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Tax Summit 2021

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A Deeper Dive Into
Several Real Estate Tax Topics

Tax Issues at Each Stage of Real Estate Ownership

- Acquisition
  - Who is buying? [individual, investors, business, best structure]
  - How will it be financed? [debt, equity, both]
  - What will you do with the property? [live in it, rent it, hold for appreciation, business]
- Ownership / Management
  - Personal Residence
    - Deduction for mortgage interest and property taxes, but only if you itemize
  - Rental / Investment Property
    - Above deductions plus depreciation, operating expenses, some repairs (whether itemize or not)
- Sale / Disposition
  - Personal Residence [Exclusion of Capital Gains]
  - Rental / Investment Property [sale or 1031 like-kind exchange]
    - Capital gains; depreciation recapture

Tax Issues of Residential Real Estate

- Acquiring
  - Apportionment of property taxes
  - Interest on mortgage vs. nondeductible service charges & other expenses
- Owning
  - Property tax deduction
  - Mortgage interest deduction
  - Office-at-home deduction
  - Conversion to rental property
  - Vacation homes rented by owner
- Selling
  - Exclusion of Gain on Sale of Principal Residence
  - Loss on Sale of Residence – not deductible

Apportionment of Real Property Taxes

- Generally, certain costs (including RE taxes) are pro-rated between buyer & seller
  - Seller usually responsible from 1st of year to closing date & buyer for rest of year
  - Can be bargaining issue, but regardless, tax law provides who gets to deduct

Apportionment of Real Property Taxes

- Tax law provides for statutory apportionment
  - Based on # of days each holds property

- **Example:**
  - Property tax year runs from April 1 to March 31
  - Adams sells home to Baker on June 30
  - Annual property taxes are $3,650
    - Adams (seller) is allocated 90 days (04/01 to 06/29) or $900 (90/365*$3,650)
    - Baker (buyer) is allocated 275 days (06/30 to 03/31) or $2,750 (275/365*$3,650)

Mortgage interest vs. nondeductible service charges and other expenses

- To be deductible, charges to borrower must be interest and not fees for services rendered in making the loan (which are nondeductible)
- Points are generally deductible if they are additional interest and if paid by borrower directly from separate funds and not deducted from proceeds
- Other expenses are usually nondeductible but can be added to basis of home – smart to keep track of them

Real Property Tax Deduction

- Tax law allows homeowners to deduct state & local real property taxes
  - Before 2018, deduction was unlimited, but now subject to overall SALT deduction limit of $10,000
    - Limit scheduled to expire at end of 2025
    - Political hot potato
  - Tax must be levied for general public welfare – special assessments not deductible
  - Itemized deduction

Mortgage Interest Deduction

- History
- Defining terms:
  - Acquisition Indebtedness - $1 million limit (reduced to $750K from 2018-2025), but $1 million limit grandfathered
    - Refinancing
    - Principal residence plus one qualifying second home
  - Home Equity Indebtedness – interest deduction suspended from 2018-2025)
  - Qualified Residence
  - Debt must be secured by Qualified Residence
  - Pre-12/15/2017 Indebtedness (grandfathered)
- Mortgage insurance premiums – deduction expires at 12/31/2021
- Itemized deduction

Office-at-Home Deduction

- Self-employed & business owners may claim deduction for a home office, but only if you meet 2 fairly strict tests:
  - **Exclusive Use Test:**
    - Principal place of business,
    - Place of business used by clients, customers in meeting with taxpayer in normal course of business, or
    - If separate structure, used in connection w/place of business.
  - **Qualifying Purpose Test:**
    - Essential to taxpayer’s business
    - Taxpayer spends substantial time in home office
    - No other location available for office functions
  - No longer deductible for employees (2017 tax act suspended misc. itemized deductions from 2018-2025)

Office-at-Home Deduction

Optional, Simplified Method

- Safe Harbor
- Limited to $1,500 per year ($5 per sq ft, max of 300 sq ft)
- No additional deduction for depreciation
- Mortgage interest & property tax still fully deductible on Schedule A
- Basic tests for eligibility still apply

Office-at-Home Deduction

- Limits on Deduction:
  - Cannot create a business loss
  - Cannot exceed gross income from business use of residence (less directly allocated expenses)
  - “Deductions otherwise allowable” deduction and limitation
  - Business expense deduction and limitation

