Tax Planning for Rental Real Estate

RRE4/26/F1

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Learning Objectives

- Recall exceptions to rental status in the regulations
- Identify the different types of depreciation recapture that apply to rental properties
- Recognize tax planning opportunities for personal and vacation properties
- Identify how the §1237 safe harbor may be used to avoid ordinary income tax treatment on divided land parcel sales

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Tax Basics of Real Estate

- One may invest in real estate in multiple ways:
  - Indirectly: REITs and RICs
  - Directly: buying property and renting it out
- For the most part, in today's course, we will be talking about direct ownership of real estate
- Rental real estate activities are generally considered to be passive. Passive losses may only be taken to the extent of passive income.

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Opportunities

- If a client just wants exposure to real estate to diversify the portfolio (without the headaches of direct ownership), an investment in a fund may be better
- Funds generally offer better liquidity than direct investments
- Some funds may be more tax efficient than others. This is where an investment advisor can help.

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Planning With Direct Ownership

- If the goal is to be "cash flow positive" but break even from a tax perspective, then we may want to focus on depreciation deductions
  - Need to be mindful of reasonable rent
  - Cost segregation studies may be helpful
- Losses are generally only available to real estate dealers, not to investors (because of the passive activity rules)
  - Dealer status eliminates the ability to use a §1031 exchange
  - Dealers also generally have ordinary gains on real estate sales

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Reasonable Rent

- Reasonable rent is essentially the fair market value for the area given current market conditions
  - Prices should be comparable to what others in the area are charging based on location, use, and square footage
- Renting to a related party is generally fine as long as the rent charged is the same as what would be charged to an unrelated party
- A small business owner renting their building to their own business is fine as long as rent is reasonable. Unreasonably high rent is nondeductible to the company. Unreasonably low rent may be reclassified as a loan or capital contribution to the company.

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Investor vs. Dealer

- Investors:
  - Can take advantage of §1031 exchange rules
  - Normally have capital gain treatment (subject to depreciation recapture)
  - Sales expenses are a reduction of proceeds from a disposition – not an ordinary expense
  - Can defer gain using an installment sale

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Investor vs. Dealer

- Dealers:
  - Cannot take advantage of §1031 exchange rules
  - Normally have ordinary gain treatment on sales
  - Sales expenses are an ordinary expense
  - Cannot defer gain using an installment sale
- The biggest advantage then for dealers is the ability to take losses each year… not on the sale of the property

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Considerations of the Tax Court

- Number of sales
- Frequency of sales
- Intent when purchased and how was the property used
- Time period owned (how fast was the disposal?)

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Considerations of the Tax Court

- How did the client promote selling the property?
- Time and money spent to improve and develop the property
- Did the client have a liquidation intent when purchasing?
- Real estate gains vs. other income on the return

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Investor vs. Dealer – Planning Considerations

- If the client is flipping houses, then they may be a dealer. In that case, try to sell in years where income is down.
- If the client is an investor, then gains (not losses) may be stretched out with installment sale treatment
- Like-kind exchanges defer gains for investors, but the client needs to have another property they want

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Passive Activities

- Under §469(c)(1) & (2), there are two ways that an activity becomes passive:
  1. A business activity in which a taxpayer is NOT materially participating
  2. The activity is a rental activity
- Treas. Regs. §1.469-1T(e)(3)(ii) provides a list of items that are NOT rental activities – that is, they are not automatically considered to be passive
- However, even if a business activity is on the §1.469-1T(e)(3)(ii) list, it may still be passive (if the material participation requirements are not met)

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Exceptions to Rental Status – §1.469-1T(e)(3)(ii)

1. Each customer uses the property for an average of seven days or less (for example, car rental businesses, tuxedo rentals)
2. Each customer uses the property for over seven days but not over 30 days and "significant" personal services are provided by or on behalf of the owner (for example, operating a hotel). Routine services commonly provided in long-term rentals (for example, collecting garbage, routine repairs, doorman, and so on) are not significant services.
3. Extraordinary personal services are provided by individuals by or on behalf of the property's owner in connection with the rental (such as a hospital)

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Exceptions to Rental Status – §1.469-1T(e)(3)(ii)

4. In PLR 9247003, the IRS held that the management and operation of retirement centers are not rental activities. The residents' monthly payments were more than twice the cost of a luxury apartment, and the IRS concluded that a center's income was principally for the services provided (for example, meals, laundry and maid service, utilities) rather than for the use of the tangible property.
5. The property is made available during defined business hours for nonexclusive use by various customers (such as a public golf course)

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Exceptions to Rental Status – §1.469-1T(e)(3)(ii)

6. Rental of the property is treated as incidental to an investment in the property where:
   a. The owner seeks gain by increase in value and the gross rent is under 2 percent of the lesser of the property's market value or basis;
   b. The property is used in a trade or business and the rent is under 2 percent of the property's value or basis;
   c. The property is held for sale and is sold during the year; or
   d. The property is used as lodging for the taxpayer's employees for the taxpayer's convenience
7. The property is used in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest

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Example 1

Alice owns a small bed and breakfast where she hosts guests for short-term stays (10 days on average). She often works more than 40 hours per week in this activity. Even though this is a rental activity, it is not automatically considered to be passive – since it involves significant personal service elements.

Alice would be materially participating since she is well above the required hours to be materially participating as well.

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Example 2

Alice owns a small bed and breakfast where she hosts guests for short-term stays (10 days on average). While she will occasionally stop in to see how things are going, she puts in very little time on this activity. She is mainly just an investor.

Even though running a bed and breakfast would generally qualify as an activity where there are a substantial amount of personal services, this activity would still likely be considered as passive for Alice. Since her hours are limited, she is unlikely to qualify as materially participating (unless her activity was "substantially all" the participation in the activity). Therefore, the activity is still considered to be passive to her.

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What About Airbnbs?

- Documentation on average length of stay would seem to be important (also personal vs. rental use)
- Personal services provided in conjunction with activity would also seem to be important
- Is the client's occupation in a real property trade or business? If so, can they qualify as a real estate professional?

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Material Participation – §469

- Taxpayer participates in activity for more than 500 hours
- Taxpayer activity constitutes substantially all the participation in the activity
- Taxpayer participates more than 100 hours, and no other individual has greater participation
- Sum of the taxpayer's significant participation activities exceeds 500 hours, and the taxpayer participates more than 100 hours in the activity

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Material Participation – §469

- Taxpayer materially participates in the activity in five of the past 10 preceding taxable years
- Taxpayer materially participates in a personal service activity for any three preceding taxable years
- Taxpayer participates on regular, continuous, substantial basis in the activity (essentially a facts and circumstances determination)

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Let's Take a Step Back

- All rental activities are considered to be passive – just by their nature
- The regulations provide a list of rental activities that are not automatically passive
- However, even if your taxpayer's activity is on the list, it may still be considered to be passive if none of the hours requirements for material participation are met

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Passive Activity or Not?

