#footnote-ref-484)
484. *See* I.R.C. § 51(d) for definition of members of targeted groups. [↑](#footnote-ref-485)
485. See *Choice of Vehicle for Acquiring, Holding, and Improving Real Property*, Ch. 10A, Powell on Real Estate, § 10A.03[3][a]. [↑](#footnote-ref-486)
486. I.R.C. § 465(b). [↑](#footnote-ref-487)
487. A C corporation is subject to § 465 only if it meets the personal holding company stock ownership rules of I.R.C. § 542(a)(2). After taking into account the constructive ownership rules, virtually all closely held corporations satisfy the stock ownership test of I.R.C. § 465(a)(1)(B). I.R.C. § 465(c)(7) exempts certain qualifying businesses of some C corporations from the application of § 465. [↑](#footnote-ref-488)
488. I.R.C. § 465(c)(3), in 1978, expanded the coverage of the at-risk rules from traditional tax-shelter type investments to most all investments. [↑](#footnote-ref-489)
489. *See* I.R.C. § 465(c)(2) regarding covered activities. [↑](#footnote-ref-490)
490. Although “activity” is defined for purposes of the passive loss rules, *see* Treas. Reg. § 1.469-4, the scope of an activity for purposes of § 465 is more asset specific than an activity for purposes of § 469. *See* Staff of Joint Comm. on Tax’n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 246 n.40 (1987). [↑](#footnote-ref-491)
491. I.R.C. § 465(d). [↑](#footnote-ref-492)
492. I.R.C. § 465(a)(2). The carryforward is indefinite. [↑](#footnote-ref-493)
493. *See* Prop. Reg. §§ 1.465-22(b); 1.465-22(c); 1.465-25(a)(2). [↑](#footnote-ref-494)
494. Prop. Reg. §§ 1.465-5; 1.465-6(b); 1.465-6(c). [↑](#footnote-ref-495)
495. The loss limitations of I.R.C. § 465 make it impossible for losses to reduce the taxpayer’s at-risk amount below zero, but it is possible for the taxpayer’s at-risk amount to fall below zero due to distributions or due to the conversion of a qualified debt into a nonrecourse obligation. [↑](#footnote-ref-496)
496. I.R.C. § 465(e). [↑](#footnote-ref-497)
497. In an entity taxed as a partnership, a partner’s or member’s share of the entity’s liabilities for purposes of the at-risk rules is determined under I.R.C. § 752. However, while a partner will be allocated a partnership’s nonrecourse debt to the extent that partner guarantees the debt under I.R.C. § 752, Prop. Treas. Reg. § 1.465-6(d) provides that a guarantee of nonrecourse debt does not increase the guarantor’s amount of risk. Some courts have held to the contrary. *See, e.g.*, Melvin v. Comm’r, 88 T.C. 63 (1987). [↑](#footnote-ref-498)
498. I.R.C. § 465(b)(6)(B). [↑](#footnote-ref-499)
499. I.R.C. § 465(b)(6)(B)(ii). [↑](#footnote-ref-500)
500. I.R.C. § 465(b)(6)(D) by reference to I.R.C. § 49(a)(1)(D)(iv). [↑](#footnote-ref-501)
501. I.R.C. § 465(b)(6)(B)(iii). [↑](#footnote-ref-502)
502. I.R.C. § 465(b)(6)(B). A “qualified person” is defined as by reference to I.R.C. § 49(a)(1)(D)(iv). [↑](#footnote-ref-503)
503. Treas. Reg. § 1.465-27(b)(4). [↑](#footnote-ref-504)
504. I.R.C. § 469(a)(2). Personal service corporations and closely held C corporations are subject to I.R.C. § 469 at the corporate level to prevent individuals from avoiding § 469 by incorporating their investment portfolios or investing in tax shelters through their personal service corporations. However, closely held C corporations are subject to a more liberal restriction. *See* I.R.C. § 469(3)(2)(A). [↑](#footnote-ref-505)
505. *See* discussion at *Choice of Vehicle for Acquiring, Holding, and Improving Real Property*, Ch. 10A, Powell on Real Estate, § 10A.03[3][b]. [↑](#footnote-ref-506)
506. Similarly, credits from passive activities are limited to the tax attributable to passive activities. For more detailed information, see 549 T.M., Passive Loss Rules. [↑](#footnote-ref-507)
507. I.R.C. § 469(c)(1). [↑](#footnote-ref-508)
508. I.R.C. § 469(e). [↑](#footnote-ref-509)
509. I.R.C. § 469(e)(1). [↑](#footnote-ref-510)
510. I.R.C. § 469(b). [↑](#footnote-ref-511)
511. I.R.C. § 469(g). [↑](#footnote-ref-512)
512. Note that if the partnership’s activity in which the partner materially participates generates a profit, the taxpayer will not be able to use that profit to offset the loss generated by the passive activity. This may be the case even though the partnership incurred an overall loss for the year, as these separate activity income and loss items could have to be separately stated in the partner’s Form K-1. *See* Treas. Reg. § 1.702-1. [↑](#footnote-ref-513)
513. Treas. Reg. § 1.469-4. [↑](#footnote-ref-514)
514. Treas. Reg. § 1.469-4(c)(2). [↑](#footnote-ref-515)