Office-at-Home Deduction - Example

- Assume Allison has 200 sq. ft. room for office in 2,000 sq. ft. home, or 10%
- Allison realizes $10,500 in gross income after deducting expenses directly allocable to business
- Her MID and taxes are $25K & $10K, meaning $3,500 is allocated to home office
- Allison also has homeowner’s insurance cost of $1,000, utilities of $5,000, and lawn care of $500
- 1st limit is gross income less directly allocable expenses – or $10,500
- 2nd limit is computed by deducting “otherwise allowable” expenses from 1st limit (MID and property taxes totaling $3,500) so, $10,500 - $3,500 = $7,000
- 3rd limit is business expense deduction, which totals $100 for insurance, $500 for utilities, and none for lawn care, for $600 total
  - Subtracting $600 from $7,000 gives us final limit of $6,400
  - Thus, Allison’s depreciation or rent expense is limited to $6,400

Residence Converted to Investment Rental Property

Vacation Home Rented by Owner

Vacation Home Rental - Example

- Bob rents out his vacation home for 90 days, uses it for 20 days himself, and lets his brother use it for 10 days
  - Rental allocation will be 90/120 or 75%
- He receives rent income of $9,000 and pays $1,000 to property manager, giving him gross rent of $8,000
- MID = $5,000 and property tax = $3,000
  - 75% of these otherwise allowable deductions = $6,000
  - 1st limitation: $8,000 - $6,000 = $2,000
- Insurance = $800 and utilities = $1,200
  - 75% of these deductions = $1,500
  - 2nd limitation: $2,000 - $1,500 = $500
  - Maximum depreciation Bob can deduct is $500

Exclusion of Gain on Sale of Principal Residence

- Eligible single taxpayer can exclude up to $250K; married filing joint return can exclude up to $500K
- Exclusion applies if, during 5-year period ending on sale date, property was owned and used by taxpayer for periods totaling 2 years or more
  - Can be used only once every 2 years
- Hardship Relief Exceptions

Exclusion of Gain on Sale – Hardship Relief

- Ownership & use and 2-year waiting period requirements are relaxed in certain cases
  - If taxpayer qualifies for hardship relief, amount excludable = portion of 2 years that requirements are met
  - Reasons that qualify for relief include:
    - Change in place of employment, health, or unforeseen circumstances
    - Example 1: Allie buys a home and uses it for residence. 12 months later she sells it due to job change. She can exclude up to $125K of the gain (12/24 x $250K)
    - Example 2: Harold owns a house and has lived in it since 2016. On 1/15/2019, Harold marries Wendy, and she moves into the house as her principal residence. On 1/15/2020, Harold sells the house due to Wendy's job change. In this case, the sum of their separate limits are used. Harold can exclude up to $250K because he meets both requirements. But Wendy can get only a limited exclusion of $125K because she has only lived there for one year (12/24 x $250K) for a total exclusion of up to $375K

Rental or Investment Real Estate

- Acquiring
- Owning
- Selling

Acquiring Rental or Investment Real Estate

- Form of ownership and/or legal entity
- Financing
  - Deductions for interest
  - Points
- Expenses of purchase
  - Mostly not currently deductible
- Basis of property

Owning Rental or Investment Real Estate

- Income
- Operating expenses
- Repairs vs capitalization
- Depreciation

Operating Expenses

- Two types of expenses relating to real estate:
  - Section 162 – ordinary & necessary expenses of carrying on a real estate business
  - Section 212 – ordinary & necessary expenses paid or incurred in the management, conservation, or maintenance of a building related to rental purposes
- However, repair rules present challenges to deductibility
  - Require certain expenditures to be capitalized and cost recovered over life of property
  - Regulations are comprehensive & complex

Repairs vs. Improvements - Regulations

- Area of long-standing controversy between taxpayers and IRS – when is an expenditure currently deductible as a repair and when does it need to be capitalized?

- In 2013, Treasury released final regulations
  - Lengthy and comprehensive
  - Effective January 1, 2014

Repairs – Deductible or Capitalized?

- General Rule for Capitalization in Regulations:
  - No deduction is allowed for any amount paid for new buildings or for permanent improvements made to increase the value of any property or for any amount paid for restoring property
- What is an "improvement"?
  - Property is improved if the amounts paid for activities performed after property is placed in service produce any of the following results:
    - A betterment
    - A restoration
    - An adaptation to a new or different use

Depreciation

General Depreciation Principles

- Depreciation allowed only for property with limited useful life
  - Thus, land is never depreciable (although certain land improvements can be)
- Depreciation does not apply to inventory or stock in trade
  - Thus, residential builders can not depreciate model homes if for sale
- When does depreciation begin?
  - When asset is placed in service

Depreciation of Real Estate

- Computed using 3-step process:

1. Determine applicable depreciation <u>method</u> (almost always S-L for real property)
2. Determine applicable recovery <u>period</u>
   - **27.5 years for residential rental property**
   - **39 years for nonresidential real property**
   - Certain property qualifies for **15-year** recovery period
     - Retail motor fuels outlet
     - Qualified Improvement Property (see next slide)
   - Taxpayers may make computation or use IRS tables
3. Determine applicable <u>convention</u> (for real property, use mid-month convention)

Qualified Improvement Property

- 2017 tax law consolidated the following into one new category now known as "Qualified Improvement Property"
  - Qualified Leasehold Improvement Property
  - Qualified Restaurant Property
  - Qualified Retail Improvement Property
    - 15-year recovery period

- Definition: An improvement to interior portion of non-residential building if placed in service after building was first placed in service
  - Does not include building enlargement, elevator, escalator, or internal structural framework

Other RE Depreciation Issues

- Depreciation of land improvements
  - Depreciated over 15 years using 150% DB method
- Cost segregation studies
  - Not same as component depreciation
  - Used to identify personal property – can be depreciated faster

Passive Loss Limitations

How Passive Loss Rules Were Designed to Work

- Deductions from passive trade or business activities, to extent they exceed income from such activities, cannot be deducted from any other income, including salaries, or from portfolio income (e.g., interest & dividends), or against gains or losses from disposition of portfolio assets

- Tax credits from such passive activities are similarly limited

- Disallowed passive losses and credits are not lost forever, but suspended and carried forward to subsequent tax years until taxpayer has passive income or until the interest in the passive activity is disposed of

Passive Loss Principles for Rental Real Estate

- General rule is that an activity is passive if it involves conduct of trade or business and taxpayer does not materially participate in activity
  - However, rental real estate is “per se” passive activity
  - Definition of “rental activity”
  - Interests in limited partnerships, LLCs or LLPs
  - Holding raw land for appreciation
  - Exceptions to “per se” treatment
- Material participation means taxpayer is involved in operation of activity on a regular, continuous, and substantial basis
  - Regulations provide 7 tests, at least one of which must be met

Passive Loss Relief for RE Professionals

- Owners of real property who materially participate in rental activities and who meet 2 eligibility standards may escape the “per se passive” restriction
- Both tests must be met:
    1. More than half of personal services performed by taxpayer during year must be in real property businesses
    2. Taxpayer must perform more than 750 hours of service during tax year in real property businesses
- Definition of real property business is quite broad
- Even if tests are met, taxpayer still needs to meet material participation requirement for rental activity itself
- Election to combine rental activities

Tests for Material Participation

1. 500-Hours Test
   - Needs to be work done as owner, not investor
   - Work by spouse also counts
2. Substantially-All-of-the-Participation Test
   - Recognizes that operation of some activities may not require more than 500 hours
3. 100-Hours-of-Participation Test
   - This time must be more than anyone else’s participation
4. Significant-Participation-Activities Test
   - Aggregates participation in all similar activities – 500 hour minimum
5. Material-Participation-in-Prior-Years Test
   - Test is met if taxpayer materially participated for any 5 of preceding 10 years
6. Personal-Service-Activity Test
   - Test is met if taxpayer performed “personal service activity” in any 3 years preceding tax year
7. Facts-and-Circumstances Test
   - Must have >100 hours, no paid manager, must be more than anyone else

$25,000 Exemption for “Moderate-Income” Taxpayers

- For “moderate income taxpayers,” tax law grants limited exemption of $25K from passive loss restrictions
  - To qualify, taxpayer must “actively participate”
  - Easier standard than “material participation”
- Exemption is subject to a phase-out
  - $25K is reduced by 50% of amount by which AGI exceeds $100K – fully phased out by AGI of $150K

Selling Rental or Investment RE

- Basis
- Computation of gain or loss
- Capital gains and losses
- Definition of capital asset
- Capital gains rates
- Capital gains of individuals
- Netting gains and losses
- Capital losses of individuals
- Section 1231 property
- Recapture of depreciation for real property

Basis

- Basis is a fundamental concept needed in at least two contexts:
  - Computing depreciation
  - Determining gain or loss upon disposition
- Basis depends how property is acquired
  - If by purchase, basis is cost
  - If by gift, basis is lesser of donor’s basis or FMV
  - If by inheritance, generally it is FMV on date of death
- Adjusted basis:
  - Basis is increased by improvements, costs to defend title, restorations
  - Basis is decreased by depreciation, amortization, losses

Computation of Gain or Loss

- Gain or loss is computed by comparing amount realized with adjusted basis
  - If amount realized > adjusted basis = gain
  - If amount realized < adjusted basis = loss

- Amount realized is sum of money plus FMV of any property received
  - If property is sold subject to mortgage, it is included in amount realized
  - Selling expenses reduce amount realized

Capital Gains and Losses

Definition of Capital Asset

- Tax law defines a capital asset by what it is not
  - A capital asset is any property held by taxpayer, whether or not connected with a trade or business, ***except***:
    - Stock in trade or inventory property or property held primarily for sale to customers in the ordinary course of trade or business
    - Property used in trade or business that is subject to depreciation

Capital Gains of Individuals

- Capital Gain Rate Groups:
  - 28% Group
    - Gains on collectibles
  - 25% Group
    - Gain attributable to SL depreciation on real property (unrecaptured Section 1250 gain)
  - 15% / 20% Group
    - Gain not in the other groups
- **Example:** Aiden sells building for $1 million that he purchased for $700K. He claimed $300K in depreciation of which $100K was in excess of SL.
  - Gain is $600K ($700k cost less $300 depreciation = $400 adjusted basis; $1 million sales price less $400K)
  - Of $600K total gain:
    - $200K is unrecaptured Section 1250 gain taxed at max 25% rate
    - $100K is accelerated depreciation taxed at ordinary income as recapture
    - $300K is taxed at max 15% rate (or 20% or 23.8% depending on taxable income)

Capital Losses of Individuals

- Individuals may use capital losses to offset unlimited amount of capital gains, but any excess may offset ordinary income only to extent of $3,000 or the excess of losses over gains, whichever is less

- Excess net capital loss may be carried forward for unlimited period as short-term or long-term, as the case may be

Overview of Section 1031

- Section 1031(a)(1)

  "No gain or loss shall be recognized on the exchange of **real** property held for productive use in a trade or business or for investment if such **real** property is exchanged solely for **real** property of like kind which is to be held either for productive use in a trade or business or for investment."

- Statutory requirements
  - "Exchange" versus sale and rollover
  - Same "taxpayer" must transfer relinquished property and receive replacement property
  - Qualifying property
    - Real property used in trade or business OR Property held for investment
    - Qualifying use requirement applies to relinquished property and replacement property
    - Examples
      - Trade or business property and investment property interchangeable

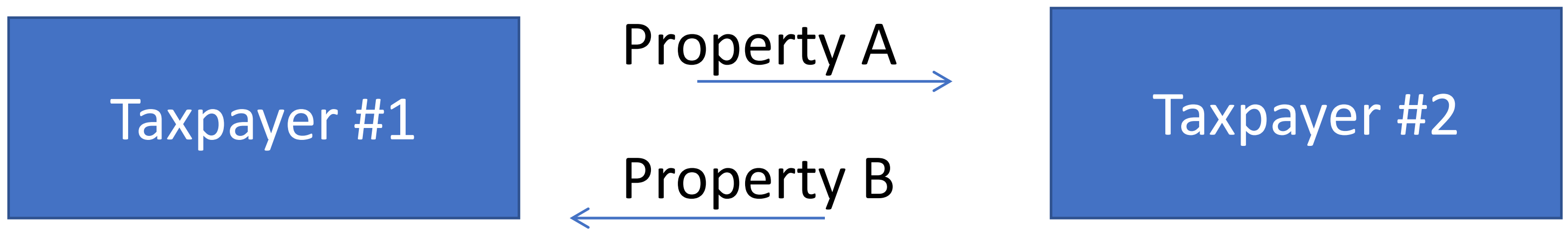
Statutory Requirements (continued)

- Excluded property
  - Personal use property
  - Property held for sale in ordinary course of business (“dealer property”)
  - All personal property
  - Compare with pre-2018 rules, which excluded only certain types of personal property, such as stock, bonds, and partnership interests

- “Like Kind” requirement
  - All real estate like kind to real estate (except foreign & domestic)
  - Compare treatment of personal property under pre-2018 law

Structuring Exchanges

Two-party exchange



Legislative history from 1920’s

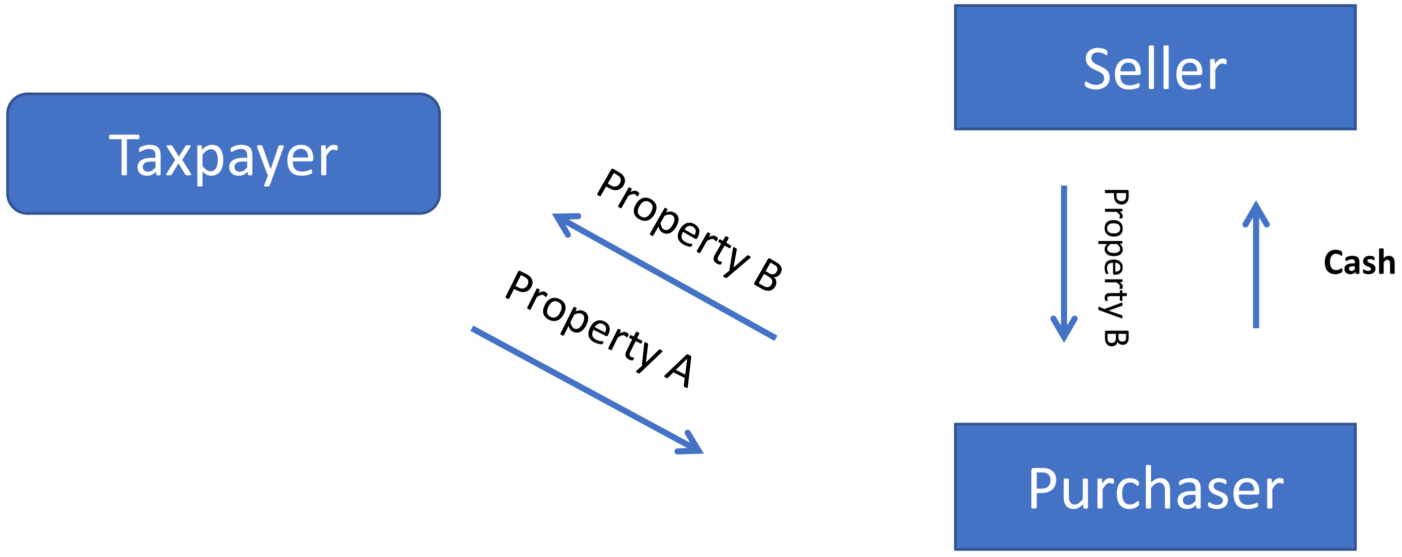
Result: Taxpayer #1 and Taxpayer #2 each make exchange.

Case #1: Property A and Property B are of equal value.

Case #2: Property A with FMV $100 and Property B FMV $80

Taxpayer #1 receives Property B and $20

Three-party exchange



Result: Taxpayer makes a like-kind exchange of Property A for Property B

Purchaser makes taxable purchase of Property A

Property B is not qualifying property in hands of Purchaser

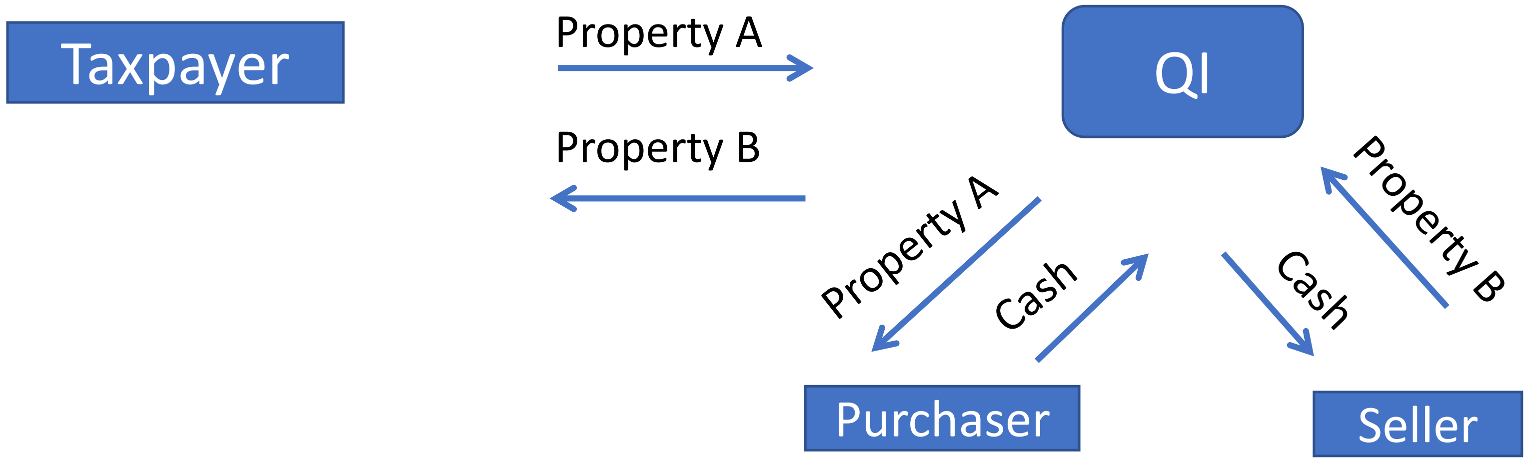
However, Purchaser has no gain on disposition of Property B because basis equals FMV

Seller has taxable sale

Three–party exchange (continued)

- Potential issues
  - Agency
    - Is Purchaser an agent of Taxpayer?
    - If so, Purchaser cannot make a qualified like kind exchange because he is making an exchange with himself
    - Case law evolved favorably
  - Purchaser’s concerns with taking title to Property B
  - Potential impact of contract disputes, particularly in deferred exchange

Four-party Exchange



Result: Taxpayer makes a like kind exchange of Property A for Property B

Purchaser makes a taxable purchase of Property A

Seller has a taxable sale of Property B

QI exchanges Property B and is Taxpayer's exchange party and is paid a fee

Regulations confirm role of QI. See Regs. Sec. 1.1031(k)-1(g)(4).

Four-party exchange (continued)

- Potential issues
  - Agency
    - Regulations issued in 1991 ignore agency and constructive receipt issues and create QI safe harbor
  - Implementation
    - Taxpayer and QI enter exchange agreement and escrow agreement
    - Taxpayer negotiates and enters contracts with Purchaser and Seller
    - Taxpayer assigns contract rights to QI
    - As assignee of sale contract, QI receives cash paid by Purchaser
    - As assignee of purchase contract, QI pays cash to seller
    - Property A deeded from Taxpayer directly to Purchaser (to avoid transfer tax)
    - Property B deeded from Seller directly to Taxpayer (to avoid transfer tax)
    - Cash must remain in QI’s escrow account
  - Reliable QI critical

Simultaneous versus Deferred Exchange

- Simultaneous exchange
  - Sale contract and purchase contract close simultaneously
  - QI holds cash for moment
- Deferred exchange
  - Taxpayer receives offer from Purchaser with fixed closing date of Date #1
  - Taxpayer unable to locate Property B, enter contract with Seller and close on Property B by Date #1
  - QI holds cash paid by Purchaser until Date #2, the closing date on purchase of Property B

Deferred Exchange

Additional statutory requirements in Section 1031(a)(3)

(A) Taxpayer must identify replacement property (Property B) within 45 days after transferring relinquished property (Property A)

- "Identify" means deliver notice to QI describing replacement property
- Purchase contract not required within 45 days
- Identify multiple replacement properties
  - 3-property rule
  - 200% rule (properties with FMV up to 200% of FMV of relinquished property)

(B) Taxpayer must close and receive replacement property (Property B) by earlier of (i) 180 days after transferring relinquished property (Property A) and (ii) due date (with extensions) for Taxpayer's tax return for year of transfer of relinquished property. Extended due date should generally provide for at least 180 days.

Deferred Exchange (continued)

- Reason for 45-day and 180-day time limits
  - Starker decision in 1979 allowed taxpayer to conduct exchange over several years
  - 180-day limit forces Taxpayer to either report a sale or own a replacement property on first tax return filed after transfer of relinquished property

Questions?

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