1) Taxpayer owns a small rental house on the edge of town. He has a regular tenant living in the house. He puts in 600 hours per year.
2) Taxpayer rents a vacation home out on Airbnb. Guests typically stay two or three days. She puts in only 35 hours per year in the activity.
3) Taxpayer rents out a small vacation home using Airbnb. Guests typically stay for more than a week (but not more than 30 days) and the taxpayer is constantly housekeeping, doing property maintenance, and making repairs.

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Passive Activity or Not?

1) **Passive –** Taxpayer meets the material participation threshold, but the activity is still considered passive. It is a rental activity and does not fit any of the exceptions listed in the regulations.
2) **Passive –** The activity meets one of the exceptions in the regulations, so it is not a rental activity. However, she is still below any of the material participation thresholds (unless she can show that her activity constitutes "substantially all the participation in the activity").
3) **Not Passive** – The activity meets one of the exceptions in the regulations, so it is not a rental activity. Taxpayer is likely to meet an hours thresholds required for material participation, since he/she is "constantly" working on the activity.

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So, if You Have a Rental Activity, It Is Always Passive?

- In general, yes. So passive activity losses are limited to passive activity income.
- However, you may be able to deduct losses in full if you can qualify as a real estate professional
- If you can't qualify as a real estate professional, the taxpayer's activity may still qualify as active participation – which may allow for a limited deduction of losses (over and above passive activity income)

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Why Do I Want to Be a Real Estate Professional?

- Short answer: It is easier to deduct losses on your rental activities. Losses may generally be deducted in full.
- However, you often need to group rental activities together to achieve this status. Once activities are grouped together, they generally cannot be ungrouped.
- A change to real estate professional status may leave previous suspended passive activity losses permanently not deductible

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Real Estate Professional – §469(c)(7)(B)

- Two requirements – must meet both:
  1. More than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates
  2. Such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates
- Flush language: "In the case of a joint return, the requirements of the preceding sentence are satisfied if and only if either spouse separately satisfies such requirements." So, one spouse needs to qualify on their own.

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Real Estate Professional

- **Section 469(c)(7)(C) –** "For purposes of this paragraph, the term real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business"
- **Section 469(c)(7)(A) –** Each activity is evaluated separately for the purposes of meeting the 750-hour requirement, unless an election is made to group the activities together

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Example 3

Matt owns seven rental houses that he leases out to tenants. The tenants all use the houses as their principal residences. At house A, Matt performs 400 hours of services. At house B, Matt performs 375 hours of services. In the five other homes, Matt performs 200 hours of services on each home. Matt performs no other work outside of maintaining these homes.

Would these be passive activities to Matt? Is Matt a real estate professional?

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Example 3

These properties do not meet any of the rental activity exceptions referenced in the regulations. Therefore, they would all be considered passive activities. They are all rental activities.

Matt does not qualify as a real estate professional. While he clearly spends over half of his time performing services in real property trade or businesses, he does not meet the 750-hour requirement on any one property. Therefore, he is NOT a real estate professional.

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Example 4

Assume the same facts as Example 3, except that Matt makes an election to group his rental properties together. In this instance, Matt would meet the requirements to be a real estate professional. The 750-hour requirement is applied to all the activities that constitute one group. He has 1,775 hours in the grouped activity and easily qualifies.

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Example 5

Carrie works full time as an accountant. She also owns two rental properties that she leases on a regular and ongoing basis to tenants. On rental property A, she spends 400 hours. On rental property B, she spends 450 hours.

Would the rental activities be passive to Carrie? Can she qualify as a real estate professional? Would your answer change if she made an election to group?

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Example 5

These activities would be passive to Carrie, because they do not meet any of the exceptions in the regulations. Since they are rental activities, they are considered passive.

Carrie could not qualify as a real estate professional, since she is working full time as an accountant (and thus is not spending over half her time in a real property trade or business). An election to group would not help, either. While that would satisfy the 750-hour requirement, it would not help her meet the 50 percent real property trade or business requirement.

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Active Participation – §469(i)

- For taxpayers who are not able to qualify as real estate professionals, they may be able to qualify as actively participating
- By qualifying, the taxpayer is able to take up to $25,000 in losses on their rental activities (over and above passive activity income)
- Section 469(i)(3)(A) – The deduction is reduced by $1 for every $2 that the taxpayer's AGI is over $100,000 (complete phaseout at AGI of $150,000)

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Active Participation – §469(i)

- Qualifications for active participation:
  - Taxpayer must own at least a 10 percent interest in the activity (§469(i)(6)(A))
  - Participate in management decisions in a bona fide sense
- Management decisions might include setting rents, reviewing tenant applications, repairing items on the property, etc.

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Active Participation – §469(i)

- Adjusted gross income – §469(i)(3)(E):
  - "For purposes of this paragraph, adjusted gross income shall be determined without regard to:
    i. Any amount includible in gross income under Section 86;
    ii. The amounts excludable from gross income under Sections 85(c), 135, and 137;
    iii. The amounts allowable as a deduction under Sections 219, 221, and 250; and
    iv. Any passive activity loss or any loss allowable by reason of subsection (c)(7)"

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Example 6

Henry works full time as an operations manager for a manufacturing company. Additionally, he owns 100 percent of two rental properties. He makes all management decisions on both properties. Rental property A generates a passive activity loss of $10,000. Rental property B generates a passive activity loss of $30,000. He has an AGI of $90,000.

Does Henry qualify as actively participating? If so, how much may he deduct of his real estate losses? Do any of the passive losses carry forward?

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Example 6

Henry owns rental property but works full time (in something other than a real property trade or business). Therefore, he cannot qualify as a real estate professional.

He can qualify as actively participating because he owns at least 10 percent of the properties and makes all management decisions. His AGI is below $100,000; therefore, there is no phaseout. He may take a $25,000 deduction.

The total of the rental losses is $40,000. Therefore, there is a $15,000 passive loss carryforward. If Henry has passive activity income in subsequent years, the $15,000 passive loss carryforward may be used to offset this income.

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Example 7

Henry works full time as an operations manager for a manufacturing company. Additionally, he owns 100 percent of two rental properties.

He makes all management decisions on both properties. Rental property A generates passive activity income of $10,000. Rental property B generates a passive activity loss of $40,000. He has an AGI of $90,000.

Does Henry qualify as actively participating? If so, how much may he deduct of his real estate losses? Do any of the passive losses carry forward?

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Example 7

Henry is actively participating. In this instance, the net amount of passive activity losses for the rental activities is $30,000. Henry is able to deduct $25,000 of this loss in the current year (because he is below the AGI threshold). He will carry forward only $5,000 in passive activity losses.

The first $10,000 of losses on property B are deducted against the passive activity income from property A. Then an additional $25,000 of losses on property B may be deducted due to Henry's active participation.

So, a total of $35,000 in passive losses from property B may be deducted this year. The $25,000 deduction is over and above passive activity income.

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Example 8

Henry works full time as an operations manager for a manufacturing company.

Additionally, he owns 100 percent of two rental properties. He makes all management decisions on both properties. Rental property A generates a passive activity loss of $10,000. Rental property B generates a passive activity loss of $30,000. He has an AGI of $120,000.

Does Henry qualify as actively participating? If so, how much may he deduct of his real estate losses? Do any of the passive losses carry forward?

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Example 8

Henry is actively participating. The passive losses on the rental activities total $40,000. Henry is $20,000 above the AGI threshold. Therefore, the maximum $25,000 deduction is reduced to only $15,000 ($25,000 – $10,000 = $15,000).

Therefore, Henry may deduct $15,000 of rental losses this year. $25,000 will carry forward as a passive activity loss.

The maximum deduction is reduced by $1 for every $2 over the AGI threshold.

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Do the Passive Activity Rules Apply to Corporations?

- In general, no. But there are some exceptions. Passive activity rules will apply to closely held C corporations and personal service corporations.
- **Section 469(h)(4)** – "A closely held C corporation or personal service corporation shall be treated as materially participating in an activity only if:
  a. One or more shareholders holding stock representing more than 50 percent (by value) of the outstanding stock of such corporation materially participate in such activity; or
  b. In the case of a closely held C corporation (other than a personal service corporation), the requirements of Section 465(c)(7)(C) (without regard to clause (iv)) are met with respect to such activity."

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Do the Passive Activity Rules Apply to Corporations?

- So, the passive activity rules WILL APPLY to:
  1. **Closely held C corporations** – Over 50 percent of the value of the stock is owned by not more than five individuals during the last half of the tax year
  2. **Personal service corporations** – C corporations in which services are substantially performed by employee-owners (who own any stock in the corporation during the year where over 10 percent of the stock by value is owned by such employee-owners)
- The passive activity rules do NOT apply to S corporations at the entity level (but certainly apply at the shareholder level)

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Do the Passive Activity Rules Apply to Corporations?

- **Personal service C corporations** – Under the same rules as individuals. Therefore, passive losses cannot be used to offset active income or portfolio income, only passive activity income.
- **Closely held C corporations** – May take passive losses against net active income (§469(e)(2)). Therefore, passive losses may be used against active income or passive income. They may not be used against portfolio income.

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Example 9

Assume JNP, a closely held C corporation, has the following items of income and losses during the tax year:

- *Active income: $100,000*
- *Portfolio income: $40,000*
- *Passive loss on rental property: $115,000*

The passive loss may be used to offset all the passive income but none of the portfolio income. Therefore, JNP would show $40,000 of taxable income (all the portfolio income) on its tax return. It would also have a $15,000 passive loss carryforward.

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Any Other Limitations on Rental Losses?

- Rental losses are generally passive. Therefore, rental losses are subject to the limitations we have discussed. For individuals, the losses may be deducted only to the extent of rental income.
- However, passive losses are part of tiering structure for losses. For noncorporate taxpayers to take a loss on their individual tax return, a loss must generally make it through four tiers of losses. Passive losses are evaluated at tier 3.
- This is especially important for taxpayers who own rental property through an S corporation or partnership. They will generally be subject to basis, at-risk, passive income, and overall limit on business loss limitations – so more than just the passive loss rules.

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Four Tiers of Losses

- Losses must make it through all four tiers in order to be deducted on the individual tax return:
  - Basis – Partnership (§705)/S corporation (§1367)
  - At-risk – §465
  - Passive loss – §469
  - Overall limit on business losses – §461**

*** Added by TCJA, but temporarily repealed for tax years 2018, 2019, and 2020. Back in play in 2021.*

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Does It Matter Where a Loss Is Suspended?

- It matters if the activity is disposed of in its entirety:
  - Losses suspended on level 1 (basis) will be lost forever
  - Losses suspended on levels 2 and 3 (at-risk and passive losses) may be taken in full (that is, they will go down to level 4)
  - Losses suspended on level 4 (overall limit) will not be affected, since they are associated with an individual taxpayer – not a specific business

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Practitioner Considerations – Rental Status and Passive Activity Rules

- The passive tag on rental property is hard to get rid of. However, active status on rentals is a relatively easy bar to jump over for lower-income taxpayers.
- Grouping may make it easier to be a real estate professional. In general, the advantage to being a real estate professional is that it creates deductible losses that are easier to take (vs. the passive activity rules). In order to be grouped together, properties must form an appropriate economic unit according to the regulations (this is based on facts and circumstances).
- It is good to have clients keep track of their hours and tasks by property. This documentation will be necessary if they want to qualify as a real estate professional or meet the hours necessary to be a nonpassive activity.

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Depreciation Opportunities

- As we stated earlier, many clients want to try and be cash flow positive but break even for tax purposes (essentially depreciation covers any income)
- Depreciation may be sped up by doing a cost segregation study, which may help reduce income in the early years
- Also, it may be possible to take advantage of certain elections around depreciation (but we need to be aware of depreciation recapture)

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A Few Things….

- For real property (27.5- and 39-year), we assume a mid-month convention – not a half-year convention
- For mid-month or half-year conventions, the assumption is always that the item is placed into service halfway through the time period – regardless of when the property is placed into service
- For tangible personal property (not real property), if 40 percent or more of the cost of the property is placed into service in Q4 during a given year, ALL items for that year must use the mid-quarter convention!

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Example 10 – Half-Year vs. Mid-Quarter

Adam placed the following items into service during 20X1:

Machine 1 (5 year) on March 1, 20X1:	$55,000
Furniture (7 year) on July 17, 20X1:	$20,000
Machine 2 (5 year) on November 5, 20X1:	$25,000
Total	**$100,000**

All items would be eligible for the half-year convention and would be entitled to six months of depreciation for tax purposes in the first year – even though machine 2 was not placed into service until November!

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Example 11 – Half-Year vs. Mid-Quarter

Adam placed the following items into service during 20X1:

Machine 1 (5 year) on March 1, 20X1:	$55,000
Furniture (7 year) on October 17, 20X1:	$20,000
Machine 2 (5 year) on November 5, 20X1:	$25,000
Total	**$100,000**

Since 40 percent or more of the cost of the assets was placed into service in Q4, all items are now on the mid-quarter convention. Machine 1 would be entitled to 10.5 months of depreciation in the first year. The furniture and machine 2 would only be entitled to one and a half months of depreciation.

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Depreciation Elections

- In general, if the taxpayer is profitable, you want to use the method that will get the taxpayer the greatest amount of depreciation (deductions) possible
- However, if the taxpayer is going to be in a higher tax bracket next year (or you want to avoid loss carryforwards), it may be worthwhile to elect to take less depreciation in the first year
- In general, this can be accomplished by electing to use either the 150 percent method, the straight-line method, or the ADS

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Depreciation Elections

- Instead of using the 200 percent declining-balance method over the GDS recovery period for property in the three-, five-, seven-, or 10-year property class, you can elect to use the 150 percent declining-balance method. Make the election by entering “150 DB” under column (f) in Part III of Form 4562.
- Instead of using either the 200 percent or 150 percent declining-balance method over the GDS recovery period, you can elect to use the straight-line method over the GDS recovery period. Make the election by entering “S/L” under column (f) in Part III of Form 4562.

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GDS vs. ADS

- At this point, we have only discussed the general depreciation system (GDS). The alternative depreciation system (ADS) may also be elected.
- The ADS generally uses straight-line depreciation and a longer recovery period
- There are certain situations where the ADS is required…

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ADS Recovery Periods

- Rent-to-own property – four years
- Automobiles and light duty trucks – five years
- Computers and peripheral equipment – five years
- High technology telephone station equipment installed on customer premises – five years
- High technology medical equipment – five years
- Personal property with no class life – 12 years
- Natural gas gathering lines – 14 years
- Single-purpose agricultural and horticultural structures – 15 years

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ADS Recovery Periods

- Any tree or vine bearing fruits or nuts – 20 years
- Initial clearing and grading land improvements for gas utility property – 20 years
- Initial clearing and grading land improvements for electric utility transmission and distribution plants – 25 years
- Electric transmission property used in the transmission at 69 or more kilovolts of electricity – 30 years
- Natural gas distribution lines – 35 years
- Nonresidential real property – 40 years
- Residential rental property – 30 years
- Railroad grading and tunnel bore – 50 years

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ADS and the AMT Adjustment

- The ADS is generally used for AMT purposes. Therefore, if 200 percent depreciation is used for regular purposes, there will be an adjustment for AMT. It will be more income for AMT in the early years.
- No depreciation adjustment is necessary for AMT purposes on property placed in service after 1986 for which the AMT 150 percent method is elected under the provisions of §168(b)(2)(D) for property otherwise eligible MACRS (200 percent method)

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ADS and the AMT Adjustment

- Making the election to use AMT depreciation for both regular tax and AMT purposes means using the AMT 150 percent declining-balance method for both tax calculations (and no adjustment is necessary). Also, normal MACRS/GDS recovery periods can be used for regular tax and AMT purposes.
- No election is needed to avoid two computations for 27.5-year residential rental property or 39-year nonresidential real property. Such property is depreciated using the straight-line method for MACRS and AMT depreciation purposes.

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When Is the ADS Required?

- Any tangible property used primarily outside the U.S. during the year
- Certain farming equipment
- Certain types of tax-exempt property
- If the use of listed property falls below 50 percent business use

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Listed Property – Special Rules

- If your use of the property is not for your employer's convenience or is not required as a condition of your employment, you cannot deduct depreciation or rent expenses for your use of the property as an employee
- If the property is not used predominantly (more than 50 percent) for qualified business use, you cannot claim the §179 deduction or a special depreciation allowance
- Annual limits apply to depreciation deductions (including §179 deductions and any special depreciation allowance) for certain passenger automobiles

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Listed Property Includes

- Passenger automobiles
- Any other property used for transportation, unless it is an excepted vehicle
- Property generally used for entertainment, recreation, or amusement (including photographic, phonographic, communication, and video recording equipment)

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Cost Segregation Studies

- Allow parts of a building to be reclassified as depreciable assets with shorter useful lives. Common examples:
  - Moveable room partitions
  - Removable wall coverings
  - Removable floor finishes
  - Cabinets and counters
  - Decorative lighting
  - Emergency equipment
  - Signs and graphics
  - Certain electrical and plumbing systems
  - Air conditioning units

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Cost Segregation Studies

- Cost segregation studies do not result in more total depreciation – just more depreciation in the earlier years
- Rental income normally increases over time due to cost of living. In this case, it may be better to not accelerate depreciation (save depreciation deductions).
- **Potential opportunity:** Accelerate depreciation in the early years to break even. Then sell once assets start to depreciate out (but be mindful of depreciation recapture).

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Depreciation Recapture

- There are several depreciation recapture provisions related to real estate:
  - **Section 1245 recapture:** Non-real property
  - **Section 1250 recapture:** Real property
  - **Section 291 recapture:** Applicable to real property owned by corporations only
- These provisions generally make gains on the sale of business property subject to a higher rate of tax than the normal capital gains rates (except in the case of §291 recapture for corporations – which have no special capital gains rate)

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Section 1245 Recapture

- Generally referred to as a full recapture rule. Gains on the sale of non-real property must be reclassified as ordinary to the extent of accumulated depreciation (to the extent allowed or allowable).
- Therefore, unless a property is sold for more than purchased, all gains will be recaptured as ordinary income for non-real property
- Section 1245 recapture also applies to §197 intangibles

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Section 1245 Property Definition – §1245(a)(3)

- **For purposes of this section, the term §1245 property means any property that is or has been property of a character subject to the allowance for depreciation provided in §167 and is:**
  - Personal property;
  - Other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property): (i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services; (ii) constituted a research facility used in connection with any of the activities referred to in clause (i); or (iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state);

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Section 1245 Property Definition – §1245(a)(3)

- **For purposes of this section, the term §1245 property means any property that is or has been property of a character subject to the allowance for depreciation provided in §167 and is:**
  - So much of any real property (other than any property described in subparagraph (B)) that has an adjusted basis in which there are reflected adjustments for amortization under §§169, 179, 179B, 179C, 179D, 179E, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 194;
  - A single-purpose agricultural or horticultural structure (as defined in §168(i)(13));
  - A storage facility (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum; or
  - Any railroad grading or tunnel bore (as defined in §168(e)(4))

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Section 1245 Property Definition – §1245(b)

- **Section 1245 does not apply to certain transfers:**
  - Gifts
  - Transfers at death
- **Special limitations of §1245 recapture apply to:**
  - §§332, 351, 361, 721, or 731 transactions
  - Like-kind exchanges
  - Involuntary conversions
  - Property distributions by a partnership to a partner
  - Transfers to tax-exempt organization where property will be used in unrelated business
  - Timber property

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Example 12

DEF Company bought equipment for $10,000. Over a period of three years, it took depreciation deductions on the equipment of $7,000. In the current tax year, the company sold the equipment for $9,000.

The company would have a gain on the sale of equipment totaling $6,000 ($9,000 – $3,000 adjusted basis). All of it would be ordinary income.

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Example 13

DEF Company bought equipment for $10,000. Over a period of three years, it took depreciation deductions on the equipment of $7,000. In the current tax year, the company sold the equipment for $12,000.

The company would have a gain on the sale of equipment totaling $9,000 ($12,000 – $3,000 adjusted basis). Only the first $7,000 of gain would be recaptured as ordinary income. The additional $2,000 of gain would be a §1231 gain (and generally a capital gain).

Section 1245 recapture only applies to the extent of previous depreciation deductions!

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Section 1250 Recapture

- Section 1250(c) states that "for purposes of this section, the term Section 1250 property means any real property (other than Section 1245 property, as defined in Section 1245(a)(3)) which is or has been property of a character subject to the allowance for depreciation provided in Section 167"
- So, in other words, real property is generally subject to §1250 recapture provisions. Non-real property is subject to §1245 recapture.
- Similar to §1245, several types of transactions do not subject a property to the recapture provisions (or there are limitations). For example, like-kind exchanges, gifts, and transfers at death have unique rules (§1250(d)).

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Section 1250 – Two Different Types of Recapture

- Section 1250(a)(1)(A) starts off by saying that the portion of "additional depreciation" is recaptured as ordinary income (up to the extent of gain realized)
- However, §1(h)(1)(E) says that **unrecaptured** §1250 gain is subject to a maximum tax rate of 25 percent
- So, what is additional depreciation? And what gets recaptured as ordinary income? What gets recaptured at a 25 percent rate?

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Section 1250 – Two Different Types of Recapture

- **Treas. Regs. §1.1250-2(a)(1)(i) and (ii) define additional depreciation as follows:**
  - In the case of property that at the time of disposition has a holding period under §1223 of not more than one year, the depreciation adjustments (as defined in paragraph (d) of this section) in respect of such property for periods after December 31, 1963; and
  - In the case of property that at the time of disposition has a holding period under §1223 of more than one year, the depreciation adjustments in excess of straight-line for periods after December 31, 1963, computed under paragraph (b)(1) of this section

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Section 1250 – Two Different Types of Recapture

- Therefore, for §1231 property (property held for more than a year), the additional depreciation is the amounts over and above the amount of depreciation under the straight-line method
- The remaining amount of depreciation deductions (those that would be deducted using the straight-line method of depreciation) would be subject to a 25 percent rate under §1(h)(1)(E). These deductions compose unrecaptured §1250 gain.

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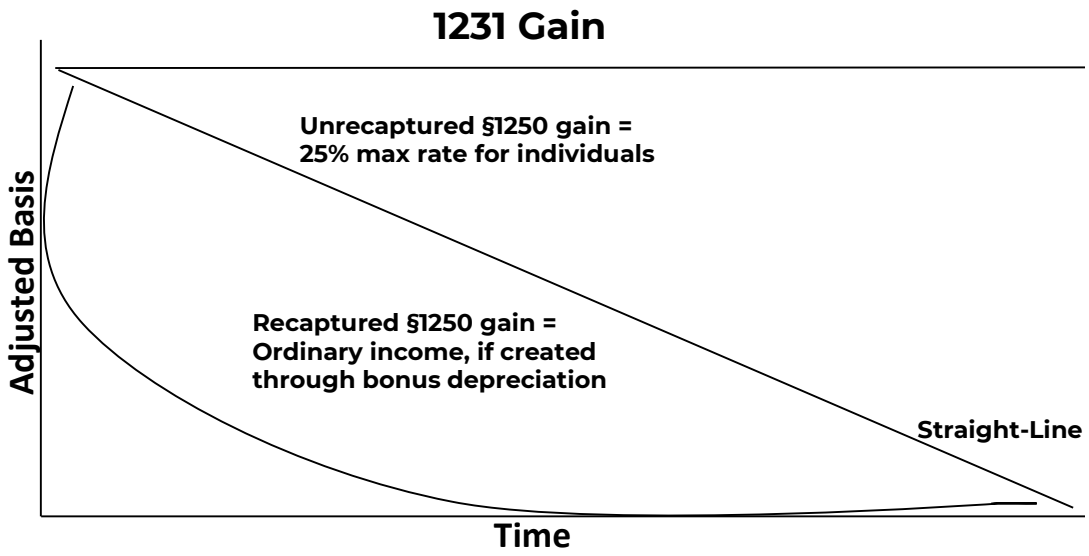

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Section 1250 – Two Different Types of Recapture

- **Two different types of recapture:**
  - **Recaptured §1250 gain** = Ordinary income (from adjusted basis up to what adjusted basis would be under the straight-line method of depreciation)
  - **Unrecaptured §1250 gain** = 25 percent rate for individuals (from straight-line adjusted basis up to original cost)
- To the extent that property is sold for more than it was purchased (like real estate that has appreciated), the gain above original cost would be §1231 gain if held for more than a year
- The 25 percent rate is a maximum rate. Therefore, if the taxpayer is in the 22 percent tax bracket, unrecaptured §1250 gain is subject to a 22 percent rate – not 25 percent.

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Example 14

Andy purchases a building costing $100,000 in year 1. The building is ineligible for bonus depreciation deductions, so he simply takes MACRS depreciation deductions (which all use the straight-line method). At the time the building is sold in year 4, total depreciation is $10,000. He sells the building for $120,000. Assume that Andy is in the 32 percent tax bracket.

The gain on the sale would be $30,000 ($120,000 – $90,000). The first $10,000 of gain would be subject to a 25 percent rate. The next $20,000 would be subject to a 15 percent capital gains rate.

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Example 15

Andy purchases a building costing $100,000 in year 1. The building is ineligible for bonus depreciation deductions, so he simply takes MACRS depreciation deductions (which all use the straight-line method). At the time the building is sold in year 4, total depreciation is $10,000. He sells the building for $120,000. Assume that Andy is in the 22 percent tax bracket.

The gain on the sale would be $30,000 ($120,000 – $90,000). The first $10,000 of gain would be subject to a 22 percent rate. The next $20,000 would be subject to a 15 percent capital gains rate.

The 25 percent rate is a maximum rate!

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Example 16

Bobbi purchases qualified improvement property (QIP) for $50,000 in year 1. She takes a bonus depreciation deduction for the QIP of $50,000 (100 percent bonus depreciation). In year 4, if she would have used the straight-line method of depreciation, accumulated depreciation would have totaled $10,000. She sells the QIP in year 4 for $65,000. Assume that Bobbi is in the 32 percent tax bracket.

The total gain is $65,000 ($65K – $0). The first $40,000 is recaptured as ordinary income. The next $10,000 of gain is subject to a 25 percent rate. The next $15,000 is a §1231 gain (and thus subject to a 15 percent capital gains rate).

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Section 1250 – Dealing With Accelerated Depreciation

- Real property is generally subject to straight-line depreciation anyway and not eligible for accelerated depreciation. If no accelerated depreciation is used, then all gain up to original cost will be unrecaptured §1250 gain (subject to a 25 percent max rate).
- Recaptured §1250 gain will only be created in the event of bonus depreciation used to create deductions over and above straight-line depreciation (such as with qualified improvement property)
- Section 179 deductions are technically recaptured under §1245 (full recapture rule) – not §1250. Therefore, all recapture of §179 deductions is recaptured as ordinary income (no 25 percent rate portion).

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Example 17

Assume the same facts as the previous example – Bobbi purchases QIP for $50,000 in year 1. However, now assume that she uses §179 to take a $50,000 first-year deduction. She then sells the property for $65,000 in year 4.

Now the property is being recaptured under §1245. In other words, the entire $50,000 would be recaptured as ordinary income. The next $15,000 of gain would be a §1231 gain (and thus subject to a 15 percent capital gains rate).

Section 179 deductions are recaptured under §1245!

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What About Corporations?

- Corporations do not have special capital gains rates. However, capital gains and losses still must go through a netting process. Capital losses may only be taken to the extent of capital gains (no $3,000 deduction).
- Therefore, instead of unrecaptured gain being taxed at a maximum 25 percent rate, this type of gain is recaptured under §291
- Section 291 effectively changes the character of the income being recaptured (however, the rate is still the corporate tax rate)

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Section 291(a)

- For purposes of this subtitle, in the case of a corporation:
  1. Section 1250 capital gain treatment
     In the case of §1250 property disposed of during the taxable year, 20 percent of the excess (if any) of:
     A. The amount that would be treated as ordinary income if such property was §1245 property; over
     B. The amount treated as ordinary income under §1250 (determined without regard to this paragraph)

     Shall be treated as gain that is ordinary income under §1250 and shall be recognized notwithstanding any other provision of this title. Under regulations prescribed by the Secretary, the provisions of this paragraph shall not apply to the disposition of any property to the extent §1250(a) does not apply to such disposition by reason of §1250(d).

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Section 291 Recapture

- Section 291 essentially says that 20 percent of unrecaptured §1250 gain is ordinary income. The remaining 80 percent of §1250 gain is a §1231 gain (generally a capital gain).
- As a reminder, unrecaptured §1250 gain is the difference between original cost and straight-line basis depreciation
- Section 291 only changes the character of the gain – which could affect the number of losses that may be netted against capital gains or §1231 gains

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Example 18

ABC Corporation purchases real property (qualifying §1250 property) for $200,000 in year 1. In year 7, the company sells the building for $300,000 after taking $50,000 of depreciation deductions.

The total gain is $150,000 ($300,000 – $150,000). Section 291 would recapture the first $10,000 of this gain ($50,000 × 20%). The remaining gain would generally be a §1231 gain (most likely a long-term capital gain).

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Practitioner Considerations – Depreciation Recapture

- *Don't assume that a sale of rental real estate will result only in capital gains. It usually won't. Depreciation recapture will probably reclassify at least some of that gain.*
- *When advising clients on accelerated depreciation related to qualified improvement property, bonus depreciation is usually better than §179*
- *Anytime we take depreciation, depreciation recapture will generally apply – including if we rent out part of a home or utilize part of a home as a home office*

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Vacation Homes

- If a client just owns a vacation home and only uses it for personal purposes, the tax implications are generally straightforward:
  - Real estate taxes may be deducted (regardless of the number of homes)
  - Mortgage interest may be deducted on the first two residences (on acquisition indebtedness of up to $750,000)
- If the client uses the home for personal purposes and rents it out, then things are more complicated… Is it a personal residence? A rental? Or something in between?

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Renting Out Vacation Homes – Overview

- Three categories of vacation home rentals:
  1. Under 15 days of rental use → Income is exempt, no rental activity deductions
  2. Greater than 14 days personal use and 10 percent of the rental days → Special vacation home rules apply, and no losses are allowed
  3. Under 15 days of personal use or 10 percent of the rental days → Rental income, rental deductions

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Category 1 – Under 15 Days of Rental Use

- Section 280A(g), special rule for certain rental use
  - *Notwithstanding any other provision of this section or §183, if a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year, then:*
    1. No deduction otherwise allowable under this chapter because of the rental use of such dwelling unit shall be allowed; and
    2. **The income derived from such use for the taxable year shall not be included in the gross income of such taxpayer under §61**

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Example 19 – Under 15 Days of Rental Use

In Richmond, Virginia, an international cycling event is taking place for one week in July. Linda, a Richmond homeowner, decides that she does not want to be in town during the event due to the expected large crowds. Therefore, she decides to rent her Richmond residence out to a group of fans attending the race. Aside from these seven days, Linda does not rent her residence out (it is used entirely for personal use).

In accordance with §280A, any rental income that Linda receives from the fans would be excluded from gross income. Linda could not deduct any expenses (such as utilities) for the time her home was rented out.

Linda would generally be able to take mortgage interest deductions on the first two residences and real estate tax deductions on Schedule A.

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Category 2 – Greater Than 14 Days Personal Use and 10 Percent of Rental Days

- Essentially, a significant amount of personal use will limit losses
- It is the greater of 15 days or 10 percent of the rental days that determines
- Category 2 is the result of several parts of §280A…

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Category 2 – Greater Than 14 Days Personal Use and 10 Percent of Rental Days

- Section 280A(a): *Except as otherwise provided in this section, in the case of a taxpayer who is an individual or an S corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit used by the taxpayer during the taxable year as a residence*
- Section 280A(c)(3), rental use
  - *Subsection (a) shall not apply to any item attributable to the rental of the dwelling unit or portion thereof (determined after the application of subsection (e))*

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Category 2 – Greater Than 14 Days Personal Use and 10 Percent of Rental Days

- Section 280A(e), expenses attributable to rental

1. *In general*
   - *In any case where a taxpayer who is an individual or an S corporation uses a dwelling unit for personal purposes on any day during the taxable year (whether or not they are treated under this section as using such unit as a residence), the amount deductible under this chapter with respect to expenses attributable to the rental of the unit (or portion thereof) for the taxable year shall not exceed an amount that bears the same relationship to such expenses as the number of days during each year that the unit (or portion thereof) is rented at a fair rental bears to the total number of days during such year that the unit (or portion thereof) is used*
2. *Exception for deductions otherwise allowable*
   - *This subsection shall not apply with respect to deductions that would be allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was rented*

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So, What Does This Mean?

- Section 280A(e) says that you have to allocate expenses between rental days and personal use days (days the taxpayer uses the home as a residence) for a vacation home that the client rents out
- Expenses for rental days are deductible. Expenses for personal use days are not (unless they are for things that are normally deductible – such as mortgage interest or real estate taxes).
- So, why is there a category 2 and a category 3? Losses are treated differently…

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So, What Does This Mean?

- Section 280A(c)(5), limitation on deductions
- *In the case of a use described in paragraphs (1), (2), or (4), and in the case of a use described in paragraph (3)* ***where the dwelling unit is used by the taxpayer during the taxable year as a residence****, the deductions allowed under this chapter for the taxable year by reason of being attributed to such use shall not exceed the excess of:*
  - *A. The gross income derived from such use for the taxable year; over*
  - *B. The sum of:*
    - *i. The deductions allocable to such use that are allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was so used; and*
    - *ii. The deductions allocable to the trade or business (or rental activity) in which such use occurs (but that are not allocable to such use) for such taxable year*
  - *Any amount not allowable as a deduction under this chapter by reason of the preceding sentence shall be taken into account as a deduction (allocable to such use) under this chapter for the succeeding taxable year. Any amount considered for any taxable year under the preceding sentence shall be subject to the limitation of the first sentence of this paragraph whether or not the dwelling unit is used as a residence during such taxable year.*

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Category 2 – Greater Than 14 Days Personal Use and 10 Percent of Rental Days

- Section 280A(d)(1), in general
- *For purposes of this section,* ***a taxpayer uses a dwelling unit during the taxable year as a residence*** *if they use such unit (or portion thereof) for personal purposes for a number of days that exceeds the greater of:*
  - *A. 14 days; or*
  - *B. 10 percent of the number of days during such year for which such unit is rented at a fair rental*
- *For purposes of subparagraph (B), a unit shall not be treated as rented at a fair rental for any day for which it is used for personal purposes*

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Category 2 vs. Category 3

- This means that losses are limited on vacation rentals that fall into category 2, because there is significant personal use. Losses are generally allowed if there is not (category 3 – but we still have to be wary of the passive activity rules)
- In either case, deductions must be allocated between days used as a residence and days used as a rental
- This may seem like it essentially says the same thing, but there is a distinction…

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Example 20 – Category 2

Missy owns a condo in Florida. She uses the condo personally for 20 days and rents it out for 190 days. When the condo is rented out, it is used for short-term rentals only such that it qualifies for a rental status exception under §1.469-1T(e)(3)(ii) – that is, it is not automatically considered passive. Assume that Missy materially participates in the rental activity.

If she were to have a loss on the condo (rental expenses exceed rental income), she would be unable to take the loss in the current year. The condo has significant personal use (over 14 days and 10 percent of the rental days). Therefore, the loss may not be deducted under §280A(c).

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Example 21 – Category 3

Assume the same facts as Example 20, except now Missy only spends 12 days in her Florida condo. She rents it out for 190 days.

In this instance, now her losses on the condo become deductible. If the activity is not under rental status and she meets the required number of hours for material participation, there is no limitation due to the passive activity rules.

Also, the limitation provided by §280A(c) would not apply either – since there is not significant personal use.

The losses can be taken in full (however, deductions would need to be allocated between personal and rental use).

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So, How Do You Allocate Days?

- For most things, you would allocate based on the following formula:

  Rental % = Rental days / (Rental days + Personal days)

- For interest and taxes, the tax court and the IRS disagree:
  - IRS says use the same formula as above
  - The tax court said use the total number of days in the year in the denominator (82-2 USTC ¶9699 9th Cir. 1982, affirming 77 TC 104):

    Rental % = Rental days / 365

- Any interest and taxes not taken on Schedule E (rental use) would generally go on Schedule A

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Practitioner Considerations – Vacation Homes

- For federal tax purposes only, renting out a vacation home for 14 days or less is tax free. But watch out for state and local taxes!
- Have clients keep track of personal vs. rental days. This can make classifying the rental easier.
- Have clients keep track of ALL costs of the vacation home they are renting – utilities, HOA fees, maintenance costs, etc.

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So, Is It Possible to Have a Rental Property Qualify for the QBI Deduction?

- Yes, but not if it is a personal residence as defined under §280A(d)
- IRS Notice 2019-07:
  - .05 *Certain rental real estate arrangements excluded. Real estate used by the taxpayer (including an owner or beneficiary of an RPE relying on this safe harbor) as a residence for any part of the year under §280A is not eligible for this safe harbor.*

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Example 22 – QBI

Missy owns a condo in Florida. She uses the condo personally for 20 days and rents it out for 190 days. When the condo is rented out, it is used for short-term rentals only such that it qualifies for a rental status exception under §1.469-1T(e)(3)(ii) – that is, it is not automatically considered passive. Assume that Missy materially participates in the rental activity.

This activity would not be eligible for the QBI deduction, because this would be a condo used as a personal residence under §280A(d).

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Section 199A – QBI Deduction

- The §199A deduction is allowed for businesses that rise to the level of a §162 trade or business
- This is a fine definition, but hard to apply in actual practice – especially for rental real estate
- In order to take some of the guesswork out of the §199A deduction for rental real estate activities, a safe harbor is allowed under Rev. Proc. 2019-38

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Rev. Proc. 2019-38 – Safe Harbor Requirements

- Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise
- For rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed per year. For other rental real estate enterprises, 250 or more hours of rental services are performed in at least three of the past five years.
- The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: hours of all services performed; description of all services performed; dates on which such services were performed; and who performed the services
- The taxpayer or RPE attaches a statement to the return filed for the tax year(s) the safe harbor is relied upon

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Separating Real Estate Activities

- Often real estate developers will buy large undeveloped plots of land and divide into smaller parcels in order to make it easier to sell
- From a tax perspective, this can become problematic. Land parcels held for investment generally result in capital gain/loss treatment.
- Land parcels held for sale in the ordinary course of business result in ordinary income. That is, at a certain point, the smaller land plots begin to resemble inventory (if the taxpayer begins to sell them regularly).
- This is a facts and circumstances determination. However, §1237 helps gives us some clarity by providing a safe harbor rule. If the client meets the requirements of §1237, the gains are treated as capital gains (and we can rest assured they will not be treated as ordinary).

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Section 1237 Safe Harbor

A. "Any lot or parcel which is part of a tract of real property in the hands of a **taxpayer other than a C corporation shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business** at the time of sale solely because of the taxpayer having subdivided such tract for purposes of sale or because of any activity incident to such subdivision or sale, if:

1. Such tract, or any lot or parcel thereof, had not previously been held by such taxpayer primarily for sale to customers in the ordinary course of trade or business (unless such tract at such previous time would have been covered by this section) and, in the same taxable year in which the sale occurs, such taxpayer does not so hold any other real property; and…"

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Section 1237 Safe Harbor

2. "…no substantial improvement that substantially enhances the value of the lot or parcel sold is made by the taxpayer on such tract while held by the taxpayer or is made pursuant to a contract of sale entered into between the taxpayer and the buyer. For purposes of this paragraph, an improvement shall be deemed to be made by the taxpayer if such improvement was made by:
   A. The taxpayer or members of his family (as defined in Section 267(c)(4)), by a corporation controlled by the taxpayer, an S corporation which included the taxpayer as a shareholder, or by a partnership which included the taxpayer as a partner; or
   B. A lessee, but only if the improvement constitutes income to the taxpayer; or
   C. Federal, state, or local government, or political subdivision thereof, but only if the improvement constitutes an addition to basis for the taxpayer; and…"

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Section 1237 Safe Harbor

3. "…such lot or parcel, except in the case of real property acquired by inheritance or devise, is held by the taxpayer for a period of five years."

- So essentially, the real property cannot be held in the course of trade or business, can't be substantially improved, and must be held for at least five years…
- The hard part about this safe harbor is the idea of being "substantially improved." What does that mean? The regulations give us some guidance…

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Treas. Regs. §1.1237-1(c)(4)

4. When an improvement is substantial. *To prevent the application of §1237, the improvement itself must be substantial in character. Among the improvements considered substantial are shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas, or electric lines. On the other hand, a temporary structure used as a field office, surveying, filling, draining, leveling and clearing operations, and the construction of minimum all-weather access roads, including gravel roads where required by the climate, are not substantial improvements.*

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Treas. Regs. §1.1237-1(c)(5)(i)

- ***An improvement will not be considered substantial*** *if all the following conditions are met:*
  - *a. The taxpayer has held the property for 10 years. The full 10-year period must elapse, whether or not the taxpayer inherited the property. Although the taxpayer must hold the property 10 years, he need not hold it for 10 years after subdividing it. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held;*
  - *b. The improvement consists of the building or installation of water, sewer, or drainage facilities (either surface, sub-surface, or both) or roads, including hard surface roads, curbs, and gutters;*
  - *c. The district director with whom the taxpayer must file his return is satisfied that, without such improvement, the lot sold would not have brought the prevailing local price for similar building sites; and*
  - *d. The taxpayer elects, as provided in subdivision (iii) of this subparagraph, not to adjust the basis of the lot sold or any other property held by him for any part of the cost of such improvement attributable to such lot and not to deduct any part of such cost as an expense.*

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Example 23 – §1237 Safe Harbor

Ronaldo had owned a piece of vacant land for 12 years. He decides to update the drainage system around the property. As long as this improvement is only to bring the property up to the prevailing local value for similar properties and the cost is not added to the basis of the property (or deducted), the property would still meet the conditions for the §1237 safe harbor.

Ronaldo could sell the property for a gain and receive capital gain treatment (assuming the other provisions under §1237 were met).

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What About Opportunities When Selling Real Estate?

- When you sell real estate, you might be able to structure the transaction as a like-kind exchange (§1031) or an installment sale (§453)
- Like-kind exchanges are normally a specialized area. However, real property that is held for investment or business purposes that is exchanged for real property held for either investment or business purposes normally qualifies (basis generally carries over to the new property)
- There are time restrictions with a like-kind exchange

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Like-Kind Exchanges – Time Restrictions

- The taxpayer has 45 days from the date they sell the relinquished property to **identify** replacement property. This identification must be in writing, signed by the taxpayer, and delivered either to the seller or to the qualified intermediary.
- The replacement property must be received (and the exchange completed) no later than 180 days after the sale of the exchange property or the due date (including extensions) of the income tax return for the year in which the relinquished property is sold, whichever is earlier. The replacement property received must be substantially the same as the property identified with the 45-day limit.

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Gains – Section 1031(b)

(b) Gain from exchanges not solely in kind

If an exchange would be within the provisions of subsection (a), of Section 1035(a), of Section 1036(a), or of Section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, ***then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property***

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Basis – Section 1031(d)

(d) Basis

If property was acquired on an exchange described in this section, Section 1035(a), Section 1036(a), or Section 1037(a), ***then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange****. If the property so acquired consisted in part of the type of property permitted by this section, Section 1035(a), Section 1036(a), or Section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, Section 1035(a), and Section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed (as determined under Section 357(d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.*

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Example 24 – Basis in Like-Kind Exchange

Assume that taxpayer A exchanges property with a basis of $100,000 and a fair market value of $250,000 for a replacement property worth $200,000. In addition, taxpayer A receives $50,000 in cash.

Taxpayer A would need to recognize a $50,000 gain. The basis in the property received would be $100,000:

$100,000 carryover + $50,000 gain recognized – $50,000 boot received

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Example 25 – Basis in Like-Kind Exchange

Assume that taxpayer A exchanges property with a basis of $225,000 and a fair market value of $250,000 for a replacement property worth $200,000. In addition, taxpayer A receives $50,000 in cash.

Taxpayer A would need to recognize a $25,000 gain. The basis in the property received would be $200,000:

$225,000 carryover + $25,000 gain recognized – $50,000 boot received

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Installment Sale Treatment Disallowed – §453

- Certain sales transactions may not use the installment sale method. In these instances, you simply declare the entire gain at the time the sale is entered into.
- Additionally, if a taxpayer wants to elect out of the installment method, they simply declare the entire gain at the time the sale is entered into
  - There is no special election form – the gain is just shown on the return

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Installment Sale Treatment Disallowed – §453

- Losses are not eligible for installment sale treatment – only gains
- Gains are based on the gross profit percentage multiplied by the cash payment received
- If all the payments are received in the current tax year, the taxpayer is not eligible for installment sale treatment
- Certain assets are not eligible for installment sale treatment

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Installment Sale Treatment Disallowed – §453

- The following are ineligible for installment sale treatment:
  - Sales of inventory related to personal property
  - Sales of stocks and securities traded on an established securities market
  - Sales of depreciable property to a related person
  - Sales of publicly traded property
  - Sales attributable to depreciation recapture
  - Sales of timeshares and residential lots by dealers unless the purchaser elects to pay a special interest charge
  - Sales by dealers

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Example 26 – Installment Sale

Jane sells land (basis $100,000) for $250,000. Payments will be made to Jane over three years:

Year 1: $90,000

Year 2: $100,000

Year 3: $60,000

Recognized gains would be based on the gross profit percentage (60% = $150,000 gain / $250,000 proceeds):

Year 1: $54,000

Year 2: $60,000

Year 3: $36,000

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Example 27 – Installment Sale

Assume the same facts, except that Jane is selling land ($100,000 basis) and a machine that is subject to $50,000 of §1245 recapture in year 0. Total proceeds received are still $250,000.

The depreciation recapture would need to be recognized right away. For the remaining payments, the gross profit percentage would be 40 percent: ($150,000 original gross profit – $50,000 recapture) / $250,000 total proceeds.

Gains recognized:

Year 0: $50,000

Year 1: $36,000

Year 2: $40,000

Year 3: $24,000

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Installment Sales Opportunities

- Avoid selling property subject to recapture on an installment sale basis
- Less cash upfront will defer more gains to later years
- Installment sale treatment only requires one payment to be made in the **next tax year** – even if that payment is in January!

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Tax Planning – Rental Real Estate

- Review questions



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Question 1

Which of the following is correct regarding passive activities?

a) If a taxpayer spends over 500 hours on a rental activity, it is NOT passive
b) A rental activity where each customer uses the property for an average of seven days or less is a passive activity
c) A rental activity that does not have an exception listed in the regulations is a passive activity
d) A rental activity where each customer uses the property for over seven days but not over 30 days and “significant” personal services are provided by or on behalf of the owner is a passive activity

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Question 1

Which of the following is correct regarding passive activities?

a) If a taxpayer spends over 500 hours on a rental activity, it is NOT passive
b) A rental activity where each customer uses the property for an average of seven days or less is a passive activity
c) A rental activity that does not have an exception listed in the regulations is a passive activity
   - *Unless the rental activity has an exception listed in the regulations, it is automatically considered passive based on §469(c)*
d) A rental activity where each customer uses the property for over seven days but not over 30 days and "significant" personal services are provided by or on behalf of the owner is a passive activity

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Question 2

By meeting the §1237 safe harbor requirements:

a) Land parcel sales generally result in capital gains
b) Land parcel sales generally result in ordinary gains
c) Land parcel sales are nontaxable
d) Land parcel sales resulting in losses may not be taken

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Question 2

By meeting the §1237 safe harbor requirements:

a) *Land parcel sales generally result in capital gains*
   - *The safe harbor allows for capital gain treatment on land that is not substantially improved*

b) Land parcel sales generally result in ordinary gains

c) Land parcel sales are nontaxable

d) Land parcel sales resulting in losses may not be taken

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Practitioner Considerations – Final Thoughts

- Grouping is only allowed if the activities form an appropriate economic unit. This is a facts and circumstances determination, but we do get some guidance from the regulations.
- Once a grouping election is made, the client must generally stick with it – unless the facts and circumstances materially change or the grouping is inappropriate
- Section 1237 provides a safe harbor election that provides relief from ordinary income treatment of certain land sales

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Practitioner Considerations – Final Thoughts

- Clients can generally take a deduction for mortgage interest and real estate taxes on their vacation homes. However, if a vacation home is rented out, the tax implications are more complex.
- Losses on mixed-use rental homes with significant personal use are not allowed in the current year
- A QBI deduction may be taken only on rental properties where the activity rises to a level of a §162 trade or business

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Thank You!

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