

FEDERAL INCOME TAXATION OF REAL ESTATE

(Chapter 15 from Illinois
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IN THIS CHAPTER

Although all real estate licensees must have basic knowledge and understanding of the federal income tax laws affecting real property, they must not give tax advice to buyers and sellers. Because each taxpayer's situation is different, only competent professional tax consultants who are familiar with the taxpayer's position should give advice of this nature. Real estate licensees should recommend that buyers and sellers seek this specialized expertise when appropriate.

This chapter presents the fundamentals of tax implications in the ownership and sale of a principal residence and business and investment property. It illustrates and explains the special tax benefits provided to owners and sellers of real property to enable you to understand these advantages.

THE TAXPAYER RELIEF ACT OF 1997

The Taxpayer Relief Act of 1997 (TRA) provided tax relief for many and increased tax liability for some. In all, more than 800 changes were made to the tax code. The biggest winners under these changes are single-family homeowners. Many homeowners will be able to take advantage of new capital gain treatment on principal residences.

Although the TRA of 1997 presents the most current major changes to the tax code, the tax code is still greatly influenced by the Revenue Reconciliation Act of 1993 (RRA) and the Tax Reform Act of 1986 (TRA). The TRA has a devastating impact on commercial, industrial, and investment real estate of all types.

CAPITAL GAIN

A **capital gain** is the profit on the sale of an asset. The gain can be arrived at by subtracting the adjusted basis of an asset from the net proceeds of the sale of the asset. Before the Tax Reform Act of 1986 (TRA) investors would pay a maximum of 20% on the sale of an investment property. The TRA raised the capital gains tax treatment of investors to 28% or the

taxpayers bracket, whichever is less. Thanks to the Taxpayer Relief Act of 1997, for sales that take place after May 6, 1997, investors pay capital gains tax at a maximum rate of 20%. Individuals in the 15% tax bracket need pay at the rate of only 10%. There are other provisions dealing with capital gains taxes that involve recapture of depreciation, the alternative minimum tax, etc., which are beyond the scope of real estate licensee. The licensee should encourage the client to seek the advice of a tax professional.

Under the new law, owner-occupied principal residences are treated very differently from investment property.

DEPRECIATION

Depreciation is an allowance deducted from the net income of a property before taxes are assessed, which is determined by the property's loss in value. (Tax shelters are discussed later in this chapter). A little historical background will help put recent changes in depreciation allowances into perspective.

Under the Tax Act of 1981, the Accelerated Cost Recovery System (ACRS) established a schedule that allowed **accelerated** (or front-loaded) **depreciation**: Higher deductions were taken in early years and lower deductions in later years, an obvious benefit to investors. The TRA of 1986, however, disallowed accelerated depreciation on real property; **straight-line depreciation** is once again the standard so *deductions are taken in equal amounts each year*.

Prior to the TRA of 1986, depreciation was allowed over 15 years, later modified to 18 and then 19 years. The TRA of 1986 set the depreciation schedule at 27 ½ years for residential property and 31 ½ years for nonresidential properties. The RRA of 1993 has further tightened depreciation allowances by expanding the depreciation period for nonresidential properties to 39 years. Real estate does not have the tax benefits it had in the early 1980's, when accelerated depreciation was allowed and depreciation schedules were shorter.

PASSIVE INCOME

The passive activity rules enacted under the TRA of 1986 allowed tax losses from investment properties to be offset only by income from passive activities, any trade or business in which the taxpayer does not materially participate. If the taxpayer materially participates, the income derived is not passive income. A taxpayer is considered a material participant if during a tax year he or she satisfies one of the following tests:

1. participates more than 500 hours
2. is the only participant in the activity
3. participates 100 hours, and no other participant has more hours involved
4. participates materially for any five years in a 10-year period
5. the activity is a personal service activity, such as health fields, engineering, architecture, accounting, and actuarial service

Under this law, if excess passive losses existed in any tax year, they could be carried over to later years and deducted then, if passive income was available, or claimed when the asset was sold. Passive losses could not be used to offset non-passive income such as wages, interest, or dividends.

With the advent of the RRA of 1993 (effective for tax years beginning after December 31, 1993), however, certain taxpayers who are involved in real property trades or businesses are no longer subject to passive activity loss (PAL) rules. This means that taxpayers who meet the special requirements are able to use rental real estate losses against non-passive income. To be eligible for this special treatment the taxpayer's material performance must be:

1. more than 50 percent of taxpayer's personal service
2. more than 750 hours of service

Real property trade or business is defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Material participation requires that the individual be involved in the operations of the activity on a regular and continuous basis. Limited partners cannot be considered material participants. For purposes of the RRA of 1993, the activities may be considered individually or aggregated into like groups.

The \$25,000 rule still applies to all other taxpayers who do not meet the special eligibility requirements. Taxpayers with adjusted gross incomes of up to \$100,000 may shelter up to \$25,000 in rental property losses. This exception phases out as the taxpayer's adjusted gross income reaches \$150,000, after which no deduction is allowed unless the taxpayer falls under the new rules of RRA of 1993. Certain deductions for real property, such as most mortgage interest and property taxes, are maintained. These deductions apply to both a principal residence and a second home.

As a result of lost deductions for consumer interest on cars and credit cards, many taxpayers are borrowing against the equity in their homes (which may be fully deductible) to pay off nondeductible interest debts. The risk in this, however, is that the home may be lost if payments are not made per the loan agreement; the risk is not typically associated with failure to pay monthly credit card installments per a credit agreement.

TAX IMPLICATIONS OF HOME OWNERSHIP

The tax-deductible expenses involved in home ownership are mortgage interest (not principal) and real property taxes paid to local authorities. In addition, taxpayers who can deduct mortgage interest usually find it advantageous to itemize and take advantage of other tax-deductible expenses not associated with home ownership. The combination of mortgage interest and other itemized expenses provides greater tax relief than is available by taking the more modest standard deduction.

Let's assume a home-buyer purchases a residence for \$100,000 with a \$10,000 down payment and finances the balance for 30 years at 11 ½ percent interest. The monthly payment of principal and interest necessary to fully amortize the remaining \$90,000 over a 30-year period is \$891.26. During the first 12 months of loan payments, the borrower will pay a total of \$10,331.21 in mortgage interest. This interest is available as a tax deduction for the year in which it is paid.

CAPITAL GAINS ON A PRINCIPAL RESIDENCE

On sales that took place before May 7, 1997, federal tax laws required a taxpayer selling a principal residence to reinvest in a new residence with a price equal or greater than the adjusted basis of the home sold to avoid capital gain liability. The old tax code gave these sellers 24 months to reinvest and allowed them to use the rollover rule each time they sold. In fact, the rollover rule was mandatory.

While this rollover provision was often considered very desirable by many taxpayers, changing demographics and economics have caused problems for an increasing number of taxpayers. Taxpayers, to defer the gain, were encouraged by the rule to buy homes that were more expensive than the home they sold, or pay the tax. Many "empty nesters" felt forced to continue to live in or purchase more expensive homes when a smaller less expensive home would have served them better. Many middle managers making generous salaries became victims of corporate downsizing and were never able to find employment that replaced their generous salaries. Transferees relocating from high cost areas of the country to lower cost areas had trouble in reinvesting in a home that cost as much as the one they just sold. If in these situations the taxpayer had "bought down" he would have incurred capital gain tax liability. Under the Taxpayer Relief Act of 1997, the taxpayer need not reinvest in a more expensive home or in any new residence. The taxpayer may take the proceeds from the sale and rent apartments for the remainder of his life or tour the world with no capital gain tax liability.

How does this work? On the sale of principal residences closed after May 6, 1997 new rules allow qualifying taxpayers an exemption of \$250,000 (\$500,000 if married and filing jointly) of capital gain. In the new rules, there is no provision for purchasing another residence, no age requirement (older tax laws required a taxpayer to be 55 years or older to be able to exclude \$125,000 of capital gain), and the exclusion can be used every two years. To be eligible for this capital gain exclusion, the taxpayer must have used the property as the principal place of residence for 2 years of the last 5 years (24 months of the past 60 months).

In the case of recently married taxpayers (who must file jointly), if one spouse owned and lived in the property for 2 of the past 5 years, they would qualify for \$250,000. If one spouse owned the property, and both spouses lived in the property for 2 of the past 5 years, they would qualify for \$500,000 of exemption. Remember that neither spouse could have used the exemption in the previous 2 years.

There are many exemptions to the 2-year rule. A provision for divorced taxpayers was inserted allowing the taxpayer to claim occupancy for the time such taxpayer's spouse lived in the property per a court order in a divorce or legal separation. Additionally, there are provisions for the proration of the exclusion for taxpayers that cannot meet the 2-year test due to:

1. change of place of employment
2. health reasons
3. certain unforeseen circumstances as stipulated by the tax code

Taxpayers who sold a principal residence prior to August 5, 1997 and purchased another residence under the old rollover rule, may use the period of ownership of this prior residence to qualify for the \$250,000 exclusion. This "tacking" provision can be used for both the use or occupancy requirement and the ownership requirement. With these complexities, again we see the need for real estate agents to have their clients direct tax questions to a tax professional.

Taxpayers selling their properties with a capital gain greater than \$250,000 (\$500,000 if married and filing jointly) will be taxed at the appropriate capital gain rate.

RENTING OF THE PRINCIPAL RESIDENCE BEFORE THE SALE

When a seller was unable to sell his property due to a slow real estate market or to a relocation that was intended to be temporary, the seller might rent the property until he was able to return to the property or decide to sell the property. Taxpayers had to be careful to make sure the property remained their principal residence to qualify for the old rollover exemption and did not become an investment property. The new capital gains requirements of "2 years of the past 5" clearly alleviate this problem. Renting a property under these or other circumstances will not change the property's tax treatment, as long as the seller has lived in the property for 2 years out of the last 5 years.

NURSING HOME EXCEPTION TO THE RESIDENCE RULE

Many elderly people that have become incapacitated will spend the remainder of their lives in nursing or adult care facilities. Congress, realizing this, liberalized the residency rule for incapacitated seniors. In fact, incapacitated persons of all ages qualify. A seller that has become incapacitated during the 5-year period prior to the sale need only to have lived in the property for 1 year out of the past 5 years to qualify for the capital gain exclusion of \$250,000. They must have spent the remainder of the 5 years in a state licensed facility.

EFFECT OF PURCHASE AND SALE

In the purchase and sale of a personal residence, both the buyer and the seller have certain expenses. Examples of these expenses and their application to buyer and seller in calculating taxable gain are offered below.

1. The premium paid for a title insurance policy may be subtracted from the selling price if the seller pays it. If the buyer pays that premium, the amount paid is added to the buyer's basis.
2. Transfer taxes, ordinarily paid by the seller at the transfer of the real estate, are based upon the seller's equity or sales price. They may be deducted by the seller from the selling price. If the tax is paid by the buyer, however, the amount is added to the buyer's basis.
3. Attorney fees paid by the seller are deductible from the selling price. Attorney fees paid by the buyer are added to the buyer's basis. Attorney fees incurred by the buyer to obtain financing, however, may not be added to the buyer's basis.
4. If the seller pays the attorney's fee for preparation of a deed, the seller may deduct this fee from the selling price. If the buyer pays the fee for drawing the deed, it may be added to the buyer's basis.
5. Buyer's closing costs that are allocable to purchasing the property may be added to the buyer's basis. Expenses of borrowing the purchase price, however, may not be added to the buyer's basis. Expenses involved with obtaining the loan include things such as appraisal fees, mortgage insurance premiums, charges by the lender's attorney, and credit report cost.
6. The seller often pays the discount points charged by many lending institutions in making home loans. Discount points charged by lending institutions may be deducted from the selling price if the seller pays them to enable the buyer to obtain a loan. These discount points are not deductible as interest by the seller because the seller has not borrowed the money and therefore has no obligation to repay. However, recent legislation retroactive to December 31, 1990, allowed buyers to deduct, as interest, any discount points paid by the seller on the buyer's behalf. Discount points paid by the buyer are also deductible as interest by the buyer for the year in which points are paid.

In 1986, the IRS ruled that discount points paid by the owner to refinance an existing loan have to be spread out over the term of the loan. The essential difference is that a buyer who pays \$2,000 in points for a new home can deduct all \$2,000 in the year paid. If refinancing the present loan for 20 years, however, the owner can deduct only \$100 per year. If a mortgage loan is not obtained to purchase or improve a principal residence, deduction of the discount points as interest must be spread out over the life of the loan. For example, if a borrower pays \$2,000 in discount points to obtain a 20-year conventional loan to purchase an apartment building, the discount points are deductible at a rate of \$100 per year for 20 years.

7. If the borrower pays a loan origination fee or a loan-processing fee, typically 1 percent of the amount of the loan, the fee is not deductible as interest because the fee is for loan services and not for use for the money borrowed. Also, the borrower may not add the cost of a loan origination fee to the basis of the property because this is an expense of borrowing the purchase price rather than a cost for obtaining the property. Loan origination fees paid by the

seller are a selling expense and may be deducted from the sales price in arriving at the amount realized.

8. Other expense items, such as surveys, escrow fees, title abstracts, recording fees, and advertising costs, may be added to the buyer's basis if paid by the buyer, or subtracted from the selling price if paid by the seller.

9. The real estate commission a seller pays may be deducted, but only from the selling price. The commission paid is not deductible from the seller's ordinary income.

10. A financial penalty required by a lender for early payoff of a mortgage loan (a repayment penalty) is deductible as interest by the borrower for the year in which the prepayment is paid.

11. Moving expenses are deductible if the taxpayer itemizes and the expenses are incurred while moving to a new job that would require 50 miles increase for self-employed taxpayers. Although buying and selling expenses (items 1 through 10) at one time were allowed as moving expense deductions from taxable income, the RRA of 1993 now allows them only as deductions toward arriving at the adjusted basis of the old or new residence for determining capital gain.

Other deductible moving expenses are used to calculate net taxable income and are deductible in the year of the sale. These expenses may include transportation of furniture and effects, and expenses of transportation and lodging when moving from the former home to the new home. Auto expenses on a personal car, gas, oil, repairs, tolls and parking (but not depreciation) during the move are deductible.

Moving expenses no longer deductible include pre-move house-hunting trips and even meals during the move. It should be noted that if the employer reimburses the employee for expenses, provides temporary living quarters, or reimburses the employee for a loss on the sale of the home, the IRS will treat this as compensation (pay), and the employer must issue a W-2 for the amount.

THE AGE-55-AND-OVER EXCLUSION

Many will remember the 55-and-over capital gains exclusion. Many called this exclusion the \$125,000 once-in-a-lifetime exclusion, because if you used the exclusion (or any part of it) you lost the opportunity to use it again.

Under the Taxpayer Relief Act of 1997, all taxpayers, even those that have used the 55-year old exemption, that can meet the occupancy and ownership requirement (2 years out of the previous 5 years) can exclude up to \$250,000 (\$500,000 if married filing jointly) of capital gain. This exclusion may be used every two years as long as the occupancy and the ownership tests are met.

Taxpayers that are over 55 and used the rollover rule in the past 3 years (take the current year minus years – the calculated year must be earlier than May 7, 1997), should talk to their tax professional and consider amending their returns. By using their 55-year old exclusion, they will be able to eliminate \$125,000 of gain and still be able to qualify for the \$250,000 exclusion on subsequent sales.

TAXPAYERS WITH TWO PROPERTIES

Taxpayers who own two properties may be able to exclude the gain on both properties. A taxpayer sells his principal place of residence and uses the \$250,000 exclusion. He may be able to move into his second property, meet the occupancy test after 2 years and use the \$250,000 exclusion again. Of course the real estate agent should direct the seller to his tax professional for advice.

COMPUTATION OF GAIN

Figures 15.1 and 15.2 illustrate the steps taken in arriving at the adjusted basis and calculating the taxable gain on the sale of a residence.

Example: Joan sells her residence for \$175,000. She pays \$10,500 in commission. Other closing costs are \$5,000. She has previously purchased the property for \$75,000 and then added a room for \$60,000. Joan qualifies for the \$250,000 exclusion. How will the sale affect Joan's tax liability?

Figure 15.1

| | |
|------------------------|----------------|
| Sales price | \$175,000 |
| Minus selling costs | 5,000 |
| Minus commission | <u>10,500</u> |
| Equals | \$159,500 |
| Minus adjusted basis | |
| Minus original cost | 75,000 |
| Plus improvements | <u>60,000</u> |
| Equals: adjusted basis | <u>135,000</u> |
| Gain realized on sale | 24,500 |
| Minus the exclusion | <u>250,000</u> |
| Taxable gain | 0 |

Since the gain of \$24,500 is less than the \$250,000 exclusion, Joan will pay no tax.

Example: Bill sells his home for \$450,000. He paid \$20,000 in expenses of the sale and another \$31,500 in commissions. Bill had purchased the home for \$150,000 many years ago. He qualifies for the \$250,000 exclusion. How will the sale affect Bill's tax liability?

Figure 15.2

| | |
|------------------------|----------------|
| Sales price | \$450,000 |
| Minus selling costs | 20,000 |
| Minus commission | <u>31,500</u> |
| Equals | 398,500 |
| Minus adjusted basis | |
| Minus original cost | 120,000 |
| Plus improvements | <u>none</u> |
| Equals: adjusted basis | <u>120,000</u> |
| Gain realized on sale | <u>278,500</u> |
| Minus the exclusion | <u>250,000</u> |
| Taxable gain | <u>28,500</u> |

In this example, Bill would have to pay tax on the capital gain of \$28,500. Bill must pay the tax due and cannot rollover or defer the tax. If Bill's adjusted gross income on his return puts him in a tax bracket of 28% or greater, Bill will pay tax at the 20% rate (\$28,500 X 20% = \$5,700).

Taxpayers and real estate licensees alike often misunderstand the fundamental provision of the tax code regarding rollovers. The issue is so important in selling (and repurchasing) decisions that the licensee should be clearly versed on the technical ruled applied. They are not difficult, but they are important.

I N H E R I T A N C E B A S I S

The tax basis for all real property received by heirs is the *market value of the property on the date of the decedent's death*, not the price of the decedent paid. As a result of this stepped-up **inheritance basis**, any tax on gains deferred under the old rollover rule during the decedent's lifetime is eliminated. Therefore, gains deferred under the old rollover rule are not taxed in the decedent's estate or final tax return.

MORTGAGE INTEREST DEDUCTION

The one major tax break that remains for the average homeowner is the tax deductibility of mortgage interest. Mortgage interest remains deductible on both a primary residence and a second or vacation home. If a home was purchased, refinanced, or incurred additional debt after October 13, 1987, the home falls into two categories of debt: acquisition debt and home-equity debt. **Acquisition debt** is debt that is secured by a primary residence or a second home and that derives from purchasing, building, or improving a home. Acquisition debt is limited to \$1,000,000. **Home-equity debt** is debt that is secured by a primary or a second home and that is borrowed for reasons other than the purchasing, building, or improving of a home. Home-equity debt is limited to \$100,000 (\$50,000 if married and filing separately) or the property's market value, whichever is less. If a person owns two homes, the cap on the home-equity debt may still not exceed \$100,000 (\$50,000 if married and filing separately). Loans made before October 1987 are under a different set of rules. Contact an accountant for the most recent IRS regulations.

POINTS

Points remain deductible in the year the home is purchased and the points are paid. However, points paid in a refinancing and loans on second homes are not deductible in the current tax year. The IRS requires the points paid in a refinancing or second home to be deducted over the life of the loan. If the loan is paid off early, the remaining points can be deducted in that year. Points (or fees) used to pay for appraisal fees, preparation of a note or deed of trust, settlement fees, notary fees, abstract or title insurance fees, commissions, and recording fees may not be deducted.

VACATION HOMES

Under the TRA of 1986, the homeowners are allowed to deduct mortgage interest on both a principal residence and a second home, such as a vacation property. Special rules apply in classifying this second property. The vacation property is considered a second home if it is occupied for personal use more than 14 days per year or 10 percent of its useful rental period. In this case, the mortgage interest and property taxes on both the principal residence and the second home can be deducted to the extent the mortgages do not exceed the original purchase of the properties plus improvements.

If, however, personal use of the second property is limited to less than 14 days or 10 percent of the useful rental period, the home is treated as a business property. In this case, it is eligible for the 27 ½ year depreciation schedule and repairs and maintenance deductions, as well as a deduction for the mortgage interest and property taxes less a percentage of these expenses that must be allocated to the owner's personal use. The proper ratio for allocating the expenses is (a) the number of days the property is used divided by (b) the total number of days the property is rented.

INSTALLMENT SALES

The subject of installment sales is included at this point because tax law applications in installment sales apply both to a personal residence and to property held for investment or for use in a trade or business. An owner may sell his or her principal residence on an **installment sale** basis, in which *at least one payment is received by the taxpayer in a tax year after the sale*, and avoid the total impact of the tax in one year. The typical installment sale is by contract for deed or land contract.

Installment sales may be used to spread the impact of federal income taxes on gains over several years or to postpone taxes to a future year or years as the principal is received. This enables the taxpayer to avoid the impact of tax on gain in the sale of property in a single year. Installment sale rules apply to the sale of real property, businesses, securities, and personal property.

The TRA of 1986 makes the installment sale method much less attractive than under previous laws. Retroactive to March 1986, for installment sales of business property it is assumed that the seller has received a minimum cash payment each year. This means the payment is recognized for tax purposes, regardless of whether any cash is actually received during that year.

INVESTMENT PROPERTY

As we have seen, ownership and sale of a principal residence have special tax benefits. Ownership and sale of real property held as an investment or for use in a trade or business also have special tax benefits including depreciation, deductible expenses, and tax-free exchanges of like-kind property. **Like-kind property** is *property of the same nature and character, such as real property for real property, depreciable personal property for depreciable personal property, and so on*.

Depreciation

The two types of depreciation are (a) tax depreciation and (b) economic depreciation. **Economic depreciation** *results from physical deterioration of property caused by normal use, damage caused by natural and other hazards, and failure to adequately maintain the property*. **Tax depreciation** is a provision of the tax law, applicable to certain types of assets, that permit a property owner to take an *ordinary business deduction for the amount of an annual depreciation*. This permits the owner to recover the cost or other basis of an asset over the period of the asset's useful life. Tax depreciation is a deduction from net income in calculating taxable income.

Tax depreciation is an accounting concept only. The property being “depreciated” actually may be appreciating in value. When the property is sold, tax may have to be paid on the “real” appreciation plus recapture of the “artificial” tax depreciation.

The Tax Reform Act of 1986 establishes two depreciation schedules for real property: 27 ½ years straight-line for residential property and 31 ½ years straight-line for nonresidential property. Under the RRA of 1993 the depreciable lives of nonresidential property increased from 31 ½ to 39 years for the properties placed in service on or after May 13, 1993. Under the TRA of 1986, the amount of claimed investment losses must equal an amount no more than the income received from similar passive activities. For example, if an investor loses \$35,000 on her properties but the properties’ income is only \$21,000, the investor can claim only \$21,000 in loss this tax year. The excess loss of \$14,000 (\$35,000 - \$21,000) cannot be used in the year of the loss. The excess loss may be carried over to future tax years. The RRA of 1993 changed this situation somewhat for those taxpayers who meet the eligibility requirements.

A limited exception to this rule applies to owners with adjusted gross income of less than \$100,000 who actively manage their own property. These owners may shelter up to \$25,000 of other wages of active income in the same tax year. Passive investors who do not actively manage their own property cannot apply excess losses to other active income in the same tax year. In the above example, if the inventory manages her own properties and has an adjusted gross income of \$70,000, she can use the \$14,000 excess loss to reduce the adjusted gross income to \$56,000.

Depreciable property includes assets such as buildings, equipment, machinery, and other things that are used in business to produce income (other than inventories) or that are held as an investment. Assets held for personal use, include a personal residence, are not depreciable assets. Also, land is not a depreciable asset. Therefore, the value of the land and the value of structures on the land must be separated to arrive at a basis for determining depreciation. This basis normally is the cost of acquiring the property reduced by the estimated salvage value of the property at the end of its useful life.

When a depreciable asset is sold, the basis of the asset used to compute the taxable gain from the sale is the depreciated value. For example, if a depreciable asset is purchase for \$100,000 and the purchaser had taken \$40,000 of tax depreciation at the time the property was sold for \$130,000, the taxable gain is \$70,000 (\$130,000 sales price minus \$60,000 depreciated value = \$70,000 taxable gain). In essence, the basis of a depreciable asset is reduced by any depreciation deduction taken.

INCOME SHELTER

*Deductible allowances from net income of property to arrive at taxable income and tax losses allowed to offset passive and active income are **income shelters** for individual taxpayer owners. Examples of expenses and allowance deductible from gross income include depreciation, operating expenses, real estate taxes, and mortgage interest.*

To see the benefit of this concept, reconsider the operating statement for an apartment building was purchased for \$6,200,000. Because land does not depreciate, an allocation between the land and the improvement (the building) was made. If 15 percent of the price is allocated to the land, the depreciable property becomes 85% x \$6,200,000, or \$5,270,000. Because the property can be depreciated over a 27 ½ year period, one year's depreciation is 1/27th or \$191,636, which may be used to offset (shelter) income from the property itself. Further interest on the debt service is deductible. The final figures are illustrated in 15.3.

Viewed another way, if the property owner is in a 28 percent tax bracket, the exclusion (sheltering) of the depreciation allowance of \$191,636 means that she saved 28 percent of this figure, or potentially \$53,658 in federal income taxes, without having to “write a check” for the depreciation.

Figure 15.3

| | |
|----------------------|------------------|
| Net Operating Income | \$745,600 |
| Less: Interest | -463,836 |
| Depreciation | -191,636 |
| Net Taxable Income | <u>\$ 90,128</u> |

DEDUCTIBLE EXPENSES

Unlike the expenses of operating property held for personal use, such as a personal residence, the *cost of operation property held for use in business or as investment* are **deductible expenses**. These operation costs may be deducted from gross income in arriving at net income. Before deducting operation expenses, *losses from vacancies and credit losses are deducted from gross scheduled rental income* to arrive at **gross operation income**. Operating expenses are deducted from gross operating expenses.

Examples of operating expenses are:

- accounting and legal fees
- advertising
- property management fee
- property insurance
- licenses and permits
- wages and salaries
- services
- maintenance and repairs supplies
- taxes
- utilities

The *result of deducting operating expenses* is **net operating income**. Mortgages interest and depreciation are deducted from net operating income to arrive at net taxable income. This otherwise taxable income may be completely or partially sheltered from tax liability as a result of the depreciation allowance. Consequently, the building may have no taxable income.

TAX-DEFERRED EXCHANGES

The Internal Revenue Code provides that, in cases of qualified exchange of property, some or all of the gain may not have to be recognized for tax purposes. The property exchanged must be investment property or business property. In a qualified **tax-deferred exchange**, *the tax on the gain is postponed, and the deduction of the loss also must be postponed*. These requirements are not discretionary with the taxpayer or the government. If the transaction qualifies as an exchange, no gain or loss may be recognized in the year of the exchange. The basis of the property each exchanger received is treated as if it were the same basis as the property each owner prior to the exchange, plus any additional expenditures on the new property. Tax-deferred exchanges are barred, however, if the property to be received is not identified on or before 45 days after the transfer or if it is not received within 180 days after the transfer or by the due date (with extensions) of the tax return for the year of transfer if earlier.

LIKE-KIND PROPERTY

To qualify as an exchange, the properties must be like-kind. Essentially, this involves exchanging personal property for other personal property or real property for other real property. Exchanges of like-kind real property may be an office building for a shopping mall, an apartment house for a tract of land, or an office building for an apartment building. Examples of personal property exchanged are a truck for a machine or an automobile for a truck. Personal residences and a foreign property do not qualify for an exchange.

BUSINESS OR INVESTMENT PROPERTY

The property exchanged must be held for use in business or as investment. Property held for personal use does not qualify. An exchange of residences by homeowners does not qualify as a tax-deferred exchange but is treated as a sale and a purchase and thus may qualify for the rollover rule.

PROPERTY NOT HELD FOR SALE

The property exchanged must not be held for sale to customers in the regular course of business, such as lots held for sale by a developer.

BOOT

If an exchanger receives cash or some other type of nonqualifying property in addition to like-kind property, the transaction may still partially qualify as a tax-deferred exchange. The

recipient of *the cash in the exchange*, called the **boot**, or other non-qualifying property must include tax liability on the boot or other unlike-kind property in the calendar year of the exchange. **Unlike-kind property** is *property that is not similar in nature and character to the property exchanged*.

BASIS

The basis of the property an exchangor receives is the basis of the property given up in the exchange plus new expenditures or debt incurred. Therefore, an exchangor does not change the basis of an asset as a result of the exchange. For example, Exchangor #1 trades a property with a market value of \$100,000 and a basis of \$20,000 for another property also worth \$100,000. The property Exchangor #1 receives also is considered to have a basis of \$20,000 plus any new debt assumed and cash paid, regardless of the other exchanger's basis.

MULTIPLE EXCHANGE

A **multiple exchange** is one in which *more than two properties are exchanged in one transaction*. Usually, multiple exchanges are three-way exchanges. For example, A, B, and C each own like-kind real property held for business purposes of investment. In the exchange, A acquires the property owned by C, B acquires the property owned by A, and C acquires the property owned by B. Multiple exchanges qualify as tax-deferred exchanges in the same way two-way exchanges do. An exchangor does not have to receive property from the same person with whom he or she is exchanging property.

STARKER EXCHANGE (STARKER TRUST)

In the case for which the Starker exchange was named, Starker sold land to a corporation. The purchaser, however, withheld the purchase price until Starker subsequently found a suitable property to be purchased with proceeds from the sale. The U.S. Circuit Court of Appeals in 1979 held that the **Starker exchange** qualified for treatment as a tax-deferred exchange because the sale proceeds were held beyond the control of the taxpayer seeking the tax-deferred exchange. The court viewed the exchanges as one continuous transaction.

Therefore, *if the proceeds of the sale of property are held beyond the seller's control until the seller can locate the like-kind property in which to invest the proceeds, the transaction may constitute a tax-free exchange*. Proceeds from the Starker exchange are held in a **Starker trust**. Some time limitations apply. The property for the exchange must be identified in writing within 45 days of the time the Starker trust is established (first closing date), and the closing on the property must be in within 180 days of establishment of the Starker trust, or April 15, whichever comes first.

INVESTMENT SYNDICATES

As a result of the tax implications and advantages in owning real estate, many people want to invest in real estate. To achieve maximum purchasing power, some investors pool their resources in a real estate **investment syndicate**, *a joint venture typically controlled by one or two persons hoping for a return to all investors*. Profit for investors is generated when the syndicate buys, sells, and develops real estate.

To protect investors from fraud by syndicate promoters, the federal and state government have enacted securities laws and regulations. Because these laws are *designed to protect investors from buying "blue sky"* they are commonly referred to as **blue sky laws**.

The Security Act of 1933 was the first federal securities law. This law regulated companies' initial issuance of securities, outlined fraudulent practices, and required registration of securities prior to sale. Since that time, many additional laws have been passed requiring further disclosure, regulating insider trading, and requiring disclosure of any conflict of interest.

The Illinois Securities Law of 1953 was enacted to protect the public when buying securities. A person who buys into a syndication owns a security. State and federal securities laws both require full disclosure of any and all material facts concerning the security. Securities, unless exempt, must be registered with the Securities and Exchange Commission (SEC). Illinois also requires registration with the Securities Division of the Secretary of State. Exemption from Federal Registration does not necessarily exempt a security from registration in Illinois.

Persons selling securities in Illinois must pass at least one of the series of exams administered by the National Association of Securities Dealers, Inc. (NASD). Dealers, salespersons employed to sell securities, and investment advisors also must register with the Illinois secretary of state.

Securities requiring registration, whether federal or state, must make complete disclosure via a document entitled a *prospectus*. Full disclosure is required even if the security is exempt from registration.

The goals of the 1933 law and subsequent laws are to protect the investing public. The act requires full disclosure by companies wishing to issue and sell stock to the public. Companies also are required to file a registration statement with the Securities and Exchange Commission (SEC). In all sales, a pamphlet or prospectus must be provided to potential investors. The SEC does not pass judgment on the quality of the investment. It merely requires all disclosures necessary for investors' full knowledge.

In certain situations, securities legislation provides for exemptions from the registration process. Exemptions from the registration of securities and dealers are generally granted to issuers selling their own securities or making offering to a small number of people, for a short period of time, and without general solicitation. Large organizations that require very little monitoring are often exempt from registration.

More typical exemptions relate to minimum number of investors and minimum amount of money to be pooled by the investors. If a pool of investors (syndicate) does not comply with federal and state securities laws, the penalty is a fine up to \$10,000 and imprisonment of up to five years.

IMPORTANT POINTS

1. Real estate licensees should be knowledgeable about tax legislation but must refrain from giving tax advice.
2. Depreciation is a deductible allowance from net income in arriving at taxable income. Therefore, it provides a tax shelter for the property owner.
3. A homeowner's real estate property taxes and mortgage interest are deductible expenses in calculation federal income tax liability.
4. Losses incurred in the sale of personal residence are not tax deductible.
5. The maximum capital gain rate is 20% and taxpayers in the 15% tax bracket have a maximum capital gain rate of 10%.
6. To qualify for the capital gain exclusion of \$250,000/\$500,000 on a principal residence, the taxpayers must have owned and occupied the property for at least 2 years of the previous 5 years.
7. Discount points whether paid by the borrower or the seller are deductible as interest by the borrower in the year of the sale. Discount points paid by the seller are not deductible by the seller as interest, but may be used to raise the adjusted basis on the sale.
8. The installment sale laws for taxation apply to the principal residence as well as to business and investment properties.
9. Depreciation enables the owner of business or investment property to recover the cost or other basis of the asset.
10. Land is not depreciable. Only structures on the land are depreciable real property.
11. Depreciation for real property is now calculated at 27 ½ years for residential property and 39 years for nonresidential property.
12. When a depreciated asset is sold, the basis of the asset used to compute taxable gain is the depreciated value, not the price the seller pays for the property.
13. Expenses of operation of a business or investment property are deductible expenses in arriving at taxable income.
14. To qualify as a tax-deferred exchange, like-kind property must be exchanged. An exchanger receiving cash (boot) or other unlike-kind property in addition to like-kind property is taxed on the value of the boot or other unlike-kind property received.
15. To qualify as a tax-deferred exchange, the property exchanged must have been held for use in business (other than inventory) or as an investment. Property held for personal use does not qualify.

16. The Illinois blue sky laws require complete disclosure in regard to the sale of securities. Sellers must be registered with the SEC and the secretary of state, and must have passed an exam administered by NASD.

REVIEW QUESTIONS

1. Which of the following is a tax-deductible expense resulting from home ownership?
 - a. Operating expenses
 - b. Depreciation
 - c. Mortgage interest
 - d. Energy use

2. The \$250,000/\$500,000 exclusion for capital gains applies only to:
 - e. residential single-family properties.
 - f. apartment buildings.
 - g. principal residences.
 - h. vacation properties.

3. Discount points paid by a borrower to obtain a conventional mortgage loan to purchase a principal residence:
 - a. are not deductible by the borrower as interest.
 - b. are deductible by the borrower as interest.
 - c. increase the basis of the new residence.
 - d. decrease the basis of the new residence.

4. A real estate commission paid by the seller:
 - a. may be deducted from the selling price as selling expense in calculating the amount realized in the sale of a principal residence.
 - b. is deductible from ordinary income (wage income) by the seller when itemizing tax deductible expense.
 - c. increases the basis of the residence sold.
 - d. decrease the basis of the residence sold.

5. A mortgage prepayment penalty paid by a borrower as a requirement for early loan payoff:
 - a. may be deducted as interest in the year paid.
 - b. may be deducted as interest over a five-year period.
 - c. may only be deducted from selling price as a selling expense.
 - d. may not be taken as a deduction for any purpose.

6. To qualify for the \$250,000 capital gains exclusion:
 - a. one of the taxpayers must be over 55 years old.
 - b. the taxpayer must purchase a new home of equal or greater value within the next 24 months.
 - c. the taxpayer must use the rolling rule.
 - d. the property must be the taxpayer's principal residence.

7. Which of the following married couples filing a joint return will not qualify for the \$500,000 capital gains exclusion?
 - a. A couple owned and lived in the property for the past 7 years.
 - b. Recently married, one spouse lived in and owned the property for the past 4 years and the other spouse moved into the property 3 years ago. They married 1 year ago.
 - c. A couple owned the property for the past 4 years. One of the spouses has spent the past 2 years in a nursing home. The other spouse has remained living in the property.
 - d. A couple lived in the home for 1 year. One spouse owned and occupied the home for 5 years before they were married. The other spouse moved in 1 year ago.

8. Which of the following is a benefit depreciation provides?
 - a. Tax credit
 - b. Tax deduction
 - c. Tax evasion
 - d. Tax deferment

9. Deductible expenses for a business property includes all of the following EXCEPT:
 - a. advertising.
 - b. utilities.
 - c. mortgage principal.
 - d. insurance.

10. Raul Ramirez and Sarah Gildar trade office buildings. In the trade, Raul receives \$20,000 in cash in addition to Sarah's office building. With regard to this transaction, which of the following is correct?
- The transaction does not qualify as a tax-free exchange
 - The cash Raul receives is called boot and is taxable for the year in which the exchange occurs
 - The exchangors, Raul and Sarah, exchange basis in the traded properties
 - The cash Raul receives is deductible for the year the exchange occurs
11. The basis of property received in a tax-free exchange is:
- the basis as it was to the prior owner at the time of the exchange.
 - the average of the difference in the basis of all properties exchanged.
 - the same basis as the basis of the property assumed and cash paid.
 - the value of the property received in the exchange.
12. In 1993, Ed and Margaret take advantage of the low interest rates to refinance their existing 30-year, 13.5 percent mortgage with a 15-year, 9.5 percent mortgage on their present home. They pay \$1,500 in discount points to refinance this loan. How will the cost of these points be treated in their income tax?
- The cost is added to the basis of their home.
 - Since all discount points are fully deductible in the year paid, they may deduct the \$1,500 from their 1993 income.
 - They may deduct only \$100 per year.
 - There is no deduction benefit at all.
13. The maximum capital gains tax rate is:
- 10%
 - 20%
 - 28%
 - 39.5%
14. Victor and Valerie own a vacation property at the beach, which they use only one week per year. The property is rented out at fair market value the rest of the year. Which item(s) of this property can they deduct?
- Mortgage principal only
 - Mortgage interest only
 - Mortgage interest, repairs, depreciation, maintenance, and property taxes
 - Mortgage interest and property taxes only

15. Charles and Maria own two properties. One is their principal residence, and the other is a vacation cottage they use three weeks of the year and rent out the rest. What item(s) can they deduct for they cottage?
- a. Mortgage interest and property taxes
 - b. Depreciation only
 - c. Repairs
 - d. Nothing, as it is a vacation home

ANSWERS

1. c
2. c
3. b
4. a
5. a
6. d
7. d
8. b
9. c
10. b
11. c
12. c
13. b
14. c
15. a