Real Estate Issues
Chapter 5 pp. 185 - 235
2019 National Income Tax Workbook™
Real Estate Issues

- Issue 1: Residential Real Estate Issues
- Issue 2: Vacation Home/Short-term rentals
- Issue 3: Tangible Property Regulations
- Issue 4: Passive Activity Loss Limits
- Issue 6: Home Office Deductions
- Issue 7: Opportunity Zones
- Issue 8: Sale of Real Estate
Issue 1: Residential Real Estate Rentals

- **Treated as Rent:**

  1. Lease option < Fair Rental Rate
  2. Option fees
Sale vs. Lease factors:
1. Option fee + Rent pymts > FMV
2. Rent > Market rate, Option < Market rate
3. Option & Rent credited to purchase price
4. Tenant must make capital improvements
5. Tenant guaranteed title
6. Contract stipulates portion as interest
Expenses:

1. If deemed sale, no depreciation/ownership costs during “lease”
2. If tenant pays owners expenses, payments are rental income
3. Ordinary expenses = utilities, cleaning, insurance, mortgage interest, repairs, taxes & depreciation.
Basis:

1. Cost must be divided between land & building

2. If cost includes personal property, will accelerate depreciation
### Recovery Periods:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Recovery Period (Years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>n/a</td>
</tr>
<tr>
<td>Commercial building</td>
<td>39</td>
</tr>
<tr>
<td>Residential rental building</td>
<td>27.5</td>
</tr>
<tr>
<td>Appliances, carpeting, furniture</td>
<td>5</td>
</tr>
<tr>
<td>Fences, roads, and shrubbery</td>
<td>15</td>
</tr>
</tbody>
</table>
Issue 1: Residential Real Estate Rentals

Depreciation Methods:

- 27.5 year & 39 year = straight line
- 5 year prop:
  - Straight-line
  - 150% DB
  - 200% DB
- 15 year prop:
  - Straight -line
  - 150% DB
Issue 1: Residential Real Estate Rentals

Where to report:

- Schedule E
- Schedule C
  - Substantial Services:
    - Daily housekeeping
    - Meals
- SE Tax?
Issue 2: Vacation Home / Short Term Rentals

- Used for personal purposes for more than the greater of:

1. 14 days; or

2. 10% of the total days it is rented to others at a fair rental price
Personal Use Days:

1. Taxpayer
2. Family Member
3. House Swap Arrangement
4. No Fair Rental Value
Three Tiers of Deductions:

1. **Allowable itemized deductions**
   (property tax, mortgage interest, etc.)

2. **Operating Costs**
   (insurance, repairs, utilities)

3. **Deductions that reduce basis**
   (depreciation)
IRS position –

- all deductions \(x\) (# of days of rental at fair value / total days the property is used)

_Bolton v. Commissioner_ –

- mortgage interest & property tax expenses \(x\) (# of rental days / # of days in the tax year)
- other deductions \(x\) (# of days of rental at fair value / total days the property is used)
FIGURE 5.3 Denise Davidson’s Rental Expense Deduction (Publication 527)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental income for 70 days</td>
<td>$10,000</td>
</tr>
<tr>
<td>Tier 1: Interest and taxes</td>
<td>$6,160</td>
</tr>
<tr>
<td>$[(3,000 + 5,800) \times 70%]</td>
<td></td>
</tr>
<tr>
<td>Tier 2: Other expenses ($2,400 \times 70%)</td>
<td>1,680</td>
</tr>
<tr>
<td>Tier 3: Depreciation ($6,400 \times 70% = 4,480 but limited)</td>
<td>2,160</td>
</tr>
<tr>
<td>Total expenses—limited to rental income</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Rental property income</td>
<td>$0</td>
</tr>
</tbody>
</table>

FIGURE 5.2 Denise Davidson’s 2019 Rental Income and Expenses

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental income</td>
<td>$10,000</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>$3,000</td>
</tr>
<tr>
<td>Property taxes</td>
<td>$5,800</td>
</tr>
<tr>
<td>Repairs</td>
<td>$2,400</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$6,400</td>
</tr>
</tbody>
</table>
### FIGURE 5.3 Denise Davidson’s Rental Expense Deduction (Publication 527)

<table>
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<tr>
<td>[ (($3,000 + $5,800) \times 70% ) ]</td>
<td></td>
</tr>
<tr>
<td>Tier 2: Other expenses</td>
<td>1,680</td>
</tr>
<tr>
<td>( \times 70% )</td>
<td></td>
</tr>
<tr>
<td>Tier 3: Depreciation</td>
<td>2,160</td>
</tr>
<tr>
<td>( \times 70% = $4,480 \text{ but limited} )</td>
<td></td>
</tr>
<tr>
<td>Total expenses—limited to rental income</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Rental property income</td>
<td>$0</td>
</tr>
</tbody>
</table>

### FIGURE 5.4 Denise Davidson’s Rental Expense Deduction (Bolton Rule)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental income for 70 days</td>
<td>$10,000</td>
</tr>
<tr>
<td>Tier 1: Interest and taxes</td>
<td>$1,688</td>
</tr>
<tr>
<td>( 	imes 19.18% )</td>
<td></td>
</tr>
<tr>
<td>Tier 2: Other expenses</td>
<td>1,680</td>
</tr>
<tr>
<td>( \times 70% )</td>
<td></td>
</tr>
<tr>
<td>Tier 3: Depreciation</td>
<td>4,480</td>
</tr>
<tr>
<td>( \times 70% )</td>
<td></td>
</tr>
<tr>
<td>Total expenses—limited to rental income</td>
<td>(7,848)</td>
</tr>
<tr>
<td>Rental property income</td>
<td>$2,152</td>
</tr>
</tbody>
</table>
Other considerations –

- **Schedule A deduction for state & local taxes**
  (Includes RE taxes)

- **Carryover Depreciation**
  - Must be calculated even if not deductible
  - Deduct omitted depreciation when sold
Issue 3: Tangible Property Regulations pp. 196 - 197

- Allows TP to expense:
  1. Per item limit up to $2,500 (no AFS)
  2. Per item limit up to $5,000 (with AFS)

- In either case – not treated as a material or supply

- Items deducted as a business expense
Economic Useful Life:

- EUL may not be its inherent useful life
- The period during which the property may reasonably be expected to be useful in the taxpayer’s trade or business
- It may last longer but not be effective to be used any longer
Issue 3: Tangible Property Regulations

Applicable Financial Statements (AFS) defined:

- Statement required to be filed with the SEC
- Certified audited financial statements
- Other financial statement (not a tax return)
Routine Maintenance Safe Harbor:

- Expenses are deductible if required for ongoing maintenance

- Routine maintenance includes:
  a) inspections
  b) cleaning
  c) testing
  d) replacing worn parts
Issue 3: Tangible Property Regulations

- Nature of the recurring activity
- Industry practice
- Manufactures’ recommendations
- Taxpayer experience
Safe Harbor for Small Taxpayers:

- Small qualifying taxpayers (including renters):
  - Those with 3-year average receipts ≤ $10M.

- Can elect (annually) to deduct building repairs & maintenance if the cost is lesser of:
  - $10,000 or 2% of property’s unadjusted basis for an eligible building property which is:
    - Owned or leased by small qualifying TP.
    - Has unadjusted basis ≤ 1M.
Issue 3: Tangible Property Regulations

- Cost
- Plus any capitalized improvements
- That's it!
- No depreciation
- No bonus depreciation
- No IRC 179 deduction
Issue 3: Tangible Property Regulations

Three Categories of Improvements:
- Betterment
- Restoration
- Adaptation

All require Capitalization

Includes direct and indirect costs
Routine maintenance election provided for buildings where the particular activity is expected to perform more than once in a 10 year period.

Taxpayer’s treatment on the AFS is not considered or applicable.

Exceptions are:
1. Amounts paid for a betterment to a unit of property.
2. Amounts paid to adapt a unit of property to a new or different use.
### Building Systems:

1. HVAC systems
2. Plumbing systems
3. Electrical systems
4. All escalators
5. All elevators
6. Fire protection & alarm systems
7. Security systems
8. Gas distribution systems
Betterment:

1. Alter a material condition or defect that existed at the time of acquisition.
2. Is a material addition to the unit of property
3. Is a material increase in the unit of property’s capacity
4. Is reasonable expected to materially increase the productivity, efficiency, quality, etc.
Issue 3: Tangible Property
Regulations pp. 202 - 203

Restoration:

1. Replacing a component that has been sold or abandoned, & appropriate gain/loss is recognized. Includes replacement after casualty loss where basis adjustment was required.

2. Property was in a state of disrepair, & cost was incurred to bring property back to working order.

3. Results in rebuilding property to like-new condition at the end of its class life.

4. Replacement of major component or substantial structural part
Issue 3: Tangible Property Regulations

Adaption:

- New or Different Use
- Not just machinery
- Could be land and/or a building
No deduction for losses incurred in a rental or passive business activity unless:

- TP has income from the same activity or from other activities subject to the passive loss rules,

  or

- TP disposes of his or her entire interest in the activity in a fully taxable disposition to an unrelated person or entity.
Issue 4: Passive Activity
Loss Limits

Exceptions:

- $25,000 Special Allowance
- Real Estate Professional
- Disposition of an Interest
$25,000 Special Allowance requirements:

- The taxpayer is a natural person or a qualifying estate.
- The taxpayer actively participates in the rental real estate activity.
- The taxpayer’s income does not exceed the specified limit.
Issue 4: Passive Activity
Loss Limits

Real Estate Professional:

- TP performs > 1/2 of the personal services in all trades or businesses during the tax year in real property trades or businesses in which the taxpayer materially participates.

- TP performs > 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates.
Disposition:

- Dispose of entire interest
- Must be Taxable transaction to unrelated party
- Not Subject to PAL rules
7 tests for material participation:

1. More than 500 Hours
2. Sole Participant
3. >100 hrs, not less than anyone else
4. Significant Participation, Combined Activities
5. Material Participation for 5 out of 10 Years
6. Personal Service Activity
7. Facts & Circumstances
Issue 4: Passive Activity
Loss Limits pp. 208 - 209

Facts & Circumstances Rules
1. Must participate for > 100 hours
2. Mgmt activities of TP not counted if:
   a. anyone except TP compensated for mgmt services; or
   b. anyone provides more hours of mgmt services than TP
3. Satisfying a material participation test under another section of the Code does not matter
Issue 6: Home Office Deduction

Function Tests:

1. Portion of dwelling is principal place of business.

2. TP portion of dwelling to meet/deal with patients, clients, or customers.

3. TP uses separate structure (not attached to the dwelling unit)
Employee’s Home office:

- Convenience of employer
- Only applies to statutory employees to deduct on Sch C. (Misc itemized deduction subject to 2%-of-AGI floor suspended)
Actual Expenses

- Cannot create or increase loss
- Excess expenses carry over
- Four tiers for deductibility
  1. Expenses not related to home
  2. Mortgage interest, property taxes (Remember 10K limit)
  3. Household operating expenses
  4. Deductions that affect basis
Safe Harbor Method


- $5 by qualified business square footage limited to 300 square feet

- Max deduction = $1,500 ($5 x 300 sq ft)
Home office Expenses - other issues

- Partial Years
- Shared home
- More than 1 business or home
Issue 7: Opportunity Zones

pp. 219 - 220

- Qualified Opportunