PART IX: REAL ESTATE

7741. How does real estate shelter income through tax deferral?

Real estate investments can provide "shelter" from taxes through (1) deferral of payment of tax from one year to another and (2) absolute tax savings (see Q 7743).

When depreciation deductions and any other noncash deductions are large enough, the taxable income from the property can be substantially less than its positive "cash flow" (the amount of cash receipts remaining after subtracting from gross cash receipts all cash expenses and payments on mortgage principal). Often, the noncash deductions produce a loss that partly or totally "shelters" the net cash flow. In many instances, deductions for depreciation and other expenses can produce a tax loss that offsets other taxable income. Because investment in real estate will generally be a passive activity, such losses may normally offset only other passive income of the taxpayer, although passive losses and the deduction-equivalent of credits with respect to certain rental real estate activities may offset up to $25,000 of nonpassive income of an individual. (The passive loss rules are discussed in Q 7746 and Q 7918 through Q 7929.)

However, when mortgage amortization payments exceed the depreciation on the property, taxable income and even the tax itself can exceed the investor's share of cash flow or tax savings. This taxable but noncash income is often referred to as "phantom income" and, assuming constant rental income and constant mortgage amortization, phantom income can increase each year. The carryover of disallowed passive losses from earlier years may reduce or even eliminate the phantom income in later years. If the individual has not prepared for phantom income, he or she may want to dispose of the investment. The tax consequences of disposition of property, including a partnership interest, are discussed in Q 7721 to Q 7734 and Q 7771 to Q 7774.

7742. How does real estate shelter income through absolute savings?

Some types of real estate investment (e.g., low-income housing and rehabilitation of old or historic structures) provide tax credits that directly reduce the tax on an individual's income. See Q 7754 and Q 7761. Because investment in real estate will generally be a passive activity, such credits may normally offset only taxes from passive activities of the taxpayer, although passive losses and the deduction-equivalent of credits with respect to certain rental real estate activities may offset up to $25,000 of nonpassive income of an individual. (The passive loss rules are explained in Q 7918 to Q 7929.) Investment tax credits can offer absolute shelter of income that would otherwise be spent for taxes, provided the property is held long enough. If not, there is some recapture. Even if this is the case, however, there has been the benefit of deferral.

7743. How can a limited partnership be used in conjunction with real estate investments to realize tax benefits?

Because a limited partnership "passes through" the income, gain, losses, deductions, and credits of its real estate operations, the partnership provides virtually the same tax benefits offered by direct individual ownership. Passthrough of items may differ somewhat for electing large partnerships (see Q 7704), as compared to other partnerships (see Q 7703), because of the different requirements for separately stated items for the two types of partnerships. In addition, a limited partnership permits passive investment by providing management, permits participation for less capital investment, has some flexibility in allocating gains and losses among partners, and offers individual investors limited liability. While real estate investment can utilize forms other than a partnership, partnership is the most common form. See Q 7703 to Q 7734 on limited partnerships.

A *publicly traded partnership* is taxed as a corporation unless 90 percent of the partnership's income is passive-type income. A publicly traded partnership is a partnership that is traded on an established securities market or is readily tradable on a secondary market or a substantial equivalent. In general, "passive-type income" for this purpose includes interest, dividends, *real property rents, gain from the sale of real property*, income and gain from certain mineral or natural resource activities, and gain from sale of a capital or IRC Section 1231 asset. A grandfather rule treats electing 1987 partnerships (see Q 7699) as not subject to corporate taxation if they elect to be taxed at a rate of 3.5 percent on gross income; such a partnership otherwise operates as a passthrough entity. Taxation as a corporation would defeat the "passthrough" feature of a limited partnership. See Q 7699 on publicly traded partnerships.

Particular programs vary in their tax sheltering goals and methods. Some emphasize tax-free cash flow, some losses that offset other income, and some appreciation and equity build up. Real estate investments combine these elements in varying proportions – more of one element generally means less of another.

Another form of real estate investment, the real estate investment trust (REIT), is discussed at Q 7883 to Q 7908.

7744. In general, what are the tax benefits of real estate investment? What limitations may restrict enjoyment of those benefits?

The rental and management of real property is generally considered a trade or business even if the owner owns only one property,[1] is actively engaged in another profession or business and carries on all management activities through an agent,[2] or, continuously, over a period of several years, experiences losses from the operation of the business.[3] However, it has been held that where activities were minimal, rental of a single residence was not a trade or business.[4]

Credits

Credits against tax liability may be taken for certain investments in low-income housing (see Q 7754) or rehabilitation of old or historic structures. See Q 7761. Use of these credits may be subject to certain limitations. See heading "Limitations" below.

1. *Lagreide v. Comm.*, 23 TC 508 (1954).
2. *Fackler v. Comm.*, 45 BTA 708 (1941), aff'd, 133 F.2d 509 (6th Cir. 1943).
3. *Allen v. Comm.*, 72 TC 28 (1979).
4. *Grier v. U.S.*, 120 F. Supp. 395 (D. Conn. 1954), aff'd, 218 F.2d 603 (2d Cir. 1955). See also *Bauer v. U.S.*, 168 F.Supp. 539 (Ct. Cl. 1959); *Union Nat'l Bank of Troy v. U.S.*, 195 F.Supp. 382 (N.D.N.Y. 1961); GCM 39126 (2-7-84); TAM 8350008.

Depreciation

An owner of residential or nonresidential improved real property (either used in a trade or business or held for the production of income) may deduct each year amounts for depreciation of the buildings, but not the land itself, even though no cash expenditure is made. Furthermore, the depreciable amount is not limited to the owner's equity in the property.[1] See Q 620. However, the deductions may be subject to certain limitations. See heading "Limitations" below. Also, where accelerated depreciation is used, which would not be true for residential rental property or nonresidential real property placed in service after 1986, part or all of the amount deducted is subject to "recapture" on sale of the property. See Q 7774. "Bonus depreciation" has been extended, as well as 100 percent bonus depreciation for some business assets placed in service before 2014, by the 2010 Tax Relief Act (as extended by the American Taxpayer Relief Act of 2012 through 2013).

Interest

An investor in improved or unimproved real estate may generally deduct each year amounts paid for mortgage interest (subject to certain limitations, see heading "Limitations" below). However, prepaid interest must be deducted over the period to which the prepayment relates.[2] A further limitation on deduction of interest is that construction period interest must be capitalized.[3] The interest subject to capitalization may not be reduced by interest income earned from temporarily investing unexpended debt proceeds.[4]

Taxes

An investor in real property is permitted to deduct amounts paid for real property taxes (subject to certain limitations, see heading "Limitations" below).[5] In the year of acquisition the buyer may deduct the real estate taxes allocable to the number of days the buyer owns the property.[6] "Taxes" that are actually assessments for improvements (e.g., sidewalks, sewers, etc.) and that enhance the value of the property cannot be currently deducted, but must be added to the investor's basis in the property (i.e., capitalized) and deducted through depreciation allowances over the recovery period.[7] A further limitation on deduction of real estate taxes is that construction period taxes must be capitalized.[8]

Expenses

An investor in real estate may deduct each year "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business"[9] and all ordinary

1. IRC Secs. 167, 168.
2. IRC Sec. 461(g)(1).
3. IRC Sec. 263A(f).
4. Rev. Rul. 90-40, 1990-1 CB 52.
5. IRC Sec. 164(a).
6. IRC Sec. 164(d).
7. IRC Sec. 164(c).
8. IRC Sec. 263A.
9. IRC Sec. 162(a).

and necessary expenses paid or incurred during the taxable year (1) for the production and collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.[1] See also Q 7948, Q 7950. Routine repair and maintenance expenses are deductible in the year paid as business expenses or expenses incurred in connection with property held for the production of income, but the cost of improvements must be capitalized (added to the owner's basis in the property) and recovered through depreciation deductions.[2] Amounts paid for repairs are deductible if the amounts paid are not otherwise required to be capitalized.[3] Capital improvements increase the value, prolong the life, or alter the use for which the property is suitable.[4]

The first $5,000 of "start-up" expenses is deductible, but not until the year in which the business begins, and the rest must be amortized over a 180-month period, beginning with the month the business begins. The $5,000 figure is reduced by the amount that start-up expenses exceed $50,000. Expenses included in this category are those (other than interest and taxes) incurred in connection with investigating the creation or acquisition of a new business, creating an active trade or business, and "any activity engaged in for profit and for the production of income before the day on which active trade or business begins." The expenses must be expenses that would be deductible if incurred in connection with an existing active business.[5]

Generally, accrual basis taxpayers may not deduct expenses payable to related cash basis taxpayers before the amount is includable in the income of the cash basis taxpayer. The rule applies to amounts accrued by a partnership to its partners, by partners to their partnership, by an S corporation to its shareholders, and by shareholders to their S corporation. Related parties also include those discussed in Q 607.[6]

Disposition

On disposition of the property, the owner may generally defer tax on gain by exchanging it for "like kind" property. See Q 7776, Q 7777, Q 614. Alternatively, the buyer may be able to spread out the recognition of gain by using the installment method of reporting; however, an interest surcharge applies to certain installment sales of property with a sales price exceeding $150,000. See Q 586. Furthermore, the installment method of reporting is unavailable for sales of real property held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.[7]

Because of IRC Section 1231, net losses on disposition may be treated as ordinary losses instead of capital losses, unlimited by the $3,000 cap on the ordinary income offset by capital losses. See Q 7772 for discussion of gain or loss on sale.

1. IRC Sec. 212.
2. IRC Sec. 263(a).
3. Treas. Reg. §1.162-1.
4. Treas. Reg. §1.263(a)-1T; *Illinois Merchants Trust Co. v. Comm.*, 4 BTA 103 (1926).
5. IRC Sec. 195.
6. IRC Secs. 267(a)(2), 267(e).
7. IRC Secs. 453(b)(2)(A), 453(l)(1)(B).

Special Benefits and Limitations

Special benefits or limitations may apply to certain kinds of real estate investment: low-income housing (see Q 7753), "rehabs" (see Q 7761), and vacation homes (see Q 7749). In addition, an investor can develop vacant land within limits without being classified as a "dealer." See Q 7747.

As a general rule, an investor takes the same deductions and credits and recognizes income whether the investor owns the property directly or has an interest in a limited partnership that "passes through" the deductions, credits, and income. See Q 7703 regarding regular partnerships and Q 7704 regarding electing large partnerships. However, if a publicly traded partnership is taxed as a corporation (see Q 7699), investors are unable to take partnership deductions, credits, and income on their own tax returns.

Limitations

If the property is used in an activity in which the investor does not materially participate, deductions and credits are subject to the passive loss rules; however, if the property is used in a rental real estate activity in which an individual actively participates, a special exemption for up to $25,000 of passive losses and the deduction-equivalents of credits with respect to rental real estate activities may apply. Active participation is not required with respect to the low-income housing or rehabilitation tax credits. See Q 7746.

Losses incurred after 1986 with respect to real estate activities are subject to the "at risk" limitation. See Q 7745.

7745. Does the "at risk" limitation on losses apply to an investor in real estate? If so, what effect will it have?

Generally, the "at risk" rules apply to losses incurred after 1986 with respect to real estate placed in service after 1986.[1] However, in the case of an interest in an S corporation, a partnership, or other pass-through entity acquired after 1986, the "at risk" rules will apply to losses incurred after 1986 no matter when the real estate was placed in service.[2]

In general, the "at risk" rules limit the deduction an investor may claim for the investor's share of net losses generated by the real estate activity to the amount he or she has at risk in that activity. The rules do not prohibit an investor from offsetting the investor's share of the deductions generated by the activity against the income received from the activity. For a detailed explanation of the operation of the "at risk" limitation, see Q 7914 to Q 7917.

Put as simply as possible, an investor is initially "at risk" to the extent that he or she is not protected against the loss of money or other property contributed to the program. One special exception applies in the real estate context, however. An investor is considered at risk with respect to certain qualified nonrecourse financing incurred in the holding of real property. For the specifics as to how an investor's "amount at risk" is calculated, see Q 7913.

1. IRC Sec. 465(c); TRA '86 Sec. 503(c)(1).
2. TRA '86 Sec. 503(c)(2).

7746. Are investments in real estate subject to the passive loss rules? If so, what is the effect to an investor in real estate?

Rental real estate activities will generally be considered passive activities subject to the passive loss rules.[1] However, if the personal use of a residence that is also rented out exceeds 14 days or, if greater, 10 percent of the rental days (see Q 7749), the rental activity is not treated as a passive activity.[2] In addition, a real property business of a taxpayer is not automatically considered a rental activity subject to the passive loss rules for a taxable year if during the year (1) more than one-half of the personal services performed by the taxpayer in trades or businesses during the year is in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer performs more than 750 hours of service during the year in such real property trades or businesses.[3] See Q 7919. Few investors in real estate syndications will qualify for this exception.

In general, the passive loss rules limit the amount of the taxpayer's aggregate deductions from all passive activities to the amount of his aggregate income from all passive activities; credits attributable to passive activities can be taken only against tax attributable to passive activities.[4] The rules are intended to prevent taxpayers from offsetting income in the form of salaries, interest, and dividends with losses from passive activities. The benefit of the disallowed passive losses and credits is generally not lost, but rather is postponed until such time as the taxpayer has additional passive income or disposes of the activity. If an individual *actively participates* in a rental real estate activity subject to the passive activity rules, the individual may use up to $25,000 of losses and the deduction-equivalent of credits to offset nonpassive income. An individual need not actively participate in a rental real estate activity to obtain the $25,000 rental real estate exemption with respect to taking the low-income housing or rehabilitation tax credits. See Q 7918 through Q 7929 for a more detailed explanation of the rule and, in particular, Q 7929 with respect to the $25,000 exclusion applicable to rental real estate activities.

If the investment is in real estate that is not rental property, the real estate activity will generally be considered a passive activity subject to the passive loss rule unless the taxpayer *materially participates* in the activity. The $25,000 rental real estate exemption is not available with respect to nonrental property. See Q 7918 through Q 7929. As to whether an investment in vacant land is a "passive activity," see Q 7747.

If the investment in real estate is made through a publicly traded partnership subject to the passive loss rules, further restrictions may apply. See Q 7918.

See Q 7704 regarding investment in an electing large partnership.

1. IRC Sec. 469(c)(2).
2. IRC Sec. 469(j)(10).
3. IRC Sec. 469(c)(7).
4. IRC Sec. 469.

7747. What deductions are available to the owner of vacant land? How is gain or loss on sale treated?

An investor in vacant land may take various deductions, including real estate taxes, interest charges on indebtedness incurred to buy the land, and other expenses paid or incurred in connection with holding the land (possibly subject to the "passive loss" rules or the "investment" interest limitation, see below).[1] Land is not depreciable, but expenses incurred in managing, conserving, or maintaining property held for the production of income (see Q 7948) and in connection with any business use of the land are deductible.[2] If the vacant land is held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business, taxes, interest, and other expenses paid or incurred in connection with the land must be included in inventory costs.[3]

Apparently, investment in vacant land is treated as a passive activity if the activity is (1) a rental activity (as defined below and in Q 7919 and Q 7924), or (2) a trade or business in which the investor does not materially participate.[4] The rental of property used in a trade or business is treated as incidental to a trade or business activity (rather than a rental activity) during any year if (1) the taxpayer owns an interest in the trade or business activity during the year, (2) the property was predominantly used in the trade or business activity either during the year or in two out of the five preceding years, and (3) the gross rental from the property for the year is less than 2 percent of the lesser of (a) the unadjusted basis of the property, or (b) the fair market value of the property.[5]

It also appears that investment in vacant land is treated as an investment activity (rather than a passive activity) during any year in which the principal purpose for holding the property during such year is to realize gain from the appreciation of the property. The rental of investment property is treated as incidental to an investment activity (rather than a rental activity) if the gross rental from the property for the year is less than 2 percent of the lesser of (1) the unadjusted basis of the property, or (2) the fair market value of the property.[6]

> *Example 1*: Mrs. Martin holds 1,000 acres of unimproved land with a fair market value of $350,000 and an unadjusted basis of $210,000. She holds the land for the principal purpose of realizing gain from appreciation. In order to defray the cost of carrying the land, she rents the land to a rancher who uses the land to graze cattle and who pays rent of $4,000 per year. The rental of the land is treated as incidental to an investment activity rather than a rental activity. This is determined as follows: (1) The lesser of the unadjusted basis ($210,000) or the fair market value ($350,000) is $210,000. (2) Two percent of $210,000 equals $4,200. (3) Gross rental of $4,000 is less than $4,200.[7]

> *Example 2*: In 2014, Mrs. Vickers acquired vacant land for the purpose of constructing a shopping mall. Before commencing construction, she leased the land under a 1-year lease to a car dealer, who used the land to park cars held in his inventory. In 2015, Mrs. Vickers begins construction of a shopping mall on the land.

1. IRC Secs. 163, 164.
2. IRC Secs. 212, 162.
3. IRC Sec. 263A.
4. IRC Sec. 469(c); Temp. Treas. Reg. §1.469-1T(e)(1).
5. Temp. Treas. Regs. §§1.469-1T(e)(3)(ii)(D), 1.469-1T(e)(3)(vi)(A), 1.469-1T(e)(3)(vi)(C).
6. Temp. Treas. Regs. §§1.469-1T(e)(3)(ii)(D), 1.469-1T(e)(3)(vi)(A), 1.469-1T(e)(3)(vi)(B).
7. Temp. Treas. Reg. §1.469-1T(e)(3)(viii)(Ex. 5).

> Since the land was acquired principally for the purpose of development rather than held for appreciation, the rental of the land in 2014 cannot be treated as incidental to an investment activity. Also, the rental of the land cannot be treated as incidental to a trade or business activity because the land has never been used in a trade or business. The rental of the land is thus treated as a rental activity subject to the passive loss rules.[1]

In general, a taxpayer's aggregate losses from passive activities may offset only his or her aggregate income from passive activities.[2] See Q 7918 to Q 7929. Interest allocable to property held for investment purposes is generally deductible only up to the aggregate amount of the taxpayer's "investment" income.[3] See Q 7941.

Gain or loss on sale will be treated as capital gain or loss unless the property is (1) used in the taxpayer's trade or business, in which case it will be "IRC Section 1231" property subject to rules discussed in Q 7772, or (2) held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business in which case it will be ordinary gain.[4] A special rule applies to gain of a person who is not a dealer but develops land and sells parcels. See Q 7748. If the investment in vacant land is treated as a passive activity, gain or loss from sale of the property is generally gain or loss from a passive activity. See above.

7748. If an individual develops vacant land and sells parcels will the individual be considered a "dealer"?

An individual's gain on the sale of real property will be taxed as ordinary income if the individual is a "dealer," that is, if the individual holds the property "primarily for sale to customers in the ordinary course of the individual's trade or business."[5] Where an individual has bought and sold several parcels of land, subdivided land, or participated actively in its sale, the individual may be treated as a dealer. The following are some of the factors considered in determining whether an individual is a dealer with respect to property:[6]

(1) the purpose and use for which the property was acquired and thereafter held;

(2) the length of time between purchase and sale;

(3) the number and frequency of sales made over a period of time;

(4) the activities of the taxpayer and the taxpayer's agents and the developments and improvements made to put the property in a saleable condition;

(5) the activity of the taxpayer and the taxpayer's agents in advertising and promoting sales;

(6) the extent and substantiality of the above transactions;

1. Temp. Treas. Reg. §1.469-1T(e)(3)(viii)(Ex. 7).
2. IRC Sec. 469.
3. IRC Sec. 163.
4. IRC Secs. 64, 1221(a), 1231.
5. IRC Secs. 64, 1221(a)(1).
6. *Brandenburger v. U.S.*, 31 AFTR 2d ¶905 (E.D. Cal. 1973).

(7) miscellaneous factors, such as membership in a dealer organization, newspaper publicity, the nature of the taxpayer's business as shown in directory listings and tax returns, documents, and the use of a business office to sell the property;

(8) the amount of gain derived from sales as compared with other income of the taxpayer, and whether the gain is attributable to appreciation or development and promotion;

(9) prior and subsequent activities of the taxpayer in selling real estate;

(10) replacement of the property sold with additional real estate.

There are special rules that permit an individual owning a tract of real property to subdivide it; to actively promote its sale; and to erect a temporary field office, survey, fill, drain, level, clear, and construct a minimum all-weather access road on the property without being considered a "dealer" *solely* because of those activities. The individual is within these rules only if: (1) he or she did not hold the land primarily for sale to customers in the ordinary course of business in a previous year and did not hold other land primarily for sale to customers in the ordinary course of business during the same taxable year, (2) the land, unless inherited, has been held for five years by the investor, and (3) no "substantial" improvements that substantially increase the value of the land are made to the land. (The individual may be deemed to have made improvements made by certain related parties.)[1] Under very limited circumstances, the individual is permitted to install water and sewer lines and drainage facilities and to build hard surface roads, gutters, and curbs on the property without being classified as a "dealer."[2]

Gain from the sale of such property is treated under special rules. If the individual has sold fewer than six lots or parcels from the same tract up to the end of the taxable year, the entire gain will be capital gain, or, if the property is real property used in a trade or business, IRC Section 1231 gain as explained in Q 7772.[3] In computing the number of lots or parcels sold, two or more contiguous lots sold to a single buyer in a single sale will be counted as only one parcel.[4]

In the taxable year in which the sixth lot or parcel is sold from the same tract, the taxpayer will be required to recognize ordinary income as follows: the amount, if any, by which 5 percent of the selling price of each lot sold in the taxable year exceeds the expenses incurred in connection with its sale or exchange will (to the extent that it represents gain) be ordinary income. Any part of the gain not treated as ordinary income will be treated as capital gain, or, if the property is used in a trade or business, as IRC Section 1231 gain. All expenses of sale of the lot are to be deducted first from the 5 percent of the gain that would otherwise be considered ordinary income, and any remainder of such expenses will reduce the gain upon the sale or exchange that would otherwise be considered capital gain or IRC Section 1231 gain. Such expenses cannot be deducted as ordinary business expenses from other income. The 5 percent

1. IRC Sec. 1237(a).
2. IRC Sec. 1237(b)(3).
3. Treas. Regs. §§1.1237-1(e)(2)(i), 1.1237-1(f).
4. Treas. Reg. §1.1237-1(e)(2)(i).

rule applies to all lots sold from the tract in the year the sixth lot or parcel is sold. Thus, if the taxpayer sells the first six lots of a single tract in one year, 5 percent of the selling price of each lot sold is treated as ordinary income and reduced by the selling expenses. On the other hand, if the taxpayer sells the first three lots of a single tract in 2014, and the next three lots in 2015, only the gain realized from the sales made in 2014 will be so treated.[1]

If the taxpayer sells or exchanges no lots from the tract for a period of five years after the sale or exchange of at least one lot in the tract, then the remainder of the tract will be deemed a new tract for the purpose of counting the number of lots sold from the same tract. The pieces in the new tract need not be contiguous. The five-year period is measured between the dates of the sales or exchanges.[2]

7749. Are the expenses of a vacation rental home deductible if the owner's personal use of the property does not exceed 14 days or 10 percent of rental days?

IRC Section 280A provides rules for the disallowance of certain expenses in connection with renting out a vacation home. Different rules apply depending on the amount of personal use and rental use.

An individual who makes part-time use of a dwelling and rents it out during other parts of the year may take deductions for depreciation and expenses, but subject to some limitations. If the individual's personal use (discussed below) does not exceed the longer of 14 days per year or 10 percent of the number of days the unit is rented at fair rental, the taxpayer may deduct all ordinary and necessary expenses allocable to rental use even if a loss is shown (provided the activity is engaged in for profit and subject to the passive loss rules).[3] In determining expenses allocable to rental use, the IRS applies the following formula:[4]

$$\text{total expenses} \times \frac{\text{number of days rented at fair rental}}{\substack{\text{number of days unit used for any purpose} \\ \text{other than repair or maintenance}}} = \substack{\text{expenses allocable} \\ \text{to rental use}}$$

Interest, taxes, and casualty losses not allocable to rental use can be deducted as personal expenses (to the extent otherwise allowable) if the individual itemizes deductions.[5] The Service uses the same ratio for allocating interest and taxes between personal and rental use as it does in allocating other expenses.

However, if it is determined that the activity is one "not engaged in for profit," the amount of deductions is limited to the amount of gross rental income.[6] (If deductions are limited to gross rental income, the order in which deductions are allowed is the same as that applicable where personal use exceeds the longer of 14 days or 10 percent of the rental days, discussed

1. Treas. Reg. §1.1237-1(e)(2)(ii).
2. Treas. Reg. §1.1237-1(g)(2).
3. IRC Sec. 280A(e).
4. Prop. Treas. Reg. §1.280A-3(c).
5. IRC Sec. 280A(b).
6. IRC Sec. 183(b).

below (see also Q 7931). Whether the activity is engaged in for profit depends on all the facts and circumstances involved.[1] If the gross income exceeds the deductions attributable to the rental use for at least three of the five consecutive tax years ending with the current tax year, the rental use is presumed to be for profit.[2] (The individual may elect to defer the determination as to whether the presumption applies until the end of the fourth taxable year following the first tax year in which rental use began. If this election is made, the period for determining a tax deficiency remains open for two years after the return is due (without extensions) for the last year in the five year period).[3]

If the personal use does not exceed the greater of 14 days or 10 percent of rental days, the rental activity will generally be subject to the passive loss rules (see Q 7746). However, if the individual actively participates in the rental real estate activity, as much as $25,000 of losses (and the credit-equivalents of such losses) from the rental activity could be used to offset nonpassive income of the taxpayer.[4]

7750. Are the expenses of a vacation rental home deductible if the owner's personal use of the property exceeds 14 days or 10 percent of rental days?

If the owner uses the dwelling unit for more than the longer of 14 days or 10 percent of the days the unit is rented at fair rental, the owner's deductions allocable to rental use (using the above ratio) are limited to gross rental income (as reduced by expenditures to obtain tenants).[5] The Service's position is that mortgage interest and real estate taxes must be allocated to rental use in the ratio that the number of days rented bears to the number of days of use.[6] This position with respect to interest and taxes has been ruled unreasonable.[7] *Bolton* and *McKinney* held that interest and taxes, unlike maintenance expenses, are allocable to the rental period in the ratio that the number of days the property was rented bears to the number of days in the year. Whether the IRS and other courts will accept this position and whether it can be extended to the situation where personal use does not exceed 14 days or 10 percent of rental days is not settled.

Where, because of the limit, not all deductions are allowed, deductions are allowable in the following order: (1) allocable amounts of expenses that are deductible without regard to rental use (such as mortgage interest and real estate taxes); (2) allocable amounts of deductions allowable because of rental use but that do not result in adjustment to basis; (3) allocable amounts of deductions that would result in an adjustment to basis (such as depreciation).[8]

1. Treas. Reg. §1.183-2(a).
2. IRC Sec. 183(d).
3. IRC Sec. 183(e).
4. IRC Sec. 469(i).
5. IRC Sec. 280A; Prop. Treas. Reg. §1.280A-3(d)(2).
6. Prop. Treas. Reg. §1.280A-3(d).
7. *Bolton v. Comm.*, 694 F2d 556, 82-2 USTC ¶9699 (9th Cir. 1982); *McKinney v. Comm.*, 732 F2d 414, 83-2 USTC ¶9655 (10th Cir. 1983). See also *Buchholz v. Comm.*, TC Memo 1983-378.
8. Prop. Treas. Reg. §1.280A-3(d)(3).

Example: Mr. Jones owns a summer home that he uses for 30 days and rents to Mr. Green for 60 days for $2,000; it is vacant for the remainder of the year. Advertising and realtor's fees total $100; taxes, $600; interest, $900; utilities, $300; maintenance, $600; insurance, $150; depreciation, $2,400. He calculates his deduction as follows:

	IRS rule	*Bolton* rule
gross receipts from rental	$2,000	$2,000
less: unallocated expenses to procure tenant	(100)	(100)
limitation on deductions	$1,900	$1,900
less: taxes and interest for rental period		
(2/3 × ($600 + $900))	(1,000)	
(2/12 × ($600 + $900))		(250)
	$900	$1,650
less: maintenance, insurance and utilities ($1,050) portion allocable to rental period (2/3 × $1,050)	(700)	(700)
	$200	$950
depreciation $2,400 portion allocable to rental period (2/3 × $2,400)	$1,600	$1,600

Using the IRS rule, Mr. Jones may deduct all allocable expenses except $1,400 of depreciation. Using the *Bolton* rule, Mr. Jones may deduct all allocable expenses except $650 of depreciation.

In determining whether personal use exceeds 10 percent of the number of days a unit in a rental pool is rented at fair rental, only the days the units are actually rented are counted; days when the units are merely held out for rent or are used rent-free for business purposes cannot be included.[1]

If the personal use of a residence that is also rented out exceeds the greater of 14 days or 10 percent of the rental days, the rental activity is not treated as a passive activity for such year. See Q 7746. Deductions from such a residence are subject to limitation under the rules above, and any income, gain, loss, or deduction from the residence is not taken into account under the passive loss rules for the year.[2] However, such a residence may constitute a "qualified residence" for purposes of the deduction of mortgage interest. See Q 7934.

7751. What constitutes "personal use" for purposes of determining whether the expenses of a vacation rental home are deductible?

"Personal use" includes: (1) use, for personal purposes, by the owner or by anyone who has an interest in the unit or by a brother, sister, spouse, ancestor, or lineal descendent of the owner or other person having an interest in the unit; (2) use by a person under an arrangement that enables the owner to use some other unit whether or not the owner pays rent to use the other unit and regardless of the length of time the owner uses it; and (3) use by any individual with rent set at less than fair rental value. Fair rental is determined by taking into account factors such as comparable rents in the area. This third requirement does not apply to an employee to whom the premises are furnished for the convenience of the employer, under IRC Section 119.[3] Nonetheless, it has been held that days of rent-free use of units in a rental pool by prospective

1. *Byers v. Comm.*, 82 TC 919 (1984).
2. IRC Sec. 469(j)(10).
3. IRC Sec. 280A(d)(2).

renters are not personal use days, where unit owners have no control over such use and the use was an ordinary and necessary business use.[1] Where the owner of a vacation home donated a week's use of the home to a charitable auction, the use of the home by the successful bidder was treated as personal use.[2]

Use by the owner on any day on which the principal purpose of the use is to perform repair or maintenance work on the unit does not constitute personal use. Whether the principal purpose is to perform repair or maintenance work depends on all the facts and circumstances, including the amount of time devoted to repair and maintenance, the frequency of the use for repair and maintenance purposes during the tax year, and the presence and activities of companions. A day on which the taxpayer engages in repair or maintenance on a substantially full-time basis will not be considered a day of personal use by the taxpayer.[3] The IRC authorizes the Secretary to prescribe regulations on use by the owner while performing maintenance or repairs, but, if the taxpayer is engaged in repairs and maintenance on a substantially full-time basis for a particular day "such authority shall not allow the Secretary to treat a dwelling unit as being used for personal use by the taxpayer on such day merely because other individuals who are on the premises on such day are not so engaged."[4]

If a family member makes the unit rented to him or her a principal residence, it is not personal use by the owner. However, the preceding exception does not apply if the family member also has an interest in the dwelling unit unless the rental is pursuant to a "shared equity financing agreement." A shared equity financing agreement is an agreement under which two or more persons acquire "qualified ownership interests" in a dwelling unit, and the person(s) holding one or more of such interests is entitled to occupy the dwelling unit for use as a principal residence, and is required to pay rent to one or more other persons holding qualified ownership interests in the dwelling unit. A qualified ownership interest is an undivided interest for more than 50 years in the dwelling unit and appurtenant land being acquired in the transaction to which the shared equity financing agreement relates.[5]

A dwelling unit subject to these rules includes a house, apartment, condominium, mobile home, boat, or similar property that provides basic living accommodations such as sleeping space, toilet, and cooking facilities and all structures and other property appurtenant thereto.[6]

7752. What is the treatment of a dwelling unit that is rented for fewer than 15 days in a year?

If an individual rents a dwelling unit (as defined above) for fewer than 15 days during the year, and the individual has used it as a residence during the taxable year, the income received from such a rental is excluded from gross income and no deductions for rental are allowed.[7]

1. *Byers v. Comm.*, above.
2. Rev. Rul. 89-51, 1989-1 CB 89.
3. IRC Sec. 280A(d)(2)(c).
4. IRC Sec. 280A(d)(2).
5. IRC Sec. 280A(d)(3).
6. IRC Sec. 280A(f)(1)(A).
7. IRC Sec. 280A(g).

7753. What special tax benefits are available for investment in low-income housing?

A low-income housing tax credit is available with respect to property placed in service after 1986. In general, the credit may be taken annually over a 10-year period and can be substantial.[1] The credit is discussed in detail in Q 7754.

Construction period interest and taxes must be capitalized. Rehabilitation expenditures must also be capitalized.[2] Low-income rental housing will generally be depreciated using a straight line method over 27.5 years.[3] However, the straight line depreciation is not subject to the recapture rule or to the alternative minimum tax.[4] Additionally, low-income housing is generally a residential rental activity subject to the "passive loss" rule (see Q 7929).

The Service will not disallow losses on the theory that low-income housing is an activity entered into "not for profit" simply because of legal restrictions on rents, charges, rates of return, and methods of low income housing operations.[5] In addition, the hobby loss provisions of IRC Section 183 (see Q 7931) will not apply to disallow losses, deductions, or credits attributable to the ownership and operation of qualified low-income housing credit activities, for buildings placed in service after 1986.[6]

For housing placed in service before 1987, substantially different rules applied.

7754. What is the low-income housing tax credit?

The low-income housing tax credit is an income tax credit based on a percentage of the qualified basis of certain low-income housing placed in service after 1986. Generally, the credit is determined in the year in which the property is placed in service and may be taken annually for 10 years. Subject to certain limitations, the adjusted basis qualifying for the credit consists of expenditures for certain new housing or substantially rehabilitated housing.[7]

Taxpayers seeking the credit make application to the local housing agency in order to obtain a building identification number.[8] All taxpayers, except those who finance the project through certain tax-exempt bonds described in IRC Section 42(h)(4), must receive an allocation of the credit for the building.[9] All taxpayers, however, must comply with IRS certification requirements in order to obtain the credit.[10] If, during the 15-year compliance period, there is a change in the portion of housing that is low-income housing or the property ceases to qualify as low-income housing, there is a recapture of all or part of the credit.[11]

1. IRC Sec. 42.
2. IRC Sec. 263A.
3. IRC Secs. 168(b)(3)(B), 168(c).
4. See IRC Secs. 1250, 56(a)(1).
5. Rev. Rul. 79-300, 1979-2 CB 112.
6. Treas. Reg. §1.42-4.
7. IRC Sec. 42.
8. Notice 88-91, 1988-2 CB 414.
9. IRC Sec. 42(h)(1).
10. IRC Sec. 42(l).
11. IRC Sec. 42(j).

7755. What is amount of the low-income housing tax credit that can be claimed?

The amount of credit depends on when the property was first placed in service. A letter ruling treated a project as placed in service in the year that a temporary certificate of occupancy was issued for the project and the taxpayer advertised the property as available for occupancy.[1]

For property placed in service in 1987, or between July 31, 2008, and December 31, 2013, the credit percentage was 9 percent annually for 10 years for new buildings that were not federally subsidized for the taxable year. The credit was 4 percent annually for 10 years for (1) existing buildings or (2) new buildings that are federally subsidized.[2]

For other property placed in service after 1987, the credit percentage is the amount prescribed by the Service for the earlier of (1) the month in which the building is placed in service, or (2) at the election of the taxpayer, (a) the month in which the taxpayer and the housing credit agency enter into an agreement allocating the tax credit to the project, or (b) the month in which certain tax-exempt obligations (described in IRC Section 42(h)(4)(B)) that finance the project are issued. The election described in (2) above is irrevocable and must be made no later than five days after the close of the month elected. The amount that will be prescribed by the Service is a percentage that will yield over a 10-year period an amount of credit with a present value of 70 percent of the qualified basis of new buildings that are not federally subsidized for the year, and 30 percent of the qualified basis of existing buildings and new buildings that are federally subsidized for the year.[3]

However, the rules in the preceding paragraph are modified with respect to credits allocated from state housing credit ceilings after 1989 so that a credit is not allowed with respect to the acquisition of an existing building unless substantial rehabilitations are made to the building.[4] Generally, rehabilitation expenditures within a 24 month period must exceed the greater of (1) $3,000 per low-income housing unit, or (2) 10 percent of the building's adjusted basis. If such an existing building is substantially rehabilitated, the 70 percent present value credit is available for the rehabilitation portion and the 30 percent present value credit is available for the balance.[5] Furthermore, the credit for an existing building may not begin before the credit for the rehabilitations are allowed.[6]

The minimum expenditures requirement of IRC Section 42(e)(3) may be met in less than 24 months, and treated as placed in service at the close of the period in which the requirement is met, but the aggregation period for such expenses may not exceed 24 months.[7]

1. Let. Rul. 8844062.
2. IRC Sec. 42(b)(1), before enactment of Housing Assistance Tax Act of 2008, PL 110-289; IRC Sec. 42(b)(2).
3. IRC Sec. 42(b)(1), as amended by Housing Assistance Tax Act of 2008.
4. IRC Sec. 42(d)(2)(B)(iv).
5. IRC Sec. 42(e).
6. IRC Sec. 42(f)(5).
7. Rev. Rul. 91-38, 1991-2 CB 3.

7756. When can the low-income housing tax credit be claimed?

The *10-year credit period* generally begins in the taxable year in which the building is placed in service, or upon the irrevocable election of the taxpayer, in the succeeding taxable year, but only if the building is a qualified low-income building at the close of the first year of the credit period.[1] However, for post-1987 credit allocations, the taxpayer may begin claiming the credit in either of the next two years, so long as the taxpayer has incurred at least 10 percent of the total project costs in that year.[2] The credit stays constant throughout the 10-year period in which the credit may be claimed. Thus, if a 3.32 percent credit was taken in 2014 for property placed in service in 2014, a 3.32 percent credit may also be taken in years 2015 through 2023 (assuming the low-income housing remains qualified, see "Qualification of Low-income Housing," Q 7757).[3] For details as to how the election is made under IRC Section 42(f)(1) to defer the start of the credit period, see Revenue Ruling 91-38, Q 7755. Further, temporary relief may be granted for buildings located in federally declared disaster areas.[4]

7757. How does a building qualify for the low-income housing tax credit? What rules regarding determination of basis apply for purposes of the low-income housing tax credit?

The *eligible basis* of a building is its adjusted basis (normally cost).[5] With respect to credits allocated from state housing credit ceilings after 1989, the eligible basis of low-income housing located in designated high cost areas will be treated as being 130 percent of the otherwise eligible basis.[6]

In order for an existing building to qualify for the credit, (1) the existing building must have been acquired from an unrelated person, (2) the basis of the property must not be a stepped-up basis from a decedent's estate or determined by reference to the basis of the property in the hands of a transferee, (3) the building must not have been placed in service by the taxpayer or anyone related to the taxpayer at the time the property was previously placed in service, (4) there must have been a period of at least 10 years between when the building is acquired and the later of (a) the date the building was last placed in service, or (b) the date of the most recent nonqualified substantial improvement of the building, and (5) there must have been substantial rehabilitations made to the building (see Q 7754).[7] Special rules apply to the 10-year requirement, and under special circumstances it may be waived.[8] For allocations of credit made after 1990, a placement in service of a single-family residence by any individual who owned and used the residence for no other purpose than as his or her principal residence is not considered a placement for purposes of the 10-year rule.[9]

1. IRC Sec. 42(f)(1).
2. IRC Sec. 42(h)(1)(E).
3. IRC Sec. 42(b).
4. Rev. Proc. 95-28, 1995-1 CB 704.
5. IRC Sec. 42(d).
6. IRC Sec. 42(d)(5)(B).
7. IRC Secs. 42(d)(2)(B), 179(d)(2).
8. See Treas. Reg. §1.42-2.
9. IRC Sec. 42(d)(2)(D)(i)(V); see Rev. Rul. 91-38, above.

A nonqualified substantial improvement is a 25 percent addition, made over a 24-month period, to the adjusted basis (calculated without reduction for depreciation allowances) of property that is subject to depreciation methods in effect prior to 1987.[1] The adjusted basis of an existing building does not include any portion of the basis of the building that is determined by reference to the basis of other property held at any time by the person acquiring the building.[2]

The adjusted basis of property (for purposes of the low-income housing tax credit) is determined as of the close of the first taxable year of the credit period.[3] The eligible basis is reduced by the amount of any federal grant received with respect to the property.[4] The eligible basis must also be reduced by an amount equal to the portion of the adjusted basis of the building that is attributable to residential rental units which are not low-income housing units and which are of a higher quality than the average low-income housing unit in the building, unless an election is made to exclude certain excess costs from the eligible basis.[5]

Nonrecourse financing is included in the cost or other basis of a building (for purposes of the low-income housing tax credit) only if (1) the building is acquired by the investor from an unrelated person, (2) the financing is not convertible debt, and (3) the financing is from a "qualified person" or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government. A "qualified person" is a person who is actively and regularly engaged in the business of lending money and who is not (1) a person from whom the taxpayer acquired the property (or related to such a person), or (2) a person who receives a fee with respect to the investment in the real estate (or related to such a person). In the case of a partnership or an S corporation, the determination of whether nonrecourse financing is qualified for purposes of the low-income housing tax credit is made at the partner or shareholder level, respectively.[6]

If there is a decrease in the amount of nonqualified nonrecourse financing (not including a decrease through the surrender or similar use of the property) in a subsequent year, the amount of decrease is treated as an additional qualified investment in the low-income housing made in the year the property was placed in service. A credit for the applicable percentage of the amount of the increase is taken in the year of the increase. For purposes of determining the amount of the credit or of any subsequent recapture (see Q 7760), the investment is treated as made in the year the property was placed in service.[7]

An investor may also include certain nonrecourse financing obtained from certain qualified nonprofit organizations in basis for the purpose of determining the low-income housing tax credit.[8]

1. IRC Sec. 42(d)(2)(D).
2. IRC Sec. 42(d)(2)(C).
3. IRC Secs. 42(d)(1), 42(d)(2)(A).
4. IRC Sec. 42(d)(5)(A).
5. IRC Sec. 42(d)(3).
6. IRC Secs. 42(k), 49(a)(1).
7. IRC Sec. 49(a)(2).
8. IRC Sec. 42(k).

The eligible basis of a building is allocated to the low-income housing units in the building to determine the *qualified basis* of the qualified low-income building for any tax year. The qualified basis is determined annually by multiplying the eligible basis of the building by the lower of (1) the unit fraction or (2) the floor space fraction. The unit fraction is equal to the number of low-income units in the building divided by the number of residential units (whether or not occupied) in the building. The floor space fraction is equal to the total floor space of low-income units in the building divided by the total floor space of the residential rental units (whether or not occupied) in the building.[1] Vacant apartments, formerly occupied by low-income individuals, continue to be treated as occupied by low-income individuals so long as reasonable attempts are made to rent the apartment and no other units of comparable size or smaller are rented to nonqualified individuals.[2] A unit occupied by a full-time resident manager will be included in the eligible basis of the building; however, that unit will not be included in either the numerator or denominator of the unit fraction or floor space fraction for purposes of determining the qualified basis of the building.[3]

If there is an *increase in the qualified basis* (i.e., the applicable fraction of low-income housing units or floor space, see above, has increased) after the first year of the credit period, an additional credit is allowed with respect to such increase in an amount equal to 2/3 × the applicable credit percentage × the increase in qualified basis. This additional credit may be taken in each of the years remaining in the *15-year compliance period* which begins with the first taxable year of the 10-year credit period.

> *Example*: Nine percent property placed in service in January 1987 would have received an additional credit of 6 percent (2/3 × 9%) for an increase in the qualified basis in 1989. The 6 percent credit could have been taken annually for years 1989 through 2001.[4]

The *first year's credit* (including the year in which there has been an increase in the qualified basis resulting in additional credit being allowed) may be limited under an averaging convention. Under the averaging convention, the sum of the applicable fractions (unit or floor space, see above) as of the close of each full month in the year in which the property is placed in service is divided by 12. The resulting average fraction is multiplied by the eligible basis to determine the qualified basis for the first year only. This qualified basis is in turn multiplied by the credit percentage to determine the first year's credit (as modified under the averaging convention). The part of the first year's credit that is disallowed under this convention may be taken in the year following the credit period (i.e., the eleventh year).[5]

A subsequent owner of a building during its 15-year compliance period is eligible to continue to receive the low-income housing tax credit as if the new owner were the original owner, using the original owner's credit percentage and qualified basis.[6] The prior owner need not have actually claimed the credit for the new owner to claim it.[7]

1. IRC Sec. 42(c).
2. H.R. Conf. Rep. No. 99-841 (TRA '86), *reprinted in* 1986-3 CB (vol. 4) 94.
3. Rev. Rul. 92-61, 1992-2 CB 7.
4. IRC Sec. 42(f)(3).
5. IRC Sec. 42(f)(2).
6. IRC Sec. 42(d)(7); H.R. Conf. Rep. 99-841 (TRA '86), *reprinted in* 1986-3 CB (vol. 4) 102.
7. See Rev. Rul. 91-38, above.

7758. How does property qualify for the low-income housing tax credit?

In order to qualify for the low-income housing credit, a low-income housing project must meet certain minimum set-aside requirements and rent restrictions. Either (1) 20 percent or more of the residential units in the project must be rent-restricted and occupied by individuals (i.e., set aside for such individuals) whose income is 50 percent or less of area median gross income (AMGI) (the 20-50 test), or (2) 40 percent or more of the residential units in the project must be rent-restricted and occupied by individuals whose income is 60 percent or less of AMGI (the 40-60 test). An irrevocable election is made to use either the 20-50 or 40-60 test in the year the credit is first taken.[1]

A residential unit is rent-restricted if the gross rent with respect to the unit does not exceed 30 percent of the set-aside income limitations above. (Income is imputed based on the number of bedrooms in a unit).[2] Thus, rent may not exceed 15 percent of AMGI if the 20-50 test is used (30% × 50%) and 18 percent of AMGI if the 40-60 test is used (30% × 60%).

The determination of an individual's income and the AMGI is to be made in accordance with Section 8 of the United States Housing Act of 1937 (and is not based on gross income for federal income tax purposes).[3] Income limitations fluctuate with changes in AMGI for purposes of initially qualifying an individual under IRC Section 42(g)(1).[4] Rent does not include any Section 8 rental payment, certain fees for supportive services, and payments to the extent the owner pays an equivalent amount to the Farmer's Home Administration under section 515 of the Housing Act of 1949. However, it does include any Section 8 utility allowance.[5] The tenant's gross rent may exceed the 30 percent limitation if there is compliance with the federal housing law.[6]

Whether a unit is rent restricted is determined on the date a housing credit agency initially allocates a housing credit dollar amount to the building under IRC Section 42(h)(1) or on the building's placed in service date, if so designated by the building owner. In the case of a bond-financed building, the determination is made on the date a determination letter is initially issued to the building or on the building's placed in service date, if so designated by the building owner.[7]

Generally, these requirements must be met throughout a 15-year compliance period that begins with the first taxable year of the 10-year credit period. However, if an individual's income met the applicable income limit when the individual began occupying the residential unit or when the calculations are made for annual qualification of the low-income housing, the individual continues to meet the applicable income limit in subsequent years (so long as the unit continues to be rent restricted) unless the individual's income exceeds 140 percent of the applicable income limit and a residential unit of comparable or smaller size in the same project is occupied by a new resident whose income exceeds the applicable income limit (the available unit rule).[8]

1. IRC Sec. 42(g)(1).
2. IRC Sec. 42(g)(2).
3. Notice 88-80, 1988-2 CB 396.
4. Rev. Rul. 94-57, 1994-2 CB 5.
5. IRC Sec. 42(g)(2)(B).
6. IRC Sec. 42(g)(2)(E).
7. Rev. Proc. 94-57, 1994-2 CB 744.
8. IRC Sec. 42(g)(2)(D).

In the case of a low-income housing project for which 15 percent of the low-income units are occupied by individuals whose income is 40 percent or less of AMGI and an irrevocable election is made, this threshold is increased to 170 percent, but the income limitation for a new resident occupying a unit of comparable or smaller size cannot exceed 40 percent of AMGI.[1] Income limitations fluctuate with changes in AMGI for purposes of determining whether any available rental unit must be rented to a new low-income tenant under IRC Section 42(g)(2)(D)(ii).[2] Also, vacant apartments, formerly occupied by low-income individuals, continue to be treated as occupied by low-income individuals so long as reasonable attempts are made to rent the apartment and no other units of comparable size or smaller are rented to nonqualified individuals.[3] Once any comparable unit is rented in violation of the available unit rule, however, all over-income units lose their status as low-income units.[4]

A low-income housing project that has no other building in service at the time it places a building in service must meet these requirements no later than the close of the first year of the credit period for the building.[5] A low-income housing project that has another building already in service at the time it places a later building in service must meet these requirements with regard to the project already in service on the date the later building is placed in service. If these requirements are met, then the first building and the second building are treated as part of the low-income housing project.[6] A taxpayer may elect to have a building not treated as part of a qualified low-income housing project if the building has completed its 15-year compliance period.[7]

With respect to credits allocated from state housing credit ceilings after 1989, an extended low-income housing commitment is required in order to obtain the low-income housing tax credit. In general, the commitment obligates the taxpayer (and the taxpayer's successors) to maintain the property as low-income housing for a period of 15 years after the 15-year credit compliance period has expired (generally, a 30 year commitment). However, the extended low-income housing commitment terminates if (1) the property is subject to foreclosure (unless the foreclosure was prearranged by the taxpayer to terminate the commitment period), or (2) no buyer willing to maintain the property as low-incoming housing can be found after the 15-year credit compliance period has ended.[8] A taxpayer who received a low-income housing credit before 1990 must have entered into an extended low-income housing credit commitment to have been eligible for an additional housing credit allocation for the building after December 31, 1989.[9]

1. IRC Secs. 42(g)(2)(D)(ii), 142(d)(4)(B).
2. Rev. Rul. 94-57, 1994-2 CB 5.
3. H.R. Conf. Rep. No. 99-841 (TRA '86), *reprinted in* 1986-3 CB (vol. 4) 94.
4. Treas. Reg. §1.42-15(f).
5. IRC Sec. 42(g)(3)(A).
6. IRC Sec. 42(g)(3)(B).
7. IRC Sec. 42(g)(5).
8. IRC Sec. 42(h)(6).
9. Rev. Rul. 92-79, 1992-3 CB 10.

7759. What limitations apply when claiming the low-income housing tax credit?

The amount of low-income housing tax credit that can be taken is limited to the housing credit dollar amount that has been allocated to the building by a state housing credit agency. Once granted, the housing credit dollar amount applies to the building for the remaining years of the 15-year compliance period.[1] To facilitate tracking of credits, each building for which an allocation of the low-income housing credit is made is assigned a building identification code (BIN).[2] Allocation of the credit is made on Form 8609, which should be filed with the taxpayer's income tax return.

The low-income housing tax credit is added with certain other credits into the general business credit calculation, and is subject to the general business credit limitation.[3] See Q 7817 concerning the general business credit limitation.

The passive loss rules generally apply to the low-income housing tax credit. However, the low-income housing tax credit is given special treatment under the rental real estate rules. A taxpayer need not actively participate in the low-income housing rental activity to obtain the $25,000 rental real estate exemption amount with respect to the low-income housing tax credit.[4] Also, for property placed in service after 1989, there is no phase-out of the $25,000 rental real estate exemption with respect to the low-income housing credit.[5] For property placed in service before 1990, the $25,000 exemption amount for rental real estate with respect to the low-income housing credit began to phase-out when a taxpayer had income in excess of $200,000.[6] With respect to an interest in a pass-through entity, this repeal of the phaseout of the $25,000 exemption does not apply unless such interest was acquired after 1989.[7] In addition, the $25,000 rental real estate exemption, which is otherwise unavailable with respect to a publicly traded partnership, is available to the extent that the low-income housing credit and the rehabilitation investment credit (see Q 7761) exceed the regular tax liability attributable to income from the partnership.[8] (See Q 7929).

The not-for-profit rules of IRC Section 183 do not apply to disallow losses, deductions, or credits attributable to the operation of low-income housing.[9]

7760. What recapture rules apply when claiming the low-income housing tax credit?

If, at the close of any taxable year in the 15-year compliance period, the amount of the qualified basis of any building is less than the amount of such basis at the close of the preceding

1. IRC Sec. 42(h).
2. Notice 88-91, 1988-2 CB 414.
3. IRC Sec. 38(b)(5).
4. IRC Sec. 469(i)(6)(B)(i).
5. IRC Sec. 469(i)(3)(D).
6. IRC Sec. 469(i)(3)(B), prior to amendment by OBRA '89.
7. OBRA '89, Sec. 7109(b)(2).
8. IRC Sec. 469(k).
9. Treas. Reg. §1.42-4.

taxable year, part of the low-income housing credit may have to be recaptured and interest paid from the time when the recaptured credit was originally taken at the federal overpayment rate under IRC Section 6621. A decrease in qualified basis is not subject to the recapture rule to the extent the amount of the decrease does not exceed the amount of a previous increase in qualified basis for which an additional credit of ⅔ of the applicable percentage has been taken (see Q 7757). The recaptured credit and interest are added to the taxpayer's regularly calculated tax. No deduction may be taken for the interest paid. The amount of low-income housing credit that is recaptured is determined by subtracting from the aggregate amount of credits allowed in prior taxable years the aggregate amount of credits that would have been allowable if the aggregate credits allowable for the entire compliance period were allowed ratably over 15 years.[1] Temporary relief may be granted for buildings located in federally declared disaster areas.[2]

Generally, the qualified basis will change if the applicable fraction of low-income housing units or floor space changes or if the property ceases to qualify as low-income housing. However, if there is a *de minimis* change to the floor space fraction and the property continues to be low-income housing following the change, no recapture results.[3]

A disposition of the building (or interest therein) beyond the 15-year compliance period does not result in recapture of the low-income housing tax credit. A disposition within the 15-year compliance period will result in recapture, unless the taxpayer posts a bond and the building is reasonably expected to qualify as low-income housing throughout the remainder of the 15-year compliance period.[4]

A partnership that has 35 or more partners may make an irrevocable election to have the partnership treated as the taxpayer to whom the credit was allowable. A husband and wife (and their estates) are treated as one partner for this purpose. If the election is made, recapture is allocated to the partners in the same manner as the partnership's taxable income is allocated for the year in which recapture occurs.[5] No change of ownership will be deemed to have occurred with respect to a partnership that has made the election if within a 12-month period at least 50 percent (in value) of the original ownership remains unchanged.[6]

7761. What is the credit for rehabilitating old buildings and certified historic structures?

Designed as a tax incentive to encourage the preservation of historic buildings and as a means of spurring commercial growth in older cities and neighborhoods, a special investment tax credit is available for certain expenditures incurred in the rehabilitation of qualified buildings. The credit has been available for qualifying expenditures incurred after 1981 but underwent substantial revision in TRA '86.

1. IRC Sec. 42(j).
2. Rev. Proc. 95-28, 1995-1 CB 704.
3. IRC Sec. 42(j)(4)(F).
4. IRC Sec. 42(j)(6).
5. IRC Sec. 42(j)(5).
6. H.R. Conf. Rep. No. 99-841 (TRA 86), *reprinted in* 1986-3 CB (vol. 4) 96.

Currently, a 20 percent credit is available for expenditures incurred in rehabilitations of certified historic structures (residential or nonresidential) and a 10 percent credit is available for expenditures incurred in the rehabilitation of other buildings (nonresidential) that were first placed in service before 1936. These percentages apply to property placed in service (as a result of the rehabilitation) after 1986.[1]

7762. Can property that is used for lodging qualify for the credit for rehabilitating old buildings and certified historic structures?

Unless the building is a certified historic structure, a building will not qualify for the special investment tax credit to the extent it is used for lodging purposes.[2] Thus, the use of a building or structure that is not a certified historic structure must be commercial or nonresidential.

> *Example 1*: Expenditures are incurred to rehabilitate a five-story structure. The top three floors are apartments. The bottom two floors are commercial office space. The building is not a certified historic structure. The building and the rehabilitation work otherwise qualify for the tax credit. Expenditures incurred in connection with the rehabilitation of the top three floors do not qualify for the credit. However, the portion of the building's basis that is attributable to qualified rehabilitation expenditures for the commercial part of the building is not considered to be expenditures for property used primarily for lodging. An allocation of expenditures would therefore be made in order to determine the portion of the basis that qualifies for the credit.[3]

> *Example 2*: Expenditures are incurred to rehabilitate a five-story structure. Each of the five floors is an apartment. The building *is* a certified historic structure. The rehabilitation work otherwise qualifies for the tax credit. Because the building is a certified historic structure, the entire portion of the building's basis attributable to qualified rehabilitation expenditures qualifies for the credit.[4]

7763. What are "qualified rehabilitated buildings" for purposes of the tax credit for rehabilitating old buildings and certified historic structures?

The credit is claimed on the portion of the basis of the building that is attributable to qualified rehabilitation expenditures. Four requirements must be met for the building to be a qualified rehabilitated building and be eligible for the credit, as follows:

1. *"Placed in service" requirement*. The building must have been placed in service before the beginning of the rehabilitation.[5] "Placed in service" assumes the meaning given in Treasury Regulation Section 1.46-3(d). This requirement is met where *anyone* has placed the property in service prior to the rehabilitation of the building.[6]

2. *Structural preservation test*. Unless it is a certified historic structure, the building must meet an existing external wall or internal structural framework retention test. With respect to rehabilitation expenditures incurred after 1986:

1. IRC Secs. 47(a), 50(b)(2), 47(c); Treas. Reg. §1.46-1(q).
2. IRC Sec. 50(b)(2).
3. Treas. Reg. §1.48-1(h)(1)(iii).
4. Treas. Reg. §1.48-1(h)(2)(iv).
5. IRC Sec. 47(c)(1)(A)(ii).
6. Treas. Reg. §1.48-12(b)(1)(ii).

(a) 50 percent or more of the existing external walls must be retained in place as external walls;

(b) 75 percent or more of the existing external walls must be retained in place as internal or external walls; and

(c) 75 percent or more of the existing internal structural framework of the building must be retained in place.[1] "Internal structural framework" includes all load-bearing internal walls and any other internal structural supports, such as the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building.[2]

3. *Age requirement test*. Unless it is a certified historic structure, the building must have been located where it is rehabilitated since before 1936 in order to be entitled to the current tax credit.[3]

4. *"Substantially rehabilitated" test*. For rehabilitation to be considered "substantial," the expenditures over a 24-month period selected by the taxpayer (but ending in the tax year) must exceed the greater of $5,000, or the owner's adjusted basis in the building and its structural components, not including the cost of the land.[4] For purposes of this test, the adjusted basis of the building may not be allocated between a rehabilitated portion and a portion that is not rehabilitated.[5]

The owner's adjusted basis is generally determined at the start of the 24-month period (but if the owner's holding period begins later, the adjusted basis is determined at the beginning of the owner's holding period).[6] If the rehabilitation can be expected to be completed in phases set forth in architectural plans and specifications completed before rehabilitation work begins, a 60-month period may be used instead of a 24-month period.[7] Once it is determined that the rehabilitation is substantial, the amount of qualified rehabilitation expenditures that qualify for the credit includes expenditures incurred before, within, and after the 24-month or 60-month measuring period, provided such expenditures are incurred before the end of the taxable year in which the property is placed in service.[8]

7764. What are "certified historic structures" for purposes of the credit for rehabilitating old buildings and certified historic structures?

Generally, a certified historic structure is one that is (1) listed on the National Register of Historic Places; or (2) located in a registered historic district and certified by the Secretary of

1. IRC Sec. 47(c)(1)(A)(iii).
2. Treas. Reg. §1.48-12(b)(3)(iii).
3. IRC Sec. 47(c)(1)(B); Treas. Reg. §1.48-12(b)(5).
4. IRC Sec. 47(c)(1)(C).
5. *Alexander v. Comm.*, 97 TC 244 (1991).
6. IRC Sec. 47(c)(1)(C)(i).
7. IRC Sec. 47(c)(1)(C)(ii); Treas. Reg. §1.48-12(b)(2)(v).
8. Treas. Reg. §1.48-12(c)(6).

the Interior as being of historic significance to the district.[1] The rehabilitation of such a structure must be certified by the Secretary as consistent with the historic character of the property in order to qualify for the 20 percent credit.[2] These expenditures and the building must otherwise meet the same requirements as expenditures for the rehabilitation of buildings that are not certified historic structures except that there is no age requirement for certified historic structures.[3] Certified historic structures are exempt from the external wall retention requirement after TRA '86.[4] However, the Secretary of the Interior retains jurisdiction over the certification of a certified historic structure, and the Secretary may impose an equivalent requirement.[5]

Any expenditure for rehabilitation of a building that is in a registered historic district but that is not a certified historic structure will not qualify even for the credit for rehabilitation of buildings that are not certified historic structures unless the Secretary of the Interior has certified that the building is *not* of historic significance to the district. If rehabilitation of such a building began without such certification by the Secretary, no credit will be allowed unless the Secretary does so certify, and the taxpayer certifies that, when the rehabilitation began, he or she in good faith was not aware that such a certification was necessary.[6]

7765. What are "qualified rehabilitation expenses" that qualify for the credit for rehabilitating old buildings and certified historic structures?

For an amount to be a "qualified rehabilitation expenditure," the following four requirements must be satisfied:

1. *Amount must be chargeable to capital account*. The expenditure must be includable in the basis of real property, so any amount that is deductible as an expense in the year paid or incurred does not qualify.[7]

2. *Amount must be incurred by the taxpayer*. A qualified rehabilitation expenditure is considered incurred by the taxpayer on the date that the amount would be considered incurred under an accrual method of accounting. Under certain conditions a taxpayer acquiring rehabilitated property (*e.g.*, a condominium unit that has been rehabilitated) may be treated as having incurred the expenditure, provided that: (a) the building (or portion of the building) was not used after the rehabilitation and prior to its acquisition; and (b) no other person claimed the credit. In such case, the taxpayer's qualified rehabilitation expenditure is the lesser of (i) the amount of the qualified expenditure or (ii) the amount of the purchase price allocable to the expenditure.[8]

1. IRC Sec. 47(c)(3).
2. IRC Sec. 47(c)(2)(C).
3. Treas. Reg. §1.48-12(b)(4).
4. IRC Sec. 47(c)(1)(A)(iii).
5. See Notice 87-15, 1987-1 CB 446.
6. IRC Sec. 47(c)(2)(B)(iv); Treas. Reg. §1.48-12(d)(5).
7. Treas. Reg. §1.48-12(c)(2).
8. Treas. Reg. §1.48-12(c)(3).

3. *Expenditure must be incurred for depreciable real property*. For property placed in service after 1986, the amount must be added to the basis of depreciable property that is (a) nonresidential real property; (b) residential rental property; (c) real property that has a class life of more than 12.5 years; or (d) an addition or improvement to property described in (a), (b), or (c) above.[1]

4. *Expenditure must be made in connection with the rehabilitation of a qualified rehabilitated building*. The Service takes the position that amounts expended that are attributable to work done to facilities related to the building – such as a sidewalk, parking lot, or landscaping – do not qualify for the credit.[2]

The original cost of acquiring the building or any interest in it and amounts spent to enlarge the existing building are not eligible for the credit.[3] Furthermore, expenditures do not qualify unless straight line depreciation has been elected with respect to them, or, in the case of expenditures financed by an industrial revenue bond, is required.[4] The straight line depreciation election need be made only for the portion of the basis that is attributable to qualified rehabilitation expenditures.[5] A letter ruling determined that expenditures to repair fire damage, remove toxic substances, retain environmental and other consultants, and renovate and reconstruct the damaged building were qualified rehabilitation expenditures within the meaning of IRC Section 47(a)(2), but that the amount of the rehabilitation credit would be reduced by any gain not recognized under IRC Section 1033 (involuntary conversions). The ruling was conditioned upon the premise that the building was "substantially rehabilitated" (as defined in IRC Section 47(c)(1)(C)(i)) and that the expenditures otherwise met the requirements described above.[6]

7766. How does nonrecourse financing of rehabilitation expenditures affect the calculation of the credit for rehabilitating old buildings and certified historic structures?

Rehabilitation expenditures include nonrecourse financing in the cost or other basis of the property (for purposes of the rehabilitation tax credit) only if the following occur: (1) the property is acquired by the investor from an unrelated person; (2) the amount of the nonrecourse financing with respect to the property does not exceed 80 percent of the cost or other basis of the property; (3) the financing is not convertible debt; and (4) the financing is borrowed from a "qualified person" or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government. A "qualified person" is a person who is actively and regularly engaged in the business of lending money and who is not one or more of the following: (1) a person related in certain ways to the investor; (2) a person from whom the taxpayer acquired the property (or a person related to such a person);

1. IRC Sec. 47(c)(2)(A).
2. Treas. Reg. §1.48-12(c)(5).
3. IRC Sec. 47(c)(2)(B); Treas. Reg. §1.48-12(c)(7).
4. IRC Sec. 47(c)(2)(B)(i).
5. Treas. Reg. §1.48-12(c)(8).
6. Let. Rul. 9145019.

or (3) a person who receives a fee with respect to the investment in the property (or a person related to such a person). In the case of a partnership or an S corporation, the determination of whether nonrecourse financing is qualified for purposes of the rehabilitation tax credit is made at the partner or shareholder level, respectively.[1]

If there is a decrease in the amount of nonqualified nonrecourse financing (not including a decrease through the surrender or similar use of the property) in a subsequent year, the amount of decrease is treated as an additional qualified investment in the property made in the year the property was placed in service. A credit of the applicable percentage of the amount of the increase is taken in the year of the increase. For purposes of determining the amount of the credit or of any subsequent recapture, the investment is treated as made in the year the property was placed in service[2] (See Q 7767).

7767. How is the credit for rehabilitating old buildings and certified historic structures claimed? What other tax considerations apply?

The rehabilitation tax credit is added with certain other credits into the general business credit calculation, and is subject to the general business credit limitation[3] (see Q 7817).

The passive loss rules generally apply to the rehabilitation tax credit. However, the rehabilitation tax credit is given special treatment under the rental real estate rules. A taxpayer need not actively participate in the rental activity with respect to which the rehabilitation tax credit is taken to obtain the $25,000 rental real estate exemption amount with respect to the credit.[4] Also, the $25,000 exemption amount for rental real estate with respect to the rehabilitation tax credit does not begin to phase out until a taxpayer has income in excess of $200,000.[5] In addition, the $25,000 rental real estate exemption, which is otherwise unavailable with respect to a publicly traded partnership, is available to the extent that the rehabilitation investment credit and the low-income housing credit (see Q 7754) exceed the regular tax liability attributable to income from the partnership[6] (see Q 7929).

In the case of partnerships (other than certain publicly traded partnerships taxed as corporations (see Q 7699)), generally each partner's distributive share of any item of income, gain, loss, deduction, or credit will take into account a change in any partner's interest occurring during the taxable year. However, this general rule may not be applicable to investment tax credits for rehabilitation expenditures since the investment tax credit is not a tax item that accrues ratably over the taxable year. Investment tax credits accrue at the moment the property is placed in service. Thus, partners may be entitled to an allocation of the credit as determined by their interests in the partnership at the time the property is placed in service.[7]

1. IRC Sec. 49(a)(1).
2. IRC Sec. 49(a)(2).
3. IRC Sec. 38.
4. IRC Sec. 469(i)(6)(B)(ii).
5. IRC Sec. 469(i)(3)(B).
6. IRC Sec. 469(k).
7. Let. Rul. 8519009.

For *property placed in service after 1986*, the increase in basis resulting from the rehabilitation expenditures must be reduced by 100 percent of the credit for all rehabilitation credits taken.[1] For *property placed in service prior to 1987*, the increase in basis resulting from the rehabilitation expenditures was reduced by 100 percent of the credit taken for noncertified historic structures and, generally, for property placed in service in years 1983 through 1986, by 50 percent of the credit taken with respect to a certified historic structure.[2] The reduced basis is used to compute the cost recovery (depreciation) deduction.

Some or all of the investment credit must be recaptured on early disposition of property for which a credit was taken that reduced tax liability.[3] (If the credit did not reduce tax liability, the credit carrybacks and carryforwards are adjusted). There is no recapture if the property was held at least five years after it was placed in service, or if the early disposition was by reason of death or a transfer to a corporation in which gain or loss was not recognized because it was in exchange for stock and the individual was in control of the corporation immediately after the exchange. Recapture is accomplished by adding to tax a percentage of the credit as indicated in the following table:[4]

Percentage to be recaptures	*If property disposed of before the end of*
100% of investment credit	1st year
80% of investment credit	2nd year
60% of investment credit	3rd year
40% of investment credit	4th year
20% of investment credit	5th year

A portion of the rehabilitation tax credit is recaptured if a taxpayer claims a rehabilitation tax credit with respect to a building, and then sells or donates a facade easement with respect to the same property during the rehabilitation credit recapture period.[5] See Q 7999 with regard to a charitable contribution of a "facade easement."

For property placed in service after 1986, if part or all of the credit is recaptured, the basis in property previously reduced on account of the credit is increased by 100 percent of the recapture amount.[6]

For purposes of determining the amount of depreciation recaptured under IRC Sections 1245 and 1250 (see Q 620), the amount of the basis adjustment is treated as a deduction allowed for depreciation except that the determination of how much depreciation would have been taken using the straight line method is made as if no reduction were made in basis for the credits.[7]

1. IRC Sec. 50(c)(1).
2. IRC Sec. 48(q), prior to amendment by TRA '86.
3. IRC Sec. 50(a)(1)(A).
4. IRC Sec. 50(a)(1)(B).
5. Rev. Rul. 89-90, 1989-2 CB 3.
6. IRC Sec. 50(c)(2).
7. IRC Sec. 50(c)(4).

7768. Can a lessee qualify for credit for the rehabilitation of old and certified historic buildings?

Yes. Provided all other requirements for the rehabilitation credit are met, a lessee is eligible for the credit for expenditures the lessee makes if the property is depreciable by the lessee and the improvements are not in lieu of rent. For tax years beginning on or after January 1, 2014, eligibility is determined without regard to the period of the lease. Prior to 2014, the remaining term of the lease had to be at least as long as the recovery period for depreciation.[1] In addition, the lessor may elect to allow a lessee to take the credit that otherwise would be allowable to the lessor.[2] In order for expenditures to qualify for the credit, the building and its rehabilitation must conform to the requirements explained in Q 7761.

The lessee's adjusted basis of the building is determined as of the date that would have been used had the owner been the taxpayer.[3] To determine whether the rehabilitation is substantial, the lessee aggregates the adjusted basis of the owner in the building, and the adjusted basis of the lessee (or lessees) in the property held by lease (the "leasehold") and any leasehold improvements that are structural components of the building.[4] A lessee may include the expenditures of the owner and of other lessees in determining whether rehabilitation has been substantial.[5]

The lessee must reduce the basis in the rehabilitation expenditures for credit taken (See Q 7761).

A lessor may elect to pass through to the lessee the rehabilitation credit for rehabilitation work performed by or on behalf of the lessor.[6] If this election is made, the lessor does not adjust basis in the expenditures. Instead, the lessee must include in income ratably over the applicable recovery period an amount equal to 100 percent of the credit taken.[7] If the lessor passes the credit through to the lessee, application of the passive loss rules (see Q 7746) is determined by reference to the material participation of the lessee.[8]

7769. If a real estate lease provides for deferred or stepped rent, when is rental income includable?

Lessors and lessees under certain deferred or stepped payment lease agreements entered into after June 8, 1984, are required to report rental income and expense as they accrue, as well as interest on rent accrued but unpaid at the end of the period.[9] Agreements are subject to this rule if at least one amount allocable to the use of property during a calendar year is to be paid after the close of the calendar year following the calendar year in which the use occurs, or

1. IRC Sec. 47(c)(2)(B)(vi); Treas. Reg. §1.167(a)-4T; Let. Rul. 8441012.
2. IRC Sec. 50(d)(5); Treas. Reg. §1.48-12(f)(1).
3. Treas. Reg. §1.48-12(b)(2)(ii)(B).
4. Treas. Reg. §1.48-12(b)(2)(iii).
5. Treas. Reg. §1.48-12(b)(2)(vi).
6. IRC Sec. 50(d)(5); Treas. Reg. §1.48-12(f).
7. IRC Secs. 50(c), 50(d)(5).
8. Let. Rul. 8951072.
9. IRC Sec. 467(a).

if there are increases in the amount to be paid as rent under the agreement.[1] However, the rule does not apply unless the aggregate value of the money and other property received for use of the property exceeds $250,000.[2]

As a general rule, rents will accrue in the tax year to which they are allocable under the terms of the lease.[3] Regulations provide that the amount of rent taken into account for a taxable year is the sum of: (1) the fixed rent for any rental period that begins and ends in the taxable year, (2) a ratable portion of the fixed rent for any other rental period beginning or ending in the taxable year, and (3) any contingent rent that accrues during the taxable year.[4]

In either of two situations, rent will be deemed to accrue on a level present value basis ("constant rental amount") instead of under the terms of the agreement:

(1) if the rental agreement is silent as to the allocation of rents over the lease period; or

(2) if the rental agreement is a "disqualified leaseback or long-term agreement." A disqualified leaseback or long-term agreement is an agreement that provides for increasing rents and one of the principal purposes for increasing rents is tax avoidance and the lease is either (a) part of a leaseback transaction, or (b) for a term in excess of 75 percent of the "statutory recovery period" for the property subject to the lease.[5] The statutory recovery period is essentially the period provided for depreciation under ACRS, except that a 15-year period may be substituted for 20-year property, and a 19-year period may be used for residential rental property and nonresidential real property.[6] A leaseback transaction is one involving a lease to any person who had an interest in the property (or related person) within the two-year period before the lease went into effect.[7]

Under regulations, certain rent increases are not considered made for tax avoidance purposes: for example, increases determined by reference to price indices, to rents based on a percentage of lessee receipts, to reasonable rent holidays, or to changes in amounts paid to unrelated third persons.[8]

A constant rental amount is the amount that, if paid as of the close of each lease period under the agreement, would result in an aggregate present value equal to the present value of the aggregate payments required under the agreement.[9] Regulations provide a formula to facilitate the computation of the constant rental amount.[10]

1. IRC Sec. 467(d)(1).
2. IRC Sec. 467(d).
3. IRC Sec. 467(b)(1).
4. Treas. Reg. §1.467-1(d).
5. IRC Sec. 467(b).
6. IRC Sec. 467(e)(3).
7. IRC Sec. 467(e)(2).
8. IRC Sec. 467(b)(5); Treas. Reg. §1.467-1(c)(2).
9. IRC Sec. 467(e)(1).
10. See Treas. Reg. §1.467-3(d).

If property subject to a leaseback or a lease longer than 75 percent of the recovery period is not subject to rent leveling (i.e., there is no tax avoidance purpose or no stepped rent) and the rent accrues according to the terms of the agreement, any gain realized by the lessor on disposition of the property during the term of the agreement will be treated as recaptured ordinary income to the extent that the amount which would have been taken into account by the lessor if the rents had been reported on a constant rental basis is more than the amounts actually taken into account. Before this calculation is made, gain realized by the lessor on the disposition is reduced by the amount of any gain treated as ordinary income on the disposition under other IRC provisions: for example, depreciation recapture.[1] Regulations provide for certain exceptions from recapture and provide for carryover of the ordinary income "taint" where the property is transferred and the transferor's basis carries over to the transferee.[2]

Regulations provide comparable rules for agreements calling for decreasing rates and rules applicable to contingent payments.[3]

Present value will be determined at the rate of 110 percent of the applicable federal rate (AFR), compounded semiannually. The AFR used is that in effect at the time the lease is entered into for debt instruments having a maturity equal to the term of the lease.[4] See Q 589 for an explanation of the applicable federal rate.

While these rules apply generally to leases entered into after June 8, 1984, there are exceptions. One of these is for an agreement entered into pursuant to a written agreement binding on June 8, 1984, and at all times thereafter. A limited exception applies to certain plans existing on or before March 15, 1984.[5] The regulations apply to disqualified leasebacks and long-term agreements entered into after June 3, 1996, and for other rental agreements entered into after May 18, 1999.[6]

7770. Is the cost of demolishing a structure deductible?

No. The cost to the owner or lessee of demolishing a structure (or any loss sustained on account of the demolition) must be capitalized and added to the tax basis in the *land;* thus, the cost is also not recoverable through depreciation.[7] However, a casualty loss may be allowed if it occurs before the demolition.[8] Similarly, a loss may be allowed for the abnormal retirement of a structure due to the unexpected and extraordinary obsolescence of the structure where the loss occurs prior to the demolition.[9]

A modification of a building, other than a certified historical structure (see Q 7761), is not treated as a demolition under IRC Section 280B if (1) 75 percent or more of the existing external

1. IRC Sec. 467(c).
2. Treas. Reg. §1.467-7(c).
3. Treas. Regs. §§1.467-1(c), 1.467-3(c).
4. IRC Sec. 467(e)(4). See General Explanation–TRA '84, p. 287, fn. 22.
5. P.L. 98-369 (TRA '84) Sec. 92(c)(2).
6. Treas. Reg. §1.467-9(a).
7. IRC Sec. 280B.
8. Notice 90-21, 1990-1 CB 332.
9. *De Cou v. Comm.*, 103 TC 80 (1994).

walls of the building are retained in place as external or internal walls, and (2) 75 percent or more of the existing internal structural framework is retained in place. A modification of a certified historical structure (see Q 7761) is not treated as a demolition under IRC Section 280B if (1) the modification is part of a certified rehabilitation (see Q 7761); (2) 75 percent or more of the existing external walls of the building are retained in place as external or internal walls; and (3) 75 percent or more of the existing internal structural framework is retained in place. Such costs may generally be expensed or capitalized and added to the tax basis of the building (and thus depreciated) as appropriate (See Q 7744).[1]

7771. If real property subject to a nonrecourse mortgage is sold or abandoned, must the seller include the unpaid balance of the mortgage in his calculation of gain or loss?

Yes. Gain from sale of property is defined as the excess of the amount realized over the seller's tax basis (as adjusted for items such as depreciation). Loss is the excess of the tax basis (as adjusted) over the amount realized.[2] The tax basis of property includes any unpaid nonrecourse mortgage liability, and on sale of the property subject to the mortgage the amount realized by the owner includes the unpaid balance of any nonrecourse mortgage on the property.[3] It does not make any difference that the unpaid balance of the mortgage exceeds the fair market value of the property at the time of sale.[4]

Abandonment of property subject to a non-recourse debt is treated as a sale or exchange and the amount of outstanding debt is an "amount realized" on sale or exchange for purposes of determining and characterizing gain or loss.[5]

7772. How is gain or loss on the sale of rental real estate treated?

Gain or loss on property used in a trade or business, including rental real estate, is not "capital gain or loss" – it is referred to as "IRC Section 1231 gain or loss."[6] If all of the taxpayer's IRC Section 1231 gains in a year exceed the IRC Section 1231 losses, the net gain is treated as long-term capital gain; however, such net gain must be treated as ordinary income to the extent of net IRC Section 1231 losses of the taxpayer in the five most recent prior years (which have not been previously offset by net gains of a later year).[7] If IRC Section 1231 losses exceed IRC Section 1231 gains, the net loss is treated as ordinary loss.[8]

In order to determine whether gains exceed losses, it is necessary to aggregate *recognized* gains (in excess of recaptured accelerated depreciation) and losses in the year on all IRC Section 1231 property. Nondeductible losses and nonrecognized gains are not included: for example,

1. Rev. Proc. 95-27, 1995-1 CB 704.
2. IRC Sec. 1001.
3. *Crane v. Comm.*, 331 U.S. 1 (1947).
4. IRC Sec. 7701(g); *Comm. v. Tufts*, 100 S Ct 1826, 83-1 USTC ¶9328 (U.S. 1983).
5. *Yarbro v. Comm.*, 737 F2d 479, 84-2 USTC ¶9691 (5th Cir. 1984); *Middleton v. Comm.*, 77 TC 310 (1981), aff'd, 693 F2d 124, 82-2 USTC ¶9713 (11th Cir. 1982).
6. IRC Sec. 1231(a)(3).
7. IRC Secs. 1231(a)(1), 1231(c).
8. IRC Sec. 1231(a)(2).

losses not deductible because they involve transactions between related parties (see Q 607), gains not recognized because they involve exchanges of like-kind property (see Q 614), or unreported gain on an installment sale (see Q 586).[1]

There are generally two kinds of gains and losses that must be included in the IRC Section 1231 netting process, as follows:

(1) Includable gains and deductible losses on sales or exchanges of depreciable property and real property that have been held for more than one year and used in a trade or business (but not inventory, property held primarily for sale to customers in the ordinary course of business, or a copyright or certain other literary or artistic property), including certain sales involving timber, coal, iron ore, livestock, and unharvested crops;[2] and

(2) Includable gain and deductible losses (not compensated for by insurance) resulting from compulsory or involuntary conversion (as a result of destruction in whole or in part, theft, seizure, or an exercise of the power of requisition or condemnation) of property used in a trade or business (as defined above) or of any capital asset held for more than one year and held in connection with a trade or business or a transaction entered into for profit. However, gains and losses arising from fire, storm, shipwreck, or other casualty, or from theft, are included only if the gains exceed the losses.[3] If losses arising from fire, storm, shipwreck, or other casualty, or theft, exceed gains from such items, then rather than including such items in the IRC Section 1231 netting process: (1) loss from any such item is deductible as a loss under IRC Section 165, and (2) gain from any such item is recognized as gain (generally as capital gain, but see Q 7774) to the extent that the amount realized on the involuntary conversion exceeds the cost of replacement property (if any) purchased within two years of the involuntary conversion.[4]

Where the sale is between related persons, see Q 7773.

7773. How is gain or loss on the sale of rental property to a related person treated?

Gain on the sale of property depreciable by the purchaser is ordinary gain if the sale is between certain related parties. For this purpose, related parties are: (1) a person and a corporation or partnership of which the person owns (directly or indirectly) a 50 percent or more interest; (2) an individual and a trust in which the individual (or the individual's spouse) is a beneficiary having more than a remote interest; (3) generally, an executor and a beneficiary of an estate; and (4) an employer and a welfare benefit fund.[5] In determining 50 percent ownership,

1. Treas. Reg. §1.1231-1(d).
2. IRC Sec. 1231(b).
3. IRC Sec. 1231(a).
4. Treas. Reg. §1.165-7(a), IRC Secs. 1033, 1001.
5. IRC Secs. 1239(a), 1239(d).

the general rules of constructive ownership under IRC Section 267(c) apply (except paragraph (3) thereof).[1]

If the sale is an installment sale, the installment method of reporting is denied and the proceeds are deemed to be received in the year of sale, unless the Service is satisfied that avoidance of federal income taxes was not one of the principal purposes of the disposition[2] (See Q 586).

Gain or loss on transfers between spouses or former spouses incident to a divorce is not recognized, and the basis of the property generally remains the same in the hands of the transferee as in the hands of the transferor[3] (See Q 660).

Loss on the sale of property to certain related persons is not recognized (See Q 607).

7774. If accelerated depreciation is used, is part of the gain on the sale of real estate treated as "recaptured" ordinary income?

Where certain accelerated methods of depreciating real estate have been used, some of the gain on sale of the property must be treated as ordinary income. In effect, some or all of the ordinary income offset by the depreciation must be "recaptured." Only the gain in excess of the recaptured ordinary income may be treated as capital gain or "IRC Section 1231" gain. The amount of gain that must be treated as recaptured ordinary income will depend on whether the property is "recovery" property (that is, it was placed in service after 1980) or is depreciated under rules in effect prior to 1981. (If there is a loss on sale of the property, no "recapture" is necessary).[4]

Recovery Property Held for One Year or Less

If property is not held for more than one year, an amount equal to 100 percent of the depreciation allowable is recaptured to the extent of gain.[5]

Property Placed in Service After 1986

Residential rental real property and nonresidential real property placed in service after 1986 is depreciated under the straight line method and is not subject to the recapture rule if held for more than one year.

Property Placed in Service before 1987 and After 1980

If residential real property is held more than one year, gain on sale equal to 100 percent of "additional depreciation" is treated as ordinary income. Additional depreciation is the amount by which allowable depreciation deductions exceed the amount that would have been deducted if the investor had elected the straight line method of depreciation.[6] Thus, if

1. IRC Sec. 1239(c)(2).
2. IRC Sec. 453(g).
3. IRC Sec. 1041.
4. IRC Sec. 1250(a).
5. IRC Sec. 1250(b)(1).
6. IRC Sec. 1250(b)(1).

the owner elected the straight line method of cost recovery (depreciation), there would be no recapture.

Nonresidential property held for more than one year is subject to much stricter recapture rules. If the property is depreciated by an accelerated method, 100 percent of the allowable depreciation deductions (not just "additional depreciation") is recaptured (but not in excess of gain).[1] However, if the individual used the straight line method of depreciation, there is no recapture.[2]

Property Placed in Service Before 1981

Residential and nonresidential rental properties placed in service before 1981 are subject to the same recapture rules that apply to residential property placed in service after 1980; that is, if accelerated depreciation has been used, the amount allowable in excess of the amount allowable under the straight line method is subject to recapture. This amount is called "additional depreciation." The percentage of additional depreciation on property placed in service before 1981 is, in some instances, reduced, or phased out, if property is held over a certain length of time.

The rules for determining the phase-out effect that the owner's holding period will have on the percentage of additional depreciation to be recaptured varies for the periods 1964-1969, 1970-1975, and 1976-1980. Thus, if property was held during more than one period, the holding period must be divided into these periods for the purpose of determining (1) the additional depreciation attributable to the period; and (2) what percentage of that additional depreciation is recapturable.

Depreciation for the period from 1976 through 1980. Additional depreciation allowable from 1976 to 1980 is recaptured in full, to the extent of any gain. However, low-income housing and rehabilitation expenditures are no longer subject to recapture. The 200 month total phase-out period (reduction by one percentage point per month after a 100 month holding period) for low-income housing and rehabilitation expenditures has elapsed.

Depreciation for the period from 1970 through 1975. The percentage of additional depreciation for the years after 1969 and before 1976 that must be recaptured is determined by the classification of the property and the holding period. Low-income housing, property sold pursuant to a written contract in effect on July 24, 1964, residential rental property, and rehabilitation expenditures amortized over 60 months are no longer subject to recapture. All other property (i.e., commercial rental property) is subject to 100 percent recapture of additional depreciation.

Depreciation for the period before 1970. Additional depreciation allowable before 1970 is no longer subject to recapture. The phase-out provisions applied to all types of real property and

1. IRC Sec. 1245(a)(5), as in effect prior to TRA '86.
2. IRC Secs. 1245(a)(5)(C), as in effect prior to TRA '86; 1250.

the 120 month period for total phase-out (reduction by one percentage point per month after a 20 month holding period) has elapsed.

The recapture rules do not apply to dispositions by gift or to transfers at death. In a like-kind exchange, recapture applies to the extent of the boot received (see Q 614).

7775. If the seller finances a sale of real estate, when is interest imputed at a higher rate than the stated rate? When is imputed interest included as income by the seller? Deducted by the buyer?

Where a personal debt obligation that matures more than one year from issue is given for the purchase of real estate and any payment is due more than six months after the sale or exchange, the IRC requires that interest expense deductions taken by the buyer and interest income reported by the seller reflect use of an adequate rate of interest. Furthermore, in most cases, it requires that the interest rate not only be adequate but that interest at that rate be included in income and deducted as it accrues over the term of the loan under the original issue discount rules.

Consequently, it is necessary to test the arrangement made by the parties for adequacy of interest. This test calls for comparing the stated principal amount of the debt obligation to the sum of the present values (as of the date of the sale or exchange) of all payments under the obligation (both principal and interest) discounted at 100 percent of the applicable federal rate (AFR), compounded semiannually. The AFR is explained in Q 589. (However, a lower rate may be allowed where the stated principal amount of the obligation is not more than $2,800,000 (as indexed) or if a sale of land to a family member is involved. This is discussed below under "Exceptions").

If the stated principal amount is *less than or equal to* the sum of the present values discounted at 100 percent of the AFR, compounded semiannually, there is adequate stated interest.[1] If there is adequate stated interest, the stated principal amount is then compared to the amount payable at maturity (other than interest based on a fixed rate and payable unconditionally at fixed periodic intervals of one year or less during the entire term of the debt instrument). If the amount payable at maturity is greater than the stated principal amount, the difference represents deferred interest, or original issue discount, that must be included by the seller and deducted by the buyer as it accrues over the term of the obligation. (The accrual of original issue discount is discussed in Q 7635).

If the stated principal amount is *greater* than the sum of the present values discounted at 100 percent of the AFR, compounded semiannually, there is not adequate stated interest. In effect, the principal amount has been overstated. In this case, the sum of the present values of all the payments due, discounted at 100 percent of the AFR compounded semiannually, is imputed as the principal amount of the loan (the "imputed principal amount").[2] Then, if the imputed principal amount is less than all amounts payable at maturity (other than interest

1. IRC Sec. 1274(c)(2).
2. IRC Sec. 1274(b).

based on a fixed rate and payable unconditionally at fixed periodic intervals of one year or less during the entire term of the debt instrument), the difference is original issue discount that must be included and deducted as it accrues over the term of the obligation under the original issue discount rules.

If the transaction is a sale-leaseback, 110 percent of the AFR must be used in testing for adequacy of interest and in determining imputed principal where there is inadequate interest.[1]

One purpose in requiring adequate interest is to prevent overstatement of the principal amount of the obligation and the consequent overstating of the basis of the property for depreciation and gain calculations. On the other hand, to prevent understatement in potentially abusive situations, the principal amount of the obligation will be the fair market value of the property (reduced by any cash down payment and other property involved), without regard to whether the stated interest is adequate. A potentially abusive situation includes any transaction involving a "tax shelter," or a situation that, because of a recent sale, nonrecourse financing, financing with a term in excess of the economic life of the property, or other circumstance, is of a type identified in regulations as having a potential for abuse.[2] For this purpose a tax shelter is defined as an entity or plan, a significant purpose of which is avoidance or evasion of federal income tax.[3]

Exceptions

(1) Where a personal debt instrument is given in connection with certain sales of property, interest is not treated as accruing under the original issue discount rules, but an adequate rate of interest is treated as included in each payment due more than six months after the date of sale (under a contract calling for payments more than one year after the transaction). These transactions are:

(a) the sale of a farm for $1,000,000 or less by an individual, estate, testamentary trust, or small business organization (corporation or partnership);

(b) the sale by an individual of his or her principal residence;

(c) a sale involving a total payment of $250,000 or less (including interest); and

(d) a land transfer to a family member (brother, sister, spouse, ancestor, or lineal descendant), with respect to the first $500,000.[4]

An adequate portion of each payment must be treated as interest and, if adequate interest is not called for, a part of the principal must be recharacterized as interest. To determine whether the contract calls for adequate interest, it is necessary to compare the sum of the payments due

1. IRC Sec. 1274(e).
2. IRC Sec. 1274(b)(3)(B).
3. IRC Sec. 6662(d)(2)(C)(ii).
4. IRC Secs. 483(e), 1274(c)(3).

more than six months after the sale to the sum of the present value of the payments and the present values of any interest payments due under the contract using a discount rate of 100 percent of the AFR, compounded semiannually. If the sum of the payments exceeds the sum of the present values, the interest rate is not adequate. The excess amount determined above is considered "total unstated interest," which must be allocated among the payments in a manner consistent with the original issue discount rules.[1] In the case of a sale-leaseback, unstated interest is determined using 110 percent instead of 100 percent of AFR.[2]

(2) If the stated principal amount of an obligation given for a sale or exchange after June 30, 1985 (other than for new property that qualifies for the investment tax credit) is not more than $5,557,200 in 2014 (up from $5,468,200 in 2013)), it is to be tested for original issue discount or for unstated interest, using a rate of 9 percent, compounded semiannually, if that is lower than 100 percent of the AFR, compounded semiannually.[3] This amount is indexed annually for inflation.[4]

(3) A debt instrument for $3,969,500 in 2014 (up from $3,905,900 in 2013) or less given in a transaction after June 30, 1985, can avoid the original issue discount accrual requirement if the lender is on the cash basis and buyer and lender jointly elect.[5] This amount is indexed annually for inflation.[6]

(4) On the sale or exchange of land after June 30, 1985, to a family member (as defined above at (1)(d)) unstated interest on the first $500,000 is determined using a discount rate of 6 percent compounded semiannually, if that is less than 100 percent of the AFR, compounded semiannually.[7]

(5) Sales of $3,000 or less are not subject to testing for adequacy of stated interest.[8]

Personal Use Property

Where substantially all the buyer's use of the property is personal (i.e., not in connection with a trade or business, or for the production of income, to be determined at the time the obligation is issued), *a cash basis buyer* deducts no more than the amount of interest he or she pays (assuming, of course, that there is authority for deducting any interest at all), without regard to any amount of imputed or unstated interest. (Purchase of a vacation home that is a qualified residence for purposes of IRC Section 163(h) with the intention of making substantial personal use of it would come within the exception). The *seller* must nonetheless include original issue discount as it accrues or unstated interest as it is allocated to payments according to his method of accounting.[9]

1. IRC Secs. 483(b), 483(a).
2. IRC Sec. 1274(e).
3. IRC Sec. 1274A(b); Rev. Rul. 2012-33, 2012-2 CB 710; Rev. Rul. 2013-23, 2013-2 CB 590.
4. IRC Sec. 1274A(d)(2).
5. IRC Sec. 1274A(c); Rev. Rul. 2012-33, 2012-2 CB 710; Rev. Rul. 2013-23, 2013-2 CB 590.
6. IRC Sec. 1274A(d)(2).
7. IRC Sec. 483(e).
8. IRC Sec. 483(d)(2).
9. IRC Sec. 1275(b).

Third Party Loan Assumptions

If a loan is assumed after June 30, 1985, or property is acquired after June 30, 1985, subject to a loan, the assumption (or taking subject to) is disregarded in determining whether the original issue discount rules discussed above apply, *provided* the terms and conditions of the debt instrument are not modified or the nature of the transaction changed.[1] Where the loan was assumed before July 1, 1985, the result is less clear. Apparently, Congress intended that such loans assumed or taken subject to would come under the imputed and unstated interest requirements.[2] However, several exceptions were made for loans assumed prior to July 1, 1985 by P.L. 98-612.

7776. What kinds of real estate may be exchanged for other real estate tax-free?

Neither gain nor loss is recognized in an exchange of real property held for productive use in a trade or business or for investment for property of a like kind that is also to be held either for productive use in a trade or business or for investment.[3] (Indeed, recognition is not permitted.) However, any gain realized will be recognized to the extent money or other property not of like kind, including net relief from debt, is received in the exchange.[4] Also, gain or loss will generally be recognized if either of the properties exchanged in a like-kind exchange between related persons is disposed of within two years thereafter.[5] It is possible for an exchange to be tax-free to one party but not to the other. See Q 614 for an explanation of the general rules applicable to like-kind exchanges.

To be of like kind, the properties must be of the same nature or character, but not necessarily of the same grade or quality. Unproductive real estate held by one other than a dealer for future use or future realization of increase in value is considered held for investment. Property held for investment may be exchanged for property held for productive use in a trade or business and *vice versa*. Unimproved land may be exchanged for improved land. City real estate may be exchanged for a ranch.[6] Rental real estate may be exchanged for a farm.[7] An empty lot held as investment property may be exchanged for two townhouses to be constructed and used as rental property.[8]

Even partial interests in real estate have been held to be like-kind property. Two leasehold interests have been held to be of like kind.[9] A lease for thirty years or more may be exchanged for an entire (fee simple) ownership interest.[10] A remainder interest in real property held for investment qualified as of like kind to a fee interest in real property held for investment or use

1. IRC Sec. 1274(c)(4).
2. H.R. Rep. No. 98-861, 98th Cong., 2d Sess., p. 889.
3. IRC Sec. 1031(a).
4. IRC Sec. 1031(b).
5. IRC Sec. 1031(f).
6. Treas. Reg. §1.1031(a)-1.
7. Rev. Rul. 72-151, 1972-1 CB 225.
8. Let. Rul. 9431025.
9. Rev. Rul. 76-301, 1976-2 CB 241.
10. Rev. Rul. 78-72, 1978-1 CB 258; Treas. Reg. §1.1031(a)-1(c)(2).

in a trade or business.[1] Undivided interests in three parcels of land held by three tenants in common were exchanged so that each received a 100 percent interest in one parcel in a non-taxable like-kind exchange.[2] Similarly, the fractional tenancy-in-common interests of related parties may be exchanged for a fee simple interest in real estate.[3] Surrender of the interests of shareholders in a housing cooperative (stock and proprietary leases with 30 or more years to run) in exchange for condominium interests in the same underlying property qualified as a like-kind exchange, when the taxpayer rented out the units and the property was therefore held for productive use in a trade or business or for investment. (Whether rights in a housing cooperative or in a condominium constitute an interest in real estate depends on state law).[4] Exchange of an agricultural conservation easement for an unencumbered fee-simple interest in another farm qualified as a like-kind exchange.[5]

Mineral interests have been exchanged for other mineral interests.[6] Mineral interests have also been exchanged for entire interests.[7]Timber rights have been exchanged for entire interests in timberland.[8] However, an exchange of the right to cut standing timber for tracts of timberland did not qualify as a like-kind exchange.[9]

Even if the property is of like kind to other property in an exchange, nonrecognition of gain will be denied unless the property is "held for productive use in a trade or business or for investment" and the replacement property is likewise to be "held for productive use in a trade or business or for investment." This "holding" requirement is not met where an individual acquires property in the exchange for the purpose of selling it or otherwise liquidating it.[10]

The Internal Revenue Service takes the position that the "holding" requirement is not met unless the property is owned over a period of time with the intention of making money rather than for personal reasons. The Service determined in a letter ruling that where an individual acquired property in an exchange with the intent to hold the property for use in a trade or business or as an investment for at least two years but then to sell it, the holding requirement was met.[11] The IRS also takes the position that if an individual acquires the property in order to exchange it, the transfer will not qualify with respect to that individual because the property is not held for business or investment purposes.[12] Property received in the liquidation of a corporation and immediately exchanged did not qualify for tax-free exchange because it had not been held for productive use in a trade or business or for investment by the taxpayer.[13]

1. Let. Rul. 9143053.
2. Rev. Rul. 73-476, 1973-2 CB 300.
3. Let. Rul. 9543011.
4. Let. Ruls. 8443054, 8445010.
5. Let. Rul. 9215049.
6. *Fleming v. Campbell*, 205 F.2d 549 (5th Cir. 1953).
7. *Comm. v. Crichton*, 122 F.2d 181 (5th Cir. 1941); Rev. Rul. 55-749, 1955-2 CB 295.
8. *Everett v. Comm.*, TC Memo 1978-53; Rev. Rul. 72-515, 1972-2 CB 466; *Starker v. U.S.*, 75-1 USTC ¶9443 (D. Ore. 1975).
9. TAM 9525002.
10. *Regals Realty Co. v. Comm.*, 127 F.2d 931 (2d Cir. 1942); *Black v. Comm.*, 35 TC 90 (1960); *Klarkowski v. Comm.*, TC Memo 1965-328, aff'd on other issues, 385 F.2d 398 (7th Cir. 1967); *Bernard v. Comm.*, TC Memo 1967-176; Rev. Rul. 75-292, 1975-2 CB 333.
11. Let. Rul. 8429039.
12. Rev. Rul. 75-291, 1975-2 CB 332; Rev. Rul. 84-121, 1984-2 CB 168.
13. Rev. Rul. 77-337, 1977-2 CB 305.

However, the Tax Court and the Ninth Circuit Court of Appeals have not been quite so strict. Where property held for investment was exchanged for like-kind property with the intent of immediately contributing the property acquired in the exchange to a partnership for a general partnership interest (itself a nonrecognition transaction), the exchange was held to meet the requirement that the acquired property be "held" for investment or productive use in a trade or business, where the purpose of the partnership was to hold the property for investment and where the total assets of the partnership were predominantly of a kind like the taxpayer's original property. The court saw a continuity of holding, although it was as a partner instead of as an individual, which distinguished the situation from those involving an intent to sell or liquidate the property.[1] Where an individual acquired property in a corporate liquidation and immediately agreed to exchange it, the court ruled the holding requirement was met, saying that all that is required is that the individual own property that the individual does not intend to liquidate or use for personal pursuits. The court concluded that an intent to exchange for like-kind property is consistent with holding the property for investment.[2] However, in a case where it was not to the taxpayer's advantage to receive like-kind treatment, another court held that property acquired for the purpose of immediate use in an exchange was not property held for investment.[3]

Property can qualify for tax-free exchange even where the owner has sold to the other party an option either to purchase the land or to exchange similar property for it.[4] However, if the like-kind exchange is between related persons, an option could operate to extend the 2-year period during which nonrecognition is defeated by a disposition of the property (see Q 614).

Partnership interests cannot be like-kind property, regardless of whether they are general or limited, and regardless of whether they are interests in the same or different partnerships.[5] However, the IRC provides that if a partnership has in effect a valid election under IRC Section 761(a) to be excluded from the application of the IRC partnership provisions (Subchapter K), it is subject to a special rule. Such an interest will be treated, for purposes of IRC Section 1031, as an interest in each of the assets of the partnership, not as an interest in the partnership itself.[6]

Exchanges of depreciable tangible personal property held for business or investment purposes (such as lamps, carpet, and other furnishings in a building that is held for investment) may qualify for nonrecognition under IRC Section 1031, if the relinquished property and the replacement property belong to the same general asset class.[7]

1. *Magneson v. Comm.*,753 F2d 1490, 85-1 USTC ¶9205 (9th Cir. 1985), aff'g 81 TC 767 (1983).
2. *Bolker v. Comm.*, 760 F2d 1039, 85-1 USTC ¶9400 (9th Cir. 1985), aff'g 81 TC 782 (1983).
3. *Barker v. U.S.*,668 F Supp 1199, 87-2 USTC ¶9444 (C.D. Ill. 1987).
4. Rev. Rul. 84-121, above.
5. Treas. Reg. §1.1031(a)-1(a)(1).
6. IRC Sec. 1031(a)(2); Treas. Reg. §1.1031(a)-1(a).
7. See Treas. Reg. §1.1031(a)-2.

7777. When will a transaction qualify as a like-kind exchange of real estate?

Assuming the properties involved qualify for tax-free exchange purposes, that is, they are of like kind and are held for the required business or investment purposes, it is also necessary that the transaction be an "exchange." A sale followed by purchase of similar property is not an exchange.[1] The exchange of nonqualifying property ("boot") does not make the transaction any the less an "exchange," but simply requires recognition of any gain to the extent of the nonqualifying property.[2] See Q 614 for an explanation of the general rules for like-kind exchanges. See Q 7778 through Q 7780 for a discussion of the various types of transactions that the IRS has addressed in the like-kind exchange context.

7778. What is a simultaneous exchange of real estate? When will this type of exchange qualify as a like-kind exchange?

The simplest form of real estate exchange is one in which parties "swap" properties they already own, but it is not necessarily the most common. Frequently, a person (A) who wishes to make an exchange can find a buyer (B) for the property, but not one who has property that A wants in return. The IRS has permitted a three-cornered solution to this problem as follows: A transfers property to B, B transfers property to C, and C transfers property to A.[3] In a 2-party exchange, the IRS determined that the buyer (B) could acquire the property from a third person or construct a building specifically in order to exchange it for A's property and that the resulting exchange could qualify with respect to A, provided B did not act as A's agent.[4] Such a transaction does not qualify as a like-kind exchange for B, who did not hold the property for business or investment but acquired it for exchange.[5] (Because B's basis was the cost of acquiring the replacement property, however, B is unlikely to realize, and thus recognize, much gain anyway.)

A number of variations on the three cornered exchange have been permitted. The Tax Court has determined that a third party's property may be purchased by a fourth party intermediary who exchanges it for A's property which it transfers to B for cash used to pay the third party. The transaction has been held an exchange even though the fourth party's ownership was transitory.[6] Similarly, a valid exchange would occur if several parties transfer their fragmented interests in real estate to an intermediary who then "reassembles" the interests and transfers whole interests back to the individuals where the total value of the replacement property is approximately equal to the total value of the relinquished property.[7]

Even if B, or a fourth party intermediary, is unable for some reason to acquire title to the third party's property, but has only a right to buy it, transactions have been held exchanges where

1. Treas. Reg. §1.1031(k)-1(a); *Von Muff v. Comm.*, TC Memo 1983-514.
2. IRC Sec. 1031(b).
3. Rev. Rul. 57-244, 1957-1 CB 247.
4. Rev. Rul. 75-291, 1975-2 CB 332.
5. Rev. Rul. 75-291, above; Rev. Rul. 77-297, 1977-2 CB 304.
6. *Barker v. Comm.*, 74 TC 555 (1980). See *Garcia v. Comm.*, 80 TC 491 (1983), acq., 1984-1 CB 1.
7. Let. Rul. 9439007.

B directed the third party to transfer title to A, who simultaneously transferred his property to B.[1] In these cases, cash paid the third party for property was transferred directly from B or the intermediary and not to or through A.[2] The IRS has held that such a transaction will qualify as a like-kind exchange.[3] However, where the cash was paid to A who paid it to the third party, the transaction was held to be a sale and repurchase.[4]

As the complexity of the transaction increases, so does the difficulty of distinguishing between exchanges and sales; in addition, the likelihood of a challenge by the IRS increases correspondingly. In three or four party exchanges, the IRS has sometimes taken the position that the exchange party is the agent of the taxpayer and that the taxpayer thus exchanged property with himself or herself, not qualifying for like-kind exchange treatment.[5] For transfers of property on or after June 10, 1991, regulations provide a safe harbor designed to prevent such a characterization. The regulations state that in the case of simultaneous transfers of like-kind properties involving a *qualified intermediary* (as defined in Q 7779), the qualified intermediary will not be considered the agent of the taxpayer for purposes of IRC Section 1031(a).[6] This safe harbor is also available for deferred exchanges, as explained in Q 7779.

7779. What is a deferred exchange of real estate? When will this type of exchange qualify as a like-kind exchange?

Where B wants title to A's property before suitable replacement property has been located, the IRC specifies a limited period of time that may elapse after property is relinquished in a transfer and the replacement property to be received is identified and transferred. For purposes of IRC Section 1031, the regulations, and this discussion, a deferred exchange is any exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (i.e., the "relinquished property") and subsequently receives property to be held for productive use in a trade or business or for investment (i.e., the "replacement property").[7]

Transfers in which property is conveyed in return for a promise to acquire and convey acceptable replacement property by a certain future date were permitted under case law predating the 1984 revision of IRC Section 1031.[8]

The IRC states that to be treated as of like kind to relinquished property, the replacement property must be (1) *identified* as the property to be received in the exchange on or before the 45th day after the property relinquished in the exchange is transferred (i.e., the "identification period"), *and* (2) *received* within 180 days after the transfer of the property relinquished or, if earlier, the due date (including extensions) of the transferor's income tax

1. *Biggs v. Comm.*, 69 TC 905 (1978), aff'd, 632 F.2d 1171 (5th Cir. 1980); *Brauer v. Comm.*, 74 TC 1134 (1980).
2. See also *W.D. Haden Co. v. Comm.*, 165 F.2d 588 (5th Cir. 1948).
3. Rev. Rul. 90-34, 1990-1 CB 154.
4. *Carlton v. U.S.*, 385 F.2d 238 (5th Cir. 1967).
5. See *Garcia v. Comm.*, above; *Rutland v. Comm.* TC Memo 1977-8; *Coupe v. Comm.*, 52 TC 394 (1969), *acq.*, 1970-2 CB xix.
6. Treas. Reg. §1.1031(b)-2.
7. Treas. Reg. §1.1031(k)-1(a).
8. See *Starker v. U.S.*, 75-1 USTC ¶9443 (D. Ore.) (Starker I); *Starker v US*, 602 F2d 1341, 79-2 USTC ¶9541 (9th Cir. 1979) (Starker III), rev'g 432 F Supp 864, 77-2 USTC ¶9512 (D. Ore. 1977) (Starker II).

return for the tax year in which the transfer of the relinquished property occurred (i.e., the "exchange period").[1] "Identified" and "received," for this purpose, are defined in the regulations as explained below.

Regulations provide that replacement property is "identified" only if it is unambiguously described and designated as such in a written document, signed by the taxpayer and delivered (faxed, mailed, etc.), before the end of the identification period, to the person obligated to transfer the replacement property, or to any other person involved in the exchange (e.g., an escrow agent or a title company), other than the taxpayer or a "disqualified person" (defined below).[2] However, replacement property actually received before the end of the identification period will be treated as identified.[3]

Because it is not always possible for a taxpayer to identify with precision the replacement property that will ultimately be received, the regulations permit identification of alternative properties. The maximum number of properties that may be identified as replacement property in a single deferred exchange is: (1) three properties, without regard to their fair market values; or (2) any number of properties, as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the fair market value of the relinquished property as of the date of transfer.[4]

If, as of the end of the identification period, the taxpayer has identified more replacement properties than permitted under the above rules, he or she will generally be treated as if no replacement had been identified. There are two exceptions to this general rule: First, any replacement property actually received before the end of the identification period will be treated as satisfying the requirements of the preceding paragraph. Second, a special "95 percent rule" may apply as follows: Any replacement property identified before the end of the identification period and received before the end of the exchange period will be treated as satisfying the requirements of the preceding paragraph if the taxpayer receives, before the end of the exchange period, identified replacement property having a fair market value that is at least 95 percent of the aggregate fair market value of all identified replacement properties.[5]

In order to meet the receipt requirement, the replacement property must be received before the end of the (180-day) exchange period, and the replacement property received must be substantially the same property as identified. If more than one replacement property was identified, these requirements apply separately to each replacement property.[6] Special rules apply for identification and receipt of replacement property that does not yet exist or is being produced at the time relinquished property is transferred.[7]

1. IRC Sec. 1031(a)(3).
2. Treas. Reg. §1.1031(k)-1(c).
3. Treas. Reg. §1.1031(k)-1(c)(1).
4. Treas. Reg. §1.1031(k)-1(c)(4)(i).
5. Treas. Reg. §1.1031(k)-1(c)(4)(ii).
6. Treas. Reg. §1.1031(k)-1(d)(1).
7. Treas. Reg. §1.1031(k)-1(e).

For taxpayers implementing a deferred exchange, the necessity of protecting the owner of the relinquished property until the transaction is completed often results in the use of an intermediary and some form of guarantee to secure the obligations of the transferee. Two issues that have tended to result in frequent challenges by the IRS to complex deferred like-kind exchanges are: (a) whether an intermediary is an agent of the taxpayer (see discussion in Q 7778 on simultaneous exchanges) and (b) whether the taxpayer who receives cash or other security guaranteeing the transaction has constructively received payment for the transfer, thus having made a sale rather than an exchange.[1] Regulations address these problems by providing four safe harbors designed to help taxpayers engaging in deferred exchanges avoid such challenges. (Of these four, only one, the qualified intermediary safe harbor, is also applicable to simultaneous exchanges; see Q 7778).

(1) *Security or guarantee arrangements*: the transferee's obligation to transfer the replacement property may be secured, without causing the taxpayer to be in actual or constructive receipt of money or other property, by: (a) a mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent); (b) a standby letter of credit (provided the requirements of Treasury Regulation Section 15A.453-1(b)(3)(iii) are met); or (c) a guarantee of a third party.[2]

(2) *Qualified escrow accounts and qualified trusts*: the transferee's obligation to transfer the replacement property may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust. Generally, a qualified escrow account or qualified trust is an account (or trust) in which (a) the escrow holder (or trustee) is not the taxpayer or a *disqualified person* (defined below); and (b) the escrow (or trust) agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account (or by the trustee).[3] The regulations specify how the escrow agreement or trust is to impose such limitations.[4]

(3) *Qualified intermediary*: A qualified intermediary is a person who is not the taxpayer or a disqualified person (defined below), and who enters into a written agreement (the "exchange agreement") with the taxpayer and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers it to the taxpayer.[5] So long as the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the money or other property held by the qualified intermediary, the qualified intermediary will not be considered the agent of the taxpayer.[6] The regulations specify how the agreement is to impose such limitations.[7]

1. See Garcia v. Comm., above; Barker v. Comm., above.
2. Treas. Reg. §1.1031(k)-1(g)(2). See Let. Rul. 9141018.
3. Treas. Reg. §1.1031(k)-1(g)(3).
4. Treas. Reg. §1.1031(k)-1(g)(6).
5. Treas. Reg. §1.1031(k)-1(g)(4)(iii).
6. Treas. Reg. §1.1031(k)-1(g)(4).
7. Treas. Reg. §1.1031(k)-1(g)(6).

The use of a qualified intermediary in an exchange involving two related parties caused the exchange to fail to qualify as a like-kind exchange when, as part of the transaction, one of the related parties received property not of like kind to the replacement property.[1]

(4) *Interest and growth factors*: The fact that the taxpayer is or may be entitled to receive any interest or growth factor with respect to the deferred exchange will not cause him or her to be in constructive receipt of money or other property, so long as the agreement expressly limits the taxpayer's rights to receive the interest or growth factor.[2] The regulations specify how the agreement is to impose such limitations.[3] Generally, a taxpayer will be treated as being entitled to receive interest or a growth factor with respect to a deferred exchange if the amount of money or property the taxpayer is entitled to receive depends upon the length of time between transfer of the relinquished property and receipt of the replacement property.[4]

For purposes of the regulations, "disqualified person" generally means one of the following:

(a) An agent of the taxpayer, including any person who acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two years preceding the transfer of the first of the relinquished properties. (However, the performance of services with respect to the like-kind exchange, or routine financial, title insurance, escrow, or trust services furnished by a financial institution, title insurance company, or escrow company is not taken into account for purposes of this paragraph).[5]

(b) A "related person" as defined in Q 614, but using "10 percent" in each place that "50 percent" appears.[6]

(c) Certain persons who are "related" (based on the definition in paragraph (b)) to a person who would be disqualified as described in paragraph (a). Certain banks and bank affiliates are exempt from this rule.[7]

The safe harbors and other provisions under Treasury Regulation Section 1.1031(k)-1 are effective for transfers of property made by taxpayers on or after June 10, 1991.[8]

Coordination with IRC Section 453

Additional safe harbors provide that, for purposes of the installment sales rules (see Q 586), transactions involving qualified escrow accounts, qualified trusts, and qualified intermediaries generally will not result in the receipt of payments to the transferor of relinquished property. Thus, in the case of qualified escrow accounts and qualified trusts, the determination of whether or not the taxpayer has received a payment for purposes of IRC Section 453 will be made without regard to the fact that the transferee's obligation to transfer property is secured by

1. Rev. Rul. 2002-83, 2002-2 CB 927.
2. Treas. Reg. §1.1031(k)-1(g)(5).
3. Treas. Reg. §1.1031(k)-1(g)(6).
4. Treas. Reg. §1.1031(k)-1(h)(1).
5. Treas. Reg. §1.1031(k)-1(k)(2).
6. Treas. Reg. §1.1031(k)-1(k)(3).
7. Treas. Reg. §1.1031(k)-1(k)(4).
8. Treas. Reg. §1.1031(k)-1(o).

cash or a cash equivalent held in a qualified escrow account or qualified trust. Also, in the case of qualified intermediaries, the determination of whether or not the taxpayer has received a payment for purposes of IRC Section 453 will be made as if the qualified intermediary is not the agent of the taxpayer. Both of these safe harbors apply only so long as the taxpayer has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period and the relinquished property is held for productive use in a trade or business. These safe harbors apply to exchanges occurring after April 19, 1994.

7780. What is a reverse exchange of real estate? When will this type of exchange qualify as a like-kind exchange? What is a qualified exchange accommodation arrangement (QEAA)?

A reverse exchange is where the replacement property is acquired before the relinquished property is transferred. The regulations above do not apply to reverse exchanges. However, the Service will not challenge the qualification of property as either replacement property or relinquished property if the property is held in a qualified exchange accommodation arrangement (QEAA). Property is considered to be held in a QEAA if the following requirements are met:

(1) The property is owned by a person (as the "exchange accommodation titleholder" (EAT)) who is not the taxpayer or a disqualified person, and that person is subject to the federal income tax or has 90 percent of its interests owned by S shareholders or partners who are subject to the federal income tax;

(2) At the time property is transferred to an EAT, the taxpayer has a bona fide intent that the property will be either replacement property or relinquished property;

(3) A written agreement providing that the property will be treated as held in a QEAA is entered into between the taxpayer and the EAT within five days of the transfer of property to the EAT;

(4) No later than 45 days after the transfer of the replacement property to the EAT, the relinquished property is identified;

(5) No later than 180 days after the transfer of property to the EAT either (a) the property is transferred to the taxpayer as replacement property, or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and

(6) The combined time that the relinquished property and replacement property are held in a QEAA does not exceed 180 days. This safe harbor is available for QEAAs entered into after September 14, 2000.

An exchange may still qualify as a like-kind exchange even if it does not meet the requirements of this safe harbor.[1]

1. Rev. Proc. 2000-37, 2000-2 CB 308.

This safe harbor will not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date of transfer to an EAT.[1]

7781. What exclusion is available for gain on the sale of a principal residence?

Generally, an individual who sells or exchanges a principal residence may elect to exclude up to $250,000 of gain from gross income ($500,000 in the case of certain married taxpayers filing jointly).[2] This treatment applies to sales or exchanges occurring after May 6, 1997; for sales occurring prior to May 7, 1997, different rules applied.

General

Residence and principal residence. Whether property is used by the taxpayer as a "residence" and his or her "principal residence" (in the case of a taxpayer using more than one property as a residence) depends upon all the facts and circumstances.[3] A property used by the taxpayer as his or her principal residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation if the dwelling that the taxpayer is entitled to occupy as a stockholder is used by the taxpayer as the principal residence. Property used by the taxpayer as a principal residence does not include personal property that is not a fixture under local law.[4]

If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayers' principal residence include (but are not limited to): (1) the taxpayer's place of employment; (2) the principal place of abode of the taxpayer's family members; (3) the address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card; (4) the taxpayer's mailing address for bills and correspondence; (5) the location of the taxpayer's banks; and (6) the location of religious organizations and recreational clubs with which the taxpayer is affiliated. The above list of factors is not exclusive.[5]

Depreciation taken after May 6, 1997. The exclusion does not apply to the portion of the gain from a sale that does not exceed the portion of the depreciation attributable to the property for periods after May 6, 1997—for example, because a room in the house was used as a home office for business purposes.[6]

1. Rev. Proc. 2004-51, 2004-2 CB 294.
2. IRC Sec. 121(b); Treas. Reg. §1.121-2(a)(1).
3. Treas. Regs. §§1.121-1(b)(1), 1.121-1(b)(2). See, e.g., *Beall v. Comm.*, TC Memo 1998-82, *aff'd in part, rev'd in part*, 229 F.3d 1156 (9th Cir. 2000); *Guinan v. U.S.*, 2003-1 USTC ¶50,475 (D.C. Ariz. 2003).
4. Treas. Reg. §1.121-1(b)(1).
5. Treas. Reg. §1.121-1(b)(2).
6. IRC 121(d)(6); Treas. Reg. §1.121-1(d)(1).

7782. Can gain on the sale of vacant land be excluded from income?

The regulations permit the gain from sales or exchanges of vacant land to be excluded under IRC Section 121 if the following requirements are satisfied: (1) the vacant land must be adjacent to the land containing the taxpayer's principal residence; (2) the taxpayer must have owned and used the vacant land as part of his or her principal residence; (3) the land sale must occur within two years before or after the date of the sale of the residence; and (4) the statutory requirements must have otherwise been met with respect to the vacant land.[1]

The sales or exchanges of the residence and the vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of $250,000 ($500,000 in the case of certain married taxpayers filing jointly) applies to the combined sales or exchanges of vacant land and the residence.[2] For more information on the rules governing sales or exchanges of vacant land, see Treasury Regulations Sections 121.1(b)(3)(ii)(A) (how to apply the maximum limitation amount to sales or exchanges occurring in different taxable years); 1.121-1(b)(3)(ii)(B) (sale or exchange of more than one principal residence in a 2-year period); 1.121-1(b)(3)(ii)(C) (sale or exchange of vacant land before residence).

7783. What ownership and use requirements apply if a taxpayer wishes to take advantage of the exclusion for gain on the sale of a principal residence?

In order to claim the full amount of the exclusion, the taxpayer generally must have owned and used the residence as his or her principal residence for an aggregate of two years during the five years prior to the sale or exchange.[3] Additionally, the full amount of the exclusion cannot be claimed if the taxpayer took the exclusion for a prior sale during the 2-year period ending on the date of the sale or exchange.[4] For an explanation of the term "use of" property, see *Gummer v. U.S.*[5]

The ownership and use requirements for periods aggregating two years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days (365 × 2). The ownership and use requirements do not have to be satisfied simultaneously so long as both tests are satisfied during the 5-year period ending on the date of the sale.[6] To establish that a taxpayer has satisfied the 2-year use requirement, occupancy of the residence is required. However, short temporary absences, such as for vacation or other seasonal absence (although accompanied with rental of the residence), are counted as periods of use.[7] For example, a 1-year sabbatical leave abroad is not considered to be a short temporary absence; on the other hand, a 2-month summer vacation does count as a short temporary absence.[8]

1. Treas. Reg. §1.121-1(b)(3)(i).
2. Treas. Reg. §1.121-1(b)(3)(ii)(A).
3. IRC Sec. 121(a); Treas. Reg. §1.121-1(a).
4. Sales or exchanges prior to May 7, 1997, are not taken into account for the purposes of this 2-year limitation. IRC Sec. 121(b)(3); Treas. Reg. §1.121-2(b).
5. 98-1 USTC ¶50,401 (Fed. Cl. 1998).
6. Treas. Reg. §1.121-1(c)(1)(i).
7. Treas. Reg. §1.121-1(c)(2)(i).
8. Treas. Reg. §1.121-1(c)(4), Ex. 4 and Ex. 5. See, e.g., *Taylor v. Comm.*, TC Sum. Op. 2001-17.

Determination of use during period of out-of-residence care. If a taxpayer has become mentally or physically incapable of self-care, and the taxpayer sells or exchanges property that he or she owned and used as a principal residence for periods aggregating at least one year during the 5-year period preceding the date of the sale, an exception to the use requirement applies. Such a taxpayer will be treated as using the property as the principal residence for any period of time during the 5-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a state or a political subdivision to care for an individual in the taxpayer's condition.[1]

Ownership by trusts. If a residence is held by a trust for a period in which the taxpayer is treated (under the grantor trust rules) as the owner of the trust (or the portion of the trust that includes the residence), the taxpayer will be treated as owning the residence during that period for purposes of satisfying the 2-year ownership requirement of IRC Section 121. Accordingly, the sale or exchange of the residence by the trust will be treated as if made by the taxpayer.[2] The Service privately ruled that the income beneficiary of a trust, which held her mother's residence as its only asset, was not considered the owner of the residence because she lacked the power to vest the trust corpus or income in herself; thus, the gain on the home was not excludable under IRC Section 121.[3]

7784. Can gain from the sale of property that was used only partly as a principal residence be excluded from income?

IRC Section 121 does not apply to the gain allocable to any portion of property that is separate from the "dwelling unit" to which a taxpayer does not satisfy the use requirement. A taxpayer is *not* required to allocate gain if both the residential and business portions of the property are within the *same* dwelling unit. Although the taxpayer must pay tax on the gain equal to the total depreciation taken after May 6, 1997, he or she may exclude any additional gain on the residence up to the maximum amount. However, if the business portion of the property is *separate* from the dwelling unit, the taxpayer is required to allocate the gain, and is able to exclude only the portion of the gain attributable to the residential unit.[4] The term "dwelling unit" has the same meaning as in IRC Section 280A(f)(1), but does not include appurtenant structures or other property.[5] The method for determining the amount of gain allocable to the residential and nonresidential portions of the property is explained in Treasury Regulation Section 1.121-1(e)(3).

7785. What limitations apply to a taxpayer's ability to exclude gain from the sale of a principal residence from income?

Generally, the amount of gain that may be excluded is $250,000. A taxpayer is eligible for only one maximum exclusion per principal residence.[6]

1. IRC Sec. 121(d)(7); Treas. Reg. §1.121-1(c)(2)(ii).
2. Treas. Reg. §1.121-1(c)(3)(i).
3. Let. Rul. 200018021.
4. Treas. Reg. §1.121-1(e)(1).
5. Treas. Reg. §1.121-1(e)(2).
6. IRC Sec. 121(b); Treas. Reg. §1.121-2(a)(1).

Married couples may exclude up to $500,000 if: (1) they file a joint return for the taxable year of the sale; (2) either spouse meets the 2-year ownership requirement (described in Q 7783); (3) both spouses meet the 2-year use requirement (described in Q 7783); and (4) neither spouse is ineligible to use the exclusion as a result of having taken the exclusion in the 2-year period ending on the date of the sale.[1]

For married taxpayers filing jointly, if either spouse does not meet the requirements described in the preceding paragraph, the maximum dollar limitation is the sum of each spouse's limitation amount, determined on a separate basis as if the spouses had not been married. For this purpose, each spouse is treated as owning the property during the entire period that either spouse owned it.[2] In other words, the full or incremental amounts of gain that would have been allowable as an exclusion to the spouses separately, if each had been single and each had owned the property throughout the period in which one spouse owned it, are added together to obtain a maximum exclusion amount.

For unmarried taxpayers who jointly own a principal residence, but file separate returns, each taxpayer may exclude up to $250,000 of gain that is attributable to each taxpayer's interest in the property (if the requirements of IRC Section 121 have otherwise been met).[3]

Special rule for certain sales by surviving spouses. If a sale of property by a surviving spouse occurs not later than two years after the deceased spouse's date of death, and the requirements for meeting the $500,000 exclusion (see above) were met immediately before the date of the spouse's death, the $500,000 limit applies. This provision applies to sales or exchanges occurring after December 31, 2007.[4]

7786. Can the maximum exclusion be reduced for gain on the sale of a principal residence in special circumstances?

If the reason that a taxpayer does not meet the ownership and use requirements (see Q 7783), or the 2-year limitation on use of the exclusion (see Q 7783), is that the sale or exchange resulted from a change in place of employment, health, or unforeseen circumstances, a reduced maximum exclusion may be available. Under such circumstances, the ownership, use, and 2-year limitations will not apply, and the exclusion amount will be computed as described below (see Q 7787).[5]

According to the regulations, in order for a taxpayer to claim a reduced maximum exclusion under IRC Section 121, the sale or exchange must be by reason of a change in place of employment, health, or unforeseen circumstances. If a safe harbor applies (see below), a sale or exchange is *deemed* to have been made for one of those reasons. However, if a safe harbor does not apply, a sale or exchange is deemed to have been made for one of those reasons only if the *primary reason* for the sale or exchange was a change in place of employment, health, or

1. IRC Sec. 121(b)(2)(A); Treas. Reg. §1.121-2(a)(3)(i).
2. IRC Sec. 121(b)(2)(B); Treas. Reg. §1.121-2(a)(3)(ii).
3. Treas. Reg. §1.121-2(a)(2).
4. IRC Sec. 121(b)(4), as added by MFDRA 2007.
5. IRC Sec. 121(c)(2).

unforeseen circumstances. Whether the requirements are satisfied depends upon all the facts and circumstances.[1]

Factors that may be relevant in determining the taxpayer's primary reason for the sale or exchange include (but are not limited to) the extent to which: (1) the sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time; (2) the suitability of the property as the taxpayer's principal residence materially changes; (3) the taxpayer's financial ability to maintain the property is materially impaired; (4) the taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property; (5) the circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and (6) the circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.[2]

Change in place of employment. According to the regulations, a sale or exchange is due to a change in place of employment if, in the case of a "qualified individual" (i.e., the taxpayer, the taxpayer's spouse, a co-owner of the house, or a member of the taxpayer's household), the primary reason for the sale or exchange is a change in the location of the individual's employment.[3] Under the *distance safe harbor*, a sale or exchange is deemed to be by reason of a change in place of employment if: (1) the change occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence; *and* (2) the qualified individual's new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment (or, if there was no former place of employment, the distance between the qualified individual's new place of employment and the residence sold or exchanged is at least 50 miles).[4]

Health reasons. A sale or exchange is by reason of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a "qualified individual" (described above), or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale by reason of health.[5] Under the *physician's recommendation safe harbor*, a sale or exchange is deemed to be by reason of health if a physician recommends a change of residence for reasons of health.[6]

Unforeseen circumstances. A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not have reasonably anticipated before purchasing and occupying the residence. A sale or exchange by reason of unforeseen circumstances does not qualify for the reduced maximum exclusion

1. Treas. Reg. §1.121-3(b).
2. Treas. Reg. §1.121-3(b).
3. Treas. Regs. §§1.121-3(c)(1), 1.121-3(f).
4. Treas. Reg. §1.121-3(c)(2).
5. Treas. Reg. §1.121-3(d)(1).
6. Treas. Reg. §1.121-3(d)(2).

if the primary reason for the sale or exchange is a preference for a different residence or an improvement in financial circumstances.[1]

Under the *specific event safe harbor*, a sale or exchange is deemed to be by reason of unforeseen circumstances if any of the events listed below occur during the period of ownership and use of the residence as the taxpayer's principal residence: (1) the involuntary conversion of the residence; (2) natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence (without regard to deductibility under IRC Section 165(h)); or, (3) in the case of a "qualified individual" described above (a) death, (b) the cessation of employment as a result of which the individual is eligible for unemployment compensation, (c) a change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household, (d) divorce or legal separation under a decree of divorce or separate maintenance, or (e) multiple births resulting from the same pregnancy.[2]

In addition, the Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability, or in a ruling directed to a specific taxpayer.[3] See e.g., Let. Rul. 200725018 (remarriage resulting in new blended family consisting of seven children from prior marriages); Let Rul. 200702032 (airport noise); CCA 200630015 (military exception); Let. Ruls. 200630004 (carjacking at taxpayer's residence), 200626024 (special needs of mother-in-law), 200615011 (undercover narcotics investigator's identity revealed, family was threatened), 200613009 (newly adopted child), 200601023 (grandchild, recently divorced daughter needing a place to live), 200601022 (birth of additional child), 200601009 (assault of family member at taxpayer's residence), 200504012, and 200403049.

7787. If the maximum exclusion for gain on the sale of a principal residence is reduced because of a change in the taxpayer's place of employment, health, or unforeseen circumstances, how is the reduced maximum exclusion calculated?

The reduced maximum exclusion is computed by multiplying the maximum dollar limitation of $250,000 ($500,000 for certain joint filers) by a fraction.

The numerator of the fraction is the shortest of: (1) the period that the taxpayer owned the property during the 5-year period ending on the date of the sale or exchange; (2) the period that the taxpayer used the property as a principal residence during the 5-year period ending on the date of the sale or exchange; or (3) the period between the date of a prior sale of property for which the taxpayer excluded gain under IRC Section 121 and the date of the current sale or exchange. The numerator of the fraction may be expressed in days or months.

The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).[4] Thus, for example, a single taxpayer who would otherwise be

1. Treas. Reg. §1.121-3(e)(1).
2. Treas. Reg. §1.121-3(e)(2).
3. Treas. Reg. §1.121-3(e)(3).
4. Treas. Reg. §1.121-3(g)(1); see also IRC Sec. 121(c)(1).

permitted to exclude $250,000 of gain, but who has owned and used the principal residence for only one year and is selling it due to a job transfer, the fraction would be ½ and the maximum excludable amount would be $125,000 [½ × $250,000].[1]

7788. What special rules apply in calculating the exclusion for gain on the sale of a principal residence?

Property of deceased spouse. For purposes of the exclusion, in the case of a surviving spouse, the period in which the deceased spouse owned and used the property as a principal residence will be attributed to the surviving spouse.[2] The regulations state this rule applies if (1) the taxpayer's spouse is deceased on the date of the sale of the property; and (2) the taxpayer has not remarried at the time of the sale of the property.[3] The Service privately ruled that if a surviving spouse who holds a "5 or 5 power" (see Q 679) in a trust sells the personal residence, the gain on the residence will be taxable to the trust as the owner of the corpus, and not the surviving spouse, except to the extent the surviving spouse is treated as the owner of a portion of the property pursuant to a "5 or 5 power."[4]

Property owned by former spouse. If property is transferred to the taxpayer by a former spouse pursuant to a divorce decree, the period in which the individual taxpayer owns the property includes the period that the former spouse owned the property. If property is used by a former spouse pursuant to a divorce decree, but is still owned by the taxpayer, the taxpayer is treated, solely for the purposes of this exclusion, as using the property as a principal residence during the use by the former spouse.[5]

Tenant-stockholder in cooperative housing corporation. If a taxpayer is a tenant stockholder in a cooperative housing corporation, the ownership requirement is applied to the holding of the stock, and the use requirement is applied to the house or apartment that the taxpayer is entitled to occupy as a stockholder.[6] The Service has determined that tenant-stockholders were allowed to exclude $500,000 of gain from the disposition of their shares of stock in their cooperative apartment, which was coordinated with a donation of the same shares to a charitable organization.[7]

Involuntary conversions. For purposes of this exclusion, the destruction, theft, seizure, requisition, or condemnation of property is treated as a sale or exchange. For purposes of applying IRC Section 1033 (involuntary conversions), the amount realized from the sale or exchange of the taxpayer's principal residence is equal to the amount of gain (determined without regard to this exclusion), reduced by the exclusion. If the basis of the property acquired as a result of an involuntary conversion is determined, in whole or in part, under the involuntary conversion rules, the holding period and use by the taxpayer of the converted property will be treated as

1. See, e.g., Treas. Reg. §1.121-3(c), Ex. 1; General Explanation of Tax Legislation Enacted in 1998 (the 1998 Blue Book), p. 166.
2. IRC Sec. 121(d)(2).
3. Treas. Reg. §1.121-4(a)(1).
4. Let. Rul. 200104005.
5. IRC Sec. 121(d)(3); Treas. Regs. §§1.121-4(b)(1), 1.121-4(b)(2). See, e.g., IRS INFO 2005-055, at www.irs.gov/pub/irs-wd/05-0055.pdf.
6. IRC Sec. 121(d)(4); Treas. Reg. §1.121-4(c).
7. FSA 200149007.

the holding and use by the taxpayer of the property sold or exchanged.[1] The Service has determined that for purposes of IRC Section 121(d)(5), the question of whether the "destruction" of a taxpayer's principal residence has occurred is a question of fact.[2]

Following several national disasters, such as Hurricane Katrina, Congress extended from two to five years the replacement period in which a taxpayer could replace property that was located in the disaster area and that was compulsorily or involuntarily converted. The extended replacement period applied only if substantially all of the use of the replacement property was in the disaster area.[3]

Sales of remainder interests. The exclusion applies to gain recognized on the sale or exchange of a remainder interest in a principal residence, provided that the sale or exchange is not to certain related persons; however, the exclusion does not apply to any other interest in such a residence that is sold or exchanged separately.[4] For the explanation of how to make the election to apply the exclusion to gain from the sale or exchange of a remainder interest, see Treasury Regulation Section 1.121-4(e)(2)(iii). For the rules governing sales or exchanges of partial interests other than remainder interests, see Treasury Regulation Section 1.121-4(e)(1).

Election to have exclusion not apply. A taxpayer may make an election *not* to have this section apply; if so, the gain from the sale or exchange of a principal residence would not be excluded.[5]

Treatment of exclusion in bankruptcy cases. According to the regulations and earlier case law (both of which appear to ignore IRC Section 121(f)), the bankruptcy estate of an individual in a Chapter 7 or Chapter 11 bankruptcy case succeeds to and takes into account the individual's IRC Section 121 exclusion with respect to the property transferred into the estate if the individual satisfies the requirements of IRC Section 121.[6]

Military Tax Relief

A taxpayer on "qualified official extended duty" in the U.S. Armed Services or the Foreign Service may suspend, for up to 10 years of such duty time, the running of the 5-year ownership-and-use period before the sale of a residence. Qualified official extended duty means any "extended duty" (1) while serving at a duty station that is at least 50 miles from the residence, or (2) while residing under government orders in government housing. "Extended duty" means a period of more than 90 days, or for an indefinite period. This election applies to only one property at a time; furthermore, the taxpayer may exclude gain on only one home sale in any 2-year period. An election may be revoked at any time.[7]

1. IRC Sec. 121(d)(5); see Treas. Reg. §1.121-4(d).
2. IRS CCA 200734021.
3. See, e.g., KETRA 2005 Sec. 405; Heartland, Habitat, Harvest and Horticulture Act of 2008 (extending replacement period to five years for victims of Kansas tornadoes in May 2007)
4. IRC Sec. 121(d)(8); Treas. Regs. §§1.121-4(e)(2)(ii)(A), 1.121-4(e)(2)(ii)(B).
5. IRC Sec. 121(f); Treas. Reg. §1.121-4(g).
6. Treas. Reg. §1.1398-3.
7. IRC Sec. 121(d)(9).

Mortgage Forgiveness Debt Relief Act of 2007

Under MFDRA 2007, certain discharges of indebtedness on a principal residence have been excludable from gross income (see Q 580), but the date of expiration of this special provision is in doubt.[1]

7789. How is the exclusion for gain on the sale of a principal residence coordinated with the like-kind exchange rules?

If a taxpayer acquires property in a like-kind exchange under which gain is not recognized (in whole or in part) to the taxpayer under IRC Sections 1031(a) or 1031(b), the exclusion of gain under IRC Section 121(a) does *not* apply to the sale or exchange of such property by the taxpayer (or by any person whose basis in the property is determined, in whole or in part, by reference to the basis in the hands of the taxpayer) during the 5-year period beginning with the date of the acquisition.[2]

The Service and the Treasury Department have released guidance on how to handle a like-kind exchange of a home taking into account IRC Section 121 (home sale gain exclusion) and IRC Section 1031 (like-kind gain deferral).[3] The revenue procedure clarifies that a homeowner who may exclude gain upon a sale or exchange of a home may also benefit from a deferral of gain for a like-kind exchange with respect to the same property.

IRC Section 1031 provides that in the case of business or investment property (with some exceptions), a property owner generally would not recognize gain upon the exchange of the property for replacement property of a like kind.[4] The property owner would recognize any gain to the extent received in cash or property that is *not* of a like kind ("boot")[5] (see Q 7775 and Q 7776). Property used solely as a home would not constitute business or investment property for these purposes, and an exchange of such property would therefore be ineligible for nonrecognition under IRC Section 1031.

The revenue procedure indicates that a homeowner may benefit from both the home sale exclusion *and* the like-kind deferral in cases where the property has been used consecutively or concurrently as a home and a business (e.g., rental residence). The basic rules for applying these statutory provisions are as follows:

(1) When computing gain, IRC Section 121 must be applied to the realized gain *before* applying IRC Section 1031.

(2) Although IRC Section 121 does not apply to gain attributable to depreciation deductions that have been claimed with respect to the business or investment portion of a residence, IRC Section 1031 may apply to such gain.

1. See IRC Sec. 108(a)(1)(E) (applying to "qualified principal residence indebtedness" discharged before January 1, 2014). Congress may retroactively extend this provision.
2. IRC Sec. 121(d)(10).
3. Rev. Proc. 2005-14, 2005-1 CB 528.
4. IRC Sec. 1031(a).
5. IRC Sec. 1031(b).

(3) When "boot" (i.e., cash or other property not of a like kind) is received in exchange for relinquished business property, the boot is taken into account only to the extent that it exceeds the gain excluded under IRC Section 121 with respect to the relinquished business property.

(4) When computing the basis of the replacement business property, any gain excluded under IRC Section 121 is treated as gain recognized by the taxpayer. Thus, the basis of the replacement business property is increased by any gain attributable to the relinquished business property excluded under IRC Section 121. Several examples are provided in the revenue procedure.[1]

1. Rev. Proc. 2005-14, 2005-1 CB 528.