515. *Id*. The regulations permit activities to be grouped even if they are conducted by different entities, such as a partnership and an LLC, if the taxpayer has an ownership interest in both entities. Treas. Reg. § 1.469-4(d)(5). [↑](#footnote-ref-516)
516. Treas. Reg. § 1.469-4(d)(5). However, once the taxpayer groups his or her activities, the taxpayer may not regroup them unless the original grouping was clearly inappropriate or there has been a material change in facts. [↑](#footnote-ref-517)
517. Treas. Reg. § 1.469-4(c)(3) Ex. 1. If a taxpayer is a partner in a partnership, the grouping of the various activities of the partnership is done first at the partnership level. The individual partner may then group his or her interest in the partnership’s activities. Partners may not ungroup activities that have been grouped together at the partnership level. Also, limited partners may generally not group together activities conducted through different limited partnerships. Treas. Reg. § 1.469-4(d)(3). [↑](#footnote-ref-518)
518. I.R.C. § 469(h)(1). [↑](#footnote-ref-519)
519. Treas. Reg. § 1.469-5T(a). [↑](#footnote-ref-520)
520. Treas. Reg. § 1.469-5T(a)(1). The other material participation tests are: (i) the taxpayer’s participation constitutes all of the participation in the activity of any individual; (ii) the taxpayer participates for more than 100 hours during the year and his or her participation is not less than that of any other individual; (iii) the taxpayer participates for more than 100 hours (but not more than 500 hours) and his or her total participation in all trade or business activities during the year exceeds 500 hours; (iv) the taxpayer materially participated in the activity for five of the preceding ten taxable years; (v) the activity is a personal service activity in which the taxpayer materially participated for any three preceding years; or (vi) based on all the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis. With respect to a closely held C corporation, it is treated as materially participating in an activity if one or more shareholders holding more than 50% of its stock (by value) materially participates. I.R.C. § 469(h)(4). [↑](#footnote-ref-521)
521. Treas. Reg. § 1.469-5T(f)(4). [↑](#footnote-ref-522)
522. Treas. Reg. § 1.469-5T(a). [↑](#footnote-ref-523)
523. Treas. Reg. § 1.469-5T(e)(3)(ii). [↑](#footnote-ref-524)
524. Treas. Reg. § 1.469-5T(e)(2). Note that under the Uniform Limited Partnership Act (2001) a control limitation is no longer imposed on limited partners. [↑](#footnote-ref-525)
525. Treas. Reg. § 1.469-5T(e)(3)(i)(B). [↑](#footnote-ref-526)
526. *See* Gregg v. U.S., 186 F. Supp. 2d 1123 (D. Or. 2001). [↑](#footnote-ref-527)
527. I.R.C. § 469(c)(2). [↑](#footnote-ref-528)
528. *See* Hillman v. Commissioner, 250 F.3d 228 (4th Cir. 2001), rev’g 114 T.C. 103 (2000) (in the absence of regulations, the rules eliminating a similar problem with self-charged interest do not apply to self-charged management fees). [↑](#footnote-ref-529)
529. Treas. Reg. § 1.469–1(e)(3)(ii)(A). [↑](#footnote-ref-530)
530. Treas. Reg. § 1.469–1(e)(3)(ii)(B). [↑](#footnote-ref-531)
531. Treas. Reg. § 1.469–1(e)(3)(ii)(C). [↑](#footnote-ref-532)
532. Treas. Reg. § 1.469–1(e)(3)(ii)(D). [↑](#footnote-ref-533)
533. Treas. Reg. § 1.469–1(e)(3)(ii)(E). [↑](#footnote-ref-534)
534. Treas. Reg. § 1.469–1(e)(3)(ii)(F). [↑](#footnote-ref-535)
535. I.R.C. §§ 469(c)(2), (i). [↑](#footnote-ref-536)
536. I.R.C. § 469(i)(3)(A). For married taxpayers who are living apart and filing separately, each is allowed to deduct only $12,500 of passive losses, and the phase-out begins at $50,000 of adjusted gross income. I.R.C. § 469(i)(5). [↑](#footnote-ref-537)
537. I.R.C. § 469(i)(3)(F). [↑](#footnote-ref-538)
538. S Rept No. 99-313 (PL 99-514) pp. 737-738 ; Instructions to Form 1040, Schedule E. [↑](#footnote-ref-539)
539. I.R.C. § 469(i)(6)(C). [↑](#footnote-ref-540)
540. I.R.C. § 469(i)(6)(A). [↑](#footnote-ref-541)
541. I.R.C. § 469(c)(2). [↑](#footnote-ref-542)
542. I.R.C. § 469(c)(7). [↑](#footnote-ref-543)
543. I.R.C. § 469(c)(7)(B)(i), (ii). [↑](#footnote-ref-544)
544. I.R.C. § 469(c)(7)(C). [↑](#footnote-ref-545)
545. I.R.C. § 469(c)(7)(D)(i). [↑](#footnote-ref-546)
546. I.R.C. § 469(c)(7)(D)(ii). [↑](#footnote-ref-547)
547. I.R.C. § 469(c)(7)(B). [↑](#footnote-ref-548)
548. I.R.C. §§ 705(a), 722, 742. [↑](#footnote-ref-549)
549. I.R.C. § 722. [↑](#footnote-ref-550)
550. I.R.C. § 705(a)(1)(A). [↑](#footnote-ref-551)
551. I.R.C. § 705(a)(1)(B), [↑](#footnote-ref-552)
552. I.R.C. §§ 752(a), 722. *See* discussion below regarding partnership liabilities. [↑](#footnote-ref-553)
553. I.R.C. § 705(a)(2). [↑](#footnote-ref-554)
554. I.R.C. § 705(a)(2)(A). [↑](#footnote-ref-555)
555. I.R.C. § 705(a)(2)(B). [↑](#footnote-ref-556)
556. I.R.C. § 752(b), 733. [↑](#footnote-ref-557)
557. Note that effective for liabilities incurred or assumed by a partnership on or after June 24, 2003, an obligation is considered a Treas. Reg. §1.752-1 liability to the extent the obligation creates or increases the basis of any of the obligor's assets (including cash), gives rise to an immediate deduction to the obligor, or gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. Treas. Reg. §1.752-1(a)(4)(i). T.D. 9207 (5/26/05). All remaining "obligations" (as defined in Treas. Reg. §1.752-1(a)(4)(ii)) are considered Treas. Reg. §1.752-7 liabilities and are subject to special rules. [↑](#footnote-ref-558)
558. I.R.C. §§ 721, 752(a). [↑](#footnote-ref-559)
559. I.R.C. § 705. [↑](#footnote-ref-560)
560. I.R.C. § 704(d). [↑](#footnote-ref-561)
561. *See generally,* 714-2nd T.M., *Partnerships – Allocation of Liabilities; Basis Rules* [↑](#footnote-ref-562)
562. Treas. Reg. § 1.752-1(a)(1). [↑](#footnote-ref-563)
563. Liabilities may be bifurcated into part recourse and part nonrecourse liabilities where there is personal liability for only a portion of the obligation. *See* Treas. Reg. § 1.752-1(i). [↑](#footnote-ref-564)
564. Treas. Reg. § 1.752-1(a)(2). [↑](#footnote-ref-565)
565. Treas. Reg. § 1.752-2(b)(1). [↑](#footnote-ref-566)
566. *See* Treas. Reg. § 1.752-2(f) examples. [↑](#footnote-ref-567)
567. Treas. Reg. § 1.752-3(a). [↑](#footnote-ref-568)
568. Partnership minimum gain is the amount of gain that the partnership would recognize if it disposed of property subject to a nonrecourse liability for no consideration other than the full satisfaction of the liability. Generally this is the difference between the amount of the liability and the (book value) basis of the property. Treas. Reg. § 1.704-2(d)(1). [↑](#footnote-ref-569)
569. Typically this will be the partner’s share of partnership profits as specified in the partnership agreement. However, the Regulations permit the partners to provide in the partnership agreement for a different percentage to be used in this third tier, if that percentage is consistent with allocations of other items. Treas. Reg. § 1.752-3(a)(3). [↑](#footnote-ref-570)
570. Treas. Reg. § 1.752-2(b). [↑](#footnote-ref-571)
571. I.R.C. § 702. [↑](#footnote-ref-572)
572. I.R.C. § 705. [↑](#footnote-ref-573)
573. I.R.C. § 731. [↑](#footnote-ref-574)
574. I.R.C. § 705. [↑](#footnote-ref-575)
575. Treas. Reg. § 1.705-1. [↑](#footnote-ref-576)
576. I.R.C. § 707. [↑](#footnote-ref-577)
577. Note, however, that a partnership could recognize gain or loss if a distribution of money or property to a partner disproportionately changes the partner’s interest in I.R.C. § 751 “hot assets.” *See* I.R.C. § 751(b). [↑](#footnote-ref-578)
578. I.R.C. § 731. [↑](#footnote-ref-579)
579. I.R.C. § 732(a)(1). [↑](#footnote-ref-580)
580. I.R.C. § 732(a)(2). For allocation of the basis among assets received, *see* I.R.C. § 732(c). [↑](#footnote-ref-581)
581. I.R.C. § 1223(1). [↑](#footnote-ref-582)
582. I.R.C. § 733. [↑](#footnote-ref-583)
583. I.R.C. § 1366(d)(1). [↑](#footnote-ref-584)
584. I.R.C. § 1366(d)(2). [↑](#footnote-ref-585)
585. I.R.C. § 1367(a). However, income from discharge of indebtedness of an S corporation that is excluded from the corporation's income under I.R.C. § 108(a) is not taken into account as an item of tax-exempt income that flows through to any shareholder under I.R.C. § 1366(a). This change was made by the Job Creation and Worker Assistance Act of 2002, effective after October 11, 2002 for tax years ending after that date. This provision was enacted specifically to reverse the U.S. Supreme Court case of *Gitlitz v. Commissioner,* 531 U.S. 206 (2001). In *Gitlitz,,* the Supreme Court allowed a shareholder to increase his stock basis by tax-exempt cancellation of debt income, thereby allowing the shareholder sufficient basis to take losses that he did not economically incur. [↑](#footnote-ref-586)
586. *See* I.R.C. § 752(a). [↑](#footnote-ref-587)
587. *See* I.R.C. § 1367(a)(2)(A). [↑](#footnote-ref-588)
588. *See* Frederick G. Brown, TC Memo ¶ 81,608 (1981), *aff’d* 706 F.2d 755 (6th Cir. 1983); Leavitt Est. v. Commissioner, 875 F.2d 420 (4th Cir. 1989); Maloof v. Commissioner, T.C. Memo 2005-75. A shareholder will obtain debt basis if a payment is made on the guaranty, in which case the shareholder steps into the shoes of the creditor. [↑](#footnote-ref-589)
589. *See* Oren v. Commissioner, 357 F.3d 854 (8th Cir. 2004). [↑](#footnote-ref-590)
590. *See* Bolding v. Commissioner, 117 F.3d 270 (5th Cir. 1997); Michael A. Gurda, Jr. v. Commissioner, TC Memo ¶ 87,394 (1987); PLR 8747013. [↑](#footnote-ref-591)
591. I.R.C. § 168(h)(1)(A). [↑](#footnote-ref-592)
592. *See* I.R.C. § 168(h)(1)(B)(ii). A disqualified lease is a lease to a tax-exempt entity where (1) the property was financed with tax-exempt bond financing and the entity participated in the financing; (2) the lease provides for a fixed sale price or sale option which involves the entity; (3) the lease has a term in excess of 20 years, and (4) the lease occurs after the transfer of the property from the entity and the property was used by the entity before the transfer. In determining the lease term, options to renew are taken into account. I.R.C. § 168(i)(3)(A). [↑](#footnote-ref-593)
593. I.R.C. § 168(h)(1)(B)(iii). [↑](#footnote-ref-594)
594. I.R.C. § 168(h)(1)(C)(i). A short term lease for this purpose is defined as a lease the term of which is: (1) less than three years; and (2) less than the greater of one year or thirty percent of the property's present class life (this does not apply to nonresidential real property and property with no present class life). I.R.C. § 168(h)(1)(C)(ii). [↑](#footnote-ref-595)
595. I.R.C. § 168(h)(1)(D). [↑](#footnote-ref-596)
596. *See* I.R.C. § 168(h)(2)(C) for definition of foreign person or entity. [↑](#footnote-ref-597)
597. I.R.C. § 168(h)(2). [↑](#footnote-ref-598)
598. I.R.C. § 168(h)(5)(B). [↑](#footnote-ref-599)
599. I.R.C. § 168(h)(5)(A). [↑](#footnote-ref-600)
600. I.R.C. § 168(h)(6)(C). [↑](#footnote-ref-601)
601. I.R.C. § 169(h)(6)(A). [↑](#footnote-ref-602)
602. I.R.C. § 168(h)(6)(B). [↑](#footnote-ref-603)
603. I.R.C. § 168(g)(1)(B). [↑](#footnote-ref-604)
604. *See* § 2.05[5] above. [↑](#footnote-ref-605)
605. I.R.C. § 47(c)(2)(B)(v). [↑](#footnote-ref-606)
606. I.R.C. § 47(c)(2)(B)(v)(II). [↑](#footnote-ref-607)
607. The law was revised in 1984 to reflect more sophisticated notions of the time value of money. The 1984 law as drafted had numerous technical problems. Transitional rules were drafted which were generally in effect for sales and exchanges after 1984. P.L. 98–612, 98th Cong., 2d Sess. (Oct. 31, 1984). A revised law replaced the transitional rules for sales and exchanges after June 30, 1985. P.L. No. 99–121, 99th Cong., 1st Sess. (Oct. 11, 1985). As a result, there are different rules for potential debt recharacterization depending on when the sale or exchange occurred. [↑](#footnote-ref-608)
608. I.R.C. § 446(c). [↑](#footnote-ref-609)
609. P. L. 98–369, 98th Cong., 2d Sess. (July 18, 1984). [↑](#footnote-ref-610)
610. I.R.C. § 1274(c)(1). [↑](#footnote-ref-611)
611. I.R.C. § 1274(c)(3)(C). [↑](#footnote-ref-612)
612. I.R.C. § 1274(c)(3)(B). [↑](#footnote-ref-613)
613. I.R.C. § 1274(c)(3)(A). [↑](#footnote-ref-614)
614. I.R.C. § 1274(c)(3)(F). [↑](#footnote-ref-615)
615. I.R.C. § 1275(a)(1)(B) (excluded from the definition of “debt instrument”). [↑](#footnote-ref-616)
616. I.R.C. § 1274(c)(3)(D). [↑](#footnote-ref-617)
617. I.R.C. § 1274(c)(3)(E). [↑](#footnote-ref-618)
618. I.R.C. § 1273(a)(2). [↑](#footnote-ref-619)
619. I.R.C. § 1274(b)(1), (2). [↑](#footnote-ref-620)
620. I.R.C. § 1274(c). [↑](#footnote-ref-621)
621. Treas. Reg. § 1.1274-4(b). [↑](#footnote-ref-622)
622. I.R.C. § 1274(d)(1)(A). [↑](#footnote-ref-623)
623. I.R.C. § 1274(d)(2)(B). [↑](#footnote-ref-624)
624. I.R.C. § 1274A(a), (b). [↑](#footnote-ref-625)
625. I.R.C. § 1274(e). [↑](#footnote-ref-626)
626. I.R.C. § 1274A(c). [↑](#footnote-ref-627)
627. I.R.C. § 1274A(c)(3). [↑](#footnote-ref-628)
628. I.R.C. § 1274A(d)(2). [↑](#footnote-ref-629)
629. I.R.C. § 1271(a)(2). [↑](#footnote-ref-630)
630. I.R.C. § 1274(c)(4). [↑](#footnote-ref-631)
631. Treas. Reg. § 1.1274-5(c). [↑](#footnote-ref-632)
632. I.R.C. § 483(c)(1)(A). Once this threshold is met, Section 483 recharacterizes all payments due more than six months after the sale or exchange. I.R.C. § 483(c)(1). [↑](#footnote-ref-633)
633. I.R.C. § 483(c)(1)(B). Total instated interest means an amount equal to the excess of (i) the sum of the payments which are due under the contract over (ii) the sum of the present value of payments, including interest, under the contract, determined using the AFR prescribed by I.R.C. §1274(d). [↑](#footnote-ref-634)
634. I.R.C. § 483(d)(1). [↑](#footnote-ref-635)
635. I.R.C. § 483(d)(2). [↑](#footnote-ref-636)
636. I.R.C. § 483(e). [↑](#footnote-ref-637)
637. I.R.C. § 103(b). [↑](#footnote-ref-638)
638. I.R.C. § 141(e)(2). The bonds must also satisfy the technical requirements of I.R.C. § 147. *See* I.R.C. § 141(e)(3). [↑](#footnote-ref-639)
639. I.R.C. § 141(e). [↑](#footnote-ref-640)
640. *See* I.R.C. § 142(a) for the complete list. [↑](#footnote-ref-641)
641. Treas. Reg. § 1.103-8. [↑](#footnote-ref-642)
642. I.R.C. § 141(d)(1). [↑](#footnote-ref-643)
643. I.R.C. § 141(e)(1)(B), (C). [↑](#footnote-ref-644)
644. I.R.C. § 143(a)(2)(A). [↑](#footnote-ref-645)
645. The single family residences must be located in the jurisdiction of the authority issuing the obligation. I.R.C. § 143(c). [↑](#footnote-ref-646)
646. At least 95% of the net proceeds of the issue must be used to finance the residences of mortgagors who had no present ownership interest in their principal residences during the three-year period ending on the date the mortgage is executed. I.R.C. § 143(d)(1). [↑](#footnote-ref-647)
647. The acquisition cost of each residence for which owner-financing is provided can not exceed 90% of the average area purchase price applicable to the residence. I.R.C. § 143(e)(1). [↑](#footnote-ref-648)
648. The mortgagor’s family income can not exceed, depending on the size of the family, 100% or 115% of the applicable median family income. I.R.C. § 143(f)(1), (f)(6)(A). [↑](#footnote-ref-649)
649. The issuer must generally use amount received as repayment of principal to redeem the bonds. I.R.C. § 143(a)(2)(A)(iv). [↑](#footnote-ref-650)
650. At least 20% of the proceeds must be available for targeted area residences. I.R.C. § 143(h)(1). [↑](#footnote-ref-651)
651. *See* I.R.C. §§ 143(g); 143(i)(1); 141(b)(1). [↑](#footnote-ref-652)
652. I.R.C. § 121; *see* § 2.13[3] below. [↑](#footnote-ref-653)
653. I.R.C. § 1014(a); *see* § 2.17[4][a] below. [↑](#footnote-ref-654)
654. See T.A.M. 200604033. [↑](#footnote-ref-655)
655. *See* Frank Lyon Co. v. U.S., 435 U.S. 561 (1978). [↑](#footnote-ref-656)
656. I.R.C. § 1016. [↑](#footnote-ref-657)
657. I.R.C. § 1012. [↑](#footnote-ref-658)
658. *See, e.g.,* § 1015. [↑](#footnote-ref-659)
659. I.R.C. § 1014. [↑](#footnote-ref-660)
660. I.R.C. § 1001(a). [↑](#footnote-ref-661)
661. I.R.C. § 1001(b). [↑](#footnote-ref-662)
662. *See* Commissioner v. Tufts, 461 U.S. 300 (1983); Crane v. Commissioner, 331 U.S. 1 (1947). [↑](#footnote-ref-663)
663. I.R.S. Pub 17. [↑](#footnote-ref-664)
664. I.R.C. § 1222(1). [↑](#footnote-ref-665)
665. I.R.C. § 1222(3) [↑](#footnote-ref-666)
666. Rev. Rul. 66-7, 1966-1 C.B. 188. [↑](#footnote-ref-667)
667. Rev. Rul. 54-607, 1954-2 C.B. 177; Rev. Rul. 70-598, 1970-2 C.B. 168. [↑](#footnote-ref-668)
668. I.R.C. § 1223(1) [↑](#footnote-ref-669)
669. Even if a taxpayer is a dealer in real estate, the taxpayer may hold certain properties for investment rather than for sale to customers, and could receive capital asset treatment for those properties. *See* Rev. Rul. 57-565, 1957-2 C.B. 546. [↑](#footnote-ref-670)
670. *See* Malat v. Riddell, 383 U.S. 569 (1966). [↑](#footnote-ref-671)
671. *See, e.g.,* Norris v. Commissioner, TC Memo 1986-151; Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992). [↑](#footnote-ref-672)
672. *See* § 2.13[1][d] above. [↑](#footnote-ref-673)
673. I.R.C. § 1222(11). [↑](#footnote-ref-674)
674. I.R.C. § 1211(a). [↑](#footnote-ref-675)
675. I.R.C. § 1212(a). [↑](#footnote-ref-676)
676. I.R.C. § 1211(b)(2). [↑](#footnote-ref-677)
677. I.R.C. § 1(h). [↑](#footnote-ref-678)
678. I.R.C. § 1(h)(4). [↑](#footnote-ref-679)
679. I.R.C. § 121. The exclusion of gain on the sale of a principal residence was introduced by the Taxpayer Relief Act of 1997, effective for sales or exchanges after May 6, 1997. Under prior law, an individual could generally defer recognition of gain on the sale of a principal residence if a replacement residence was purchased within two years before or after the sale of the old residence, both the old and new residences were owned and used by the individuals as a principal residence and the cost of the replacement residence was at least equal to the adjusted sale price of the old residence. Individuals age 55 or older could exclude up to $125,000 of the gain realized on the sale of their principal residence if they owned and used the residence as their principal residence for at least three years during the five-year period ending on the date of sale. [↑](#footnote-ref-680)
680. I.R.C. § 121(f). [↑](#footnote-ref-681)
681. I.R.C. § 121(a). The regulations look to use for at least 24 full months or 730 days. Treas. Reg. § 1.121-1(c)(1). [↑](#footnote-ref-682)
682. Treas. Reg. § 1.121-1(c)(2). [↑](#footnote-ref-683)
683. Treas. Reg. § 1.121-1(c)(1). [↑](#footnote-ref-684)
684. I.R.C. § 121(b)(3). [↑](#footnote-ref-685)
685. I.R.C. § 121(b)(2). [↑](#footnote-ref-686)
686. Treas. Reg. § 1.121-2(a)(4) Ex 4. [↑](#footnote-ref-687)
687. I.R.C. § 121(d)(3)(A). [↑](#footnote-ref-688)
688. I.R.C. § 121(d)(3)(B). This rule benefits the spouse who vacated a principal residence prior to its sale. The non-resident spouse under the gain roll-over provision of former I.R.C. § 1034 (see footnote 678) was not entitled to gain deferral on a sale if the residence was no longer his or her principal residence. [↑](#footnote-ref-689)
689. The principal residence gain roll-over of former I.R.C. § 1034 (see footnote 678) applied only to dwellings that were the principal residence of the taxpayer at the time of sale. [↑](#footnote-ref-690)
690. I.R.C. § 121(d)(6). [↑](#footnote-ref-691)
691. Treas. Reg. § 1.121-1(e)(1). [↑](#footnote-ref-692)
692. Treas. Reg. § 1.121-1(e)(4) Ex 5. [↑](#footnote-ref-693)
693. I.R.C. § 121(c)(2)(B). [↑](#footnote-ref-694)
694. Treas. Reg. § 1.121-3(b). [↑](#footnote-ref-695)
695. Treas. Reg. § 1.121-3(c)(1). [↑](#footnote-ref-696)
696. Treas. Reg. § 1.121-3(c)(2). [↑](#footnote-ref-697)
697. Treas. Reg. § 1.121-3(d)(1), (f). [↑](#footnote-ref-698)
698. Treas. Reg. § 1.121-3(d)(2). [↑](#footnote-ref-699)
699. Treas. Reg. § 1.121-3(e)(1). [↑](#footnote-ref-700)
700. Treas. Reg. § 1.121-3(e)(2). [↑](#footnote-ref-701)
701. *See* PLR 200403049 (neighborhood hostility); 200615011 (police officer who feared for his family’s safety); 200601009 (crime in neighborhood). [↑](#footnote-ref-702)
702. I.R.C. § 1033. This section does not apply to losses. Losses recognized on an involuntary conversion are treated as a sale or exchange, and may be deductible as a capital loss or as a casualty loss. *See* I.R.C. § 165. For detailed discussion, *see* Ch 79G, *Involuntary Conversions*, Powell on Real Estate. [↑](#footnote-ref-703)
703. I.R.C. § 1033(a). [↑](#footnote-ref-704)
704. *See* discussion at § 2.15 below. [↑](#footnote-ref-705)
705. Treas. Reg. § 1.1033(a)-2(c)(9)(i). [↑](#footnote-ref-706)
706. Rev. Rul. 76-319, 1976-2 C.B. 242. [↑](#footnote-ref-707)
707. Liant Record Inc. v. Commissioner, 303 F.2d 326 (2nd Cir. 1962); Steuart Bros Inc. v. Commissioner, 261 F2d 580 (4th Cir. 1958); Davis v. U.S., 589 F2d 446 (9th Cir. 1979). [↑](#footnote-ref-708)
708. Rev. Rul. 80-184, 1980-2 C.B. 232. [↑](#footnote-ref-709)
709. *See* § 2.15[4] below for discussion of the like kind standard. [↑](#footnote-ref-710)
710. I.R.C. § 1033(a)(2)(B). [↑](#footnote-ref-711)
711. *See* I.R.C. § 1033(h)(1)(B) (four years for a principal residence involuntarily converted in a Presidentially-declared disaster area); § 1033(e)(2) (four years for livestock replaced due to drought and other weather conditions). Taxpayers may also request an extension of time to replace, which will be granted at the discretion of the Internal Revenue Service. *See* Treas. Reg. § 1.1033(a)-2(c)(3). [↑](#footnote-ref-712)
712. I.R.C. § 1033(g)(4). [↑](#footnote-ref-713)
713. Treas. Reg. § 1.1033(a)-2(c)(2). [↑](#footnote-ref-714)
714. Treas. Reg. § 1.1033(a)-2(c)(1). [↑](#footnote-ref-715)
715. Treas. Reg. § 1.033(a)-2(c)(11). [↑](#footnote-ref-716)
716. I.R.C. § 1033(b)(2). [↑](#footnote-ref-717)
717. Rev. Rul. 90-16, 1990-1 C.B. 12. [↑](#footnote-ref-718)
718. I.R.C. § 61(a)(12). [↑](#footnote-ref-719)
719. Commissioner v. Tufts, 461 U.S. 300 (1983). [↑](#footnote-ref-720)
720. I.R.C. § 6045(e)(1) [↑](#footnote-ref-721)
721. Treas. Reg. § 1.6045-1(d)(2). [↑](#footnote-ref-722)
722. Treas. Reg. § 1.6045-4(i). [↑](#footnote-ref-723)
723. I.R.C. § 6045(b). [↑](#footnote-ref-724)
724. Treas. Reg. § 1.6045-4(d)(1)(i). [↑](#footnote-ref-725)
725. I.R.C. § 6045; Treas. Reg. § 1.6045-4(e)(4)(iv). [↑](#footnote-ref-726)
726. Treas. Reg. § 1.6045-4(e)(5)(i). [↑](#footnote-ref-727)
727. I.R.C. § 6045(e)(5). *See* discussion in [a] above for definition of real estate reporting person. [↑](#footnote-ref-728)
728. 2007-4 I.R.B. 357. [↑](#footnote-ref-729)
729. For this purpose, “seller” includes each owner of the residence that is sold or exchanged. Thus, if a residence has more than one owner, a real estate reporting person must obtain a certification from each owner (whether married or not). [↑](#footnote-ref-730)
730. I.R.C. § 6721(a). The penalty is increased to $100 if the failure to file is due to intentional disregard of the filing requirement. I.R.C. § 6721(e). [↑](#footnote-ref-731)
731. I.R.C. § 6722(a). [↑](#footnote-ref-732)
732. I.R.C. § 6724(d)(1)(B)(iii). [↑](#footnote-ref-733)
733. Discussed in [b] above. [↑](#footnote-ref-734)
734. Treas. Reg. § 1.6724-1(a). [↑](#footnote-ref-735)
735. *See* Ch. 18 *infra* for an in-depth treatment of installment sales **EDITOR: IS THIS CORRECT?** [↑](#footnote-ref-736)
736. I.R.C. § 1001. [↑](#footnote-ref-737)
737. I.R.C. § 453(b)(1). [↑](#footnote-ref-738)
738. I.R.C. § 453(a). [↑](#footnote-ref-739)
739. I.R.C. § 453(b)(2). [↑](#footnote-ref-740)
740. I.R.C. § 453(l). [↑](#footnote-ref-741)
741. I.R.C. § 453(d); Treas. Reg. § 15a.453-1(d)(3). *See* Rev. Rul. 90-46, 1990-1 C.B. 107 for guidance on when the I.R.S. will grant permission to make a late election out of installment reporting [↑](#footnote-ref-742)
742. Treas. Reg. § 15a.453-1(d)(2). [↑](#footnote-ref-743)
743. Treas. Reg. § 15a.453-1(d)(4). [↑](#footnote-ref-744)
744. I.R.C. § 453(c). [↑](#footnote-ref-745)
745. Treas. Reg. § 15a.453-1(b)(2)(iii). [↑](#footnote-ref-746)
746. Treas. Reg. § 15a.453-1(b)(2)(ii). [↑](#footnote-ref-747)
747. Treas. Reg. § 15a.453-1(b)(2)(v). [↑](#footnote-ref-748)
748. Treas. Reg. § 15a.453-1(b)(3). [↑](#footnote-ref-749)
749. I.R.C. § 453(f)(3); Treas. Reg. § 15a.453-1(b)(3)(i). [↑](#footnote-ref-750)
750. Treas. Reg. § 15a.453-1(b)(3)(i). [↑](#footnote-ref-751)
751. I.R.C. § 453(f)(4). [↑](#footnote-ref-752)
752. Treas. Reg. § 15a.453-1(b)(3)(i). [↑](#footnote-ref-753)
753. Treas. Reg. § 15a.453-1(b)(2)(iv). [↑](#footnote-ref-754)
754. Treas. Reg. § 15a.453-1(b)(3)(i). [↑](#footnote-ref-755)
755. I.R.C. § 453(i). [↑](#footnote-ref-756)
756. Treas. Reg. § 15a.453-1(b)(5) Ex 1. [↑](#footnote-ref-757)
757. Treas. Reg. § 15a.453-1(b)(5) Ex 2. [↑](#footnote-ref-758)
758. I.R.C. § 453(e)(1). [↑](#footnote-ref-759)
759. I.R.C. § 453(e)(2). [↑](#footnote-ref-760)
760. I.R.C. § 453(e)(6), (7). [↑](#footnote-ref-761)
761. I.R.C. § 453(f). [↑](#footnote-ref-762)
762. I.R.C. § 453(g). [↑](#footnote-ref-763)
763. I.R.C. § 453A(d)(4). [↑](#footnote-ref-764)
764. *See* Ch 8, Tax-Free Exchange of Real Estate, *infra*. [↑](#footnote-ref-765)
765. Treas. Reg. § 1.1031(a)-1(a)(1). [↑](#footnote-ref-766)
766. Click v. Commissioner, 78 T.C. 225 (1982); Regals Realty Co. v. Commissioner, 127 F.2d 931 (2nd Cir. 1942); Land Dynamics v. Commissioner, TC Memo 1978-259. [↑](#footnote-ref-767)
767. Griffin v. Commissioner, 49 T.C. 253 (1967). [↑](#footnote-ref-768)
768. Regals Realty Co. v. Commissioner, 127 F.2d 931 (2nd Cir. 1942). [↑](#footnote-ref-769)
769. Click v. Commissioner, 78 T.C. 225 (1982). [↑](#footnote-ref-770)
770. Lindsley, Jr., v. Commissioner, TC Memo 1983-729. [↑](#footnote-ref-771)
771. Rev. Rul. 75-292, 1975-2 C.B. 333. [↑](#footnote-ref-772)
772. Rev. Rul. 77-337, 1977-2 C.B. 305. [↑](#footnote-ref-773)
773. Maloney v. Commissioner, 93 T.C. 89 (1989). [↑](#footnote-ref-774)
774. 760 F.2d 1039 (9th Cir. 1985). [↑](#footnote-ref-775)
775. 753 F.2d 1490 (9th Cir. 1985). [↑](#footnote-ref-776)
776. I.R.C. § 1031(a)(2)(D). [↑](#footnote-ref-777)
777. I.R.C. § 1031(a), (b). [↑](#footnote-ref-778)
778. I.R.C. § 1031(b). [↑](#footnote-ref-779)
779. *See* Streer, *Like Kind Exchanges of Real Property: The Element of Intent*, The Tax Advisor, Jan 1986; Stanley Klaskowski v. Commissioner, 24 T.C.M. 1827; Rev. Rul. 57-244, 1957-1 C.B. 247. [↑](#footnote-ref-780)
780. *See* Dibsey v. Commissioner, T.C. Memo 1995-477. [↑](#footnote-ref-781)
781. Treas. Reg. § 1.1031(a)–1(b). [↑](#footnote-ref-782)
782. I.R.C. § 1031(a)(2), (e). [↑](#footnote-ref-783)
783. I.R.C. § 1031(h). *See* Wyndelts & Fowler, *More Restrictions on Like-Kind Exchanges,* 19 Real Est. L.J. 144 (1990). [↑](#footnote-ref-784)
784. I.R.C. § 1001. [↑](#footnote-ref-785)
785. This will be accomplished by the calculation of the basis in the replacement property. I.R.C. § 1031(d). [↑](#footnote-ref-786)
786. I.R.C. § 1031(b). [↑](#footnote-ref-787)
787. I.R.C. § 1031(d); Treas. Reg. § 1.1031(d)-1(a). For examples of basis calculations, *see* Ch 8, The Tax-Free Exchange of Real Estate, *infra*. [↑](#footnote-ref-788)
788. I.R.C. § 1031(b). [↑](#footnote-ref-789)
789. Treas. Reg. § 1.1031(d)-2. [↑](#footnote-ref-790)
790. *See* Treas. Reg. § 1.1031(d)-2 Ex. 2(c). [↑](#footnote-ref-791)
791. The taxpayer receiving boot will be taxed on that amount, up to the taxpayer’s realized gain. *See* § 2.15[5] above. [↑](#footnote-ref-792)
792. *See* § 2.15[7][c] below. [↑](#footnote-ref-793)
793. *See* § Treas. Reg. § 1.1031(k)-1(g)(4) regarding requirements for the intermediary. [↑](#footnote-ref-794)
794. The statutory limitations of I.R.C. § 1031(a)(3) arose due to the *Starker* case, 602 F.2d 1341 (9th Cir. 1979), in which the Ninth Circuit held that the transfer of the relinquished property and the transfer of the replacement property in a like-kind exchange does not have to be simultaneous. The Ninth Circuit approved the exchange even though the taxpayer could receive replacement property or cash up to five years after the transfer of the relinquished property, thereby treating the contractual right to receive property the same as ownership in the replacement property. [↑](#footnote-ref-795)
795. I.R.C. § 1031(a)(3). [↑](#footnote-ref-796)
796. Treas. Reg. § 1.1031(k)-1(c)(2). [↑](#footnote-ref-797)
797. Treas. Reg. § 1.1031(k)-1(c)(4)(i). For purposes of the rules set forth in Treas. Reg. § 1.1031(k)-1, including the 200% rule, the fair market value of property means its value without regard to any liabilities secured by the property. Treas. Reg. § 1.1031(k)-1(m). [↑](#footnote-ref-798)
798. Treas. Reg. § 1.1031(k)-1(d)(1). [↑](#footnote-ref-799)
799. Treas. Reg. § 1.1031(k)-1(e)(1). [↑](#footnote-ref-800)
800. Treas. Reg. § 1.1031(k)-1(f)(1). According to the Regulations, a taxpayer is in constructive receipt of sale proceeds “at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Treas. Reg. § 1.1031(k)-1(f)(2). [↑](#footnote-ref-801)
801. Treas. Reg. § 1.1031(k)-1(g). [↑](#footnote-ref-802)
802. It is important that the intermediary used in a tax-deferred exchange is a “qualified intermediary,” in order to avoid the intermediary being treated as a “agent” of the taxpayer’s. If an intermediary is an agent of the taxpayer’s, then the taxpayer will be in constructive receipt of the proceeds of sale of the relinquished property and the exchange will fail. [↑](#footnote-ref-803)
803. See Treas. Reg. § 1.1031(k)-1(g)(4). [↑](#footnote-ref-804)
804. Based on Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). [↑](#footnote-ref-805)
805. *See* T.D. 8346, 1991-1 C.B. 150. [↑](#footnote-ref-806)
806. 2000-2 C.B. 308. *See generally,* Lipton, *New Revenue Procedure on Reverse Like Kind Exchanges Replaces Tax Risk with Tax Certainty,* 93 J. Tax'n 327 (Dec. 2000); Levine, *Long-Awaited IRS Guidance on “Parking Arrangements” Facilitates Like-Kind Exchanges,* 28 J. Real Est. Tax'n 91 (Winter 2001). [↑](#footnote-ref-807)
807. For detailed discussion, see Ch 8, The Tax-Free Exchange of Real Estate, § 8.03[4], infra. [↑](#footnote-ref-808)
808. I.R.C. § 528(c)(1). [↑](#footnote-ref-809)
809. I.R.C. § 528(c)(1)(E); Treas. Reg. § 1.528-8 (form 1120-H is used to make the election). [↑](#footnote-ref-810)
810. I.R.C. § 528(c)(4). [↑](#footnote-ref-811)
811. As defined in I.R.C. § 528(d)(1). [↑](#footnote-ref-812)
812. I.R.C. § 2210(a). [↑](#footnote-ref-813)
813. *See* I.R.C. § 2001 *et seq.* [↑](#footnote-ref-814)
814. I.R.C. § 2032A(a)(3). [↑](#footnote-ref-815)
815. I.R.C. § 2032A(c). [↑](#footnote-ref-816)
816. I.R.C. § 2032A(c)(7). [↑](#footnote-ref-817)
817. I.R.C. § 2031(c)(8). [↑](#footnote-ref-818)
818. Defined in I.R.C. § 170(h)(4)(E). [↑](#footnote-ref-819)
819. I.R.C. § 2031(c)(8)(B). [↑](#footnote-ref-820)
820. I.R.C. § 2031(c)(5)(D). [↑](#footnote-ref-821)
821. I.R.C. § 2031(c)(3). [↑](#footnote-ref-822)
822. I.R.C. § 2031(c)(2). [↑](#footnote-ref-823)
823. I.R.C. § 2031(c)(9). [↑](#footnote-ref-824)
824. I.R.C. § 2032A(c)(8). [↑](#footnote-ref-825)
825. I.R.C. § 170(h)(5)(B)(ii). [↑](#footnote-ref-826)
826. I.R.C. § 1014(b)(6). [↑](#footnote-ref-827)
827. I.R.C. § 1022. [↑](#footnote-ref-828)
828. I.R.C. § 1022(e). [↑](#footnote-ref-829)
829. I.R.C. § 1022(d)(1)(B)(iv). [↑](#footnote-ref-830)
830. I.R.C. § 1022(b)(2)(B). [↑](#footnote-ref-831)
831. I.R.C. § 1022(b)(2)(C). [↑](#footnote-ref-832)
832. I.R.C. § 1022(c)(2)(B). [↑](#footnote-ref-833)
833. I.R.C. § 1022(b)(3). [↑](#footnote-ref-834)
834. I.R.C. § 1022(d)(4). [↑](#footnote-ref-835)
835. I.R.C. § 1022(d)(1)(A). [↑](#footnote-ref-836)
836. I.R.C. § 1022(d)(1)(B)(i)(I) [↑](#footnote-ref-837)
837. I.R.C. § 1022(d)(1)(B)(i)(II). [↑](#footnote-ref-838)
838. I.R.C. § 1022(d)(1)(B)(ii). [↑](#footnote-ref-839)
839. I.R.C. § 1022(d)(1)(B)(iv). [↑](#footnote-ref-840)
840. I.R.C. § 1022(d)(1)(C)(i). [↑](#footnote-ref-841)
841. I.R.C. § 1022(f). [↑](#footnote-ref-842)
842. I.R.C. § 1022(d)(1)(D)(i). [↑](#footnote-ref-843)
843. I.R.C. § 1022(d)(1)(D)(ii). [↑](#footnote-ref-844)
844. I.R.C. § 1022(d)(1)(D)(iii). [↑](#footnote-ref-845)
845. I.R.C. § 1022(d)(1)(D)(iv). [↑](#footnote-ref-846)
846. I.R.C. § 1022(d)(2). [↑](#footnote-ref-847)
847. *See* § 2.13[3] above. [↑](#footnote-ref-848)
848. I.R.C. § 121(d)(11). [↑](#footnote-ref-849)
849. I.R.C. § 121(d)(11)(C). [↑](#footnote-ref-850)
850. I.R.C. § 1041(a), effective for estates of decedents dying after December 31, 2009. [↑](#footnote-ref-851)
851. See I.R.C. § 72(t)(2). [↑](#footnote-ref-852)
852. I.R.C. § 72(t)(2)(F). [↑](#footnote-ref-853)
853. I.R.C. § 72(t)(8)(C). [↑](#footnote-ref-854)
854. I.R.C. § 72(t)(8)(D). [↑](#footnote-ref-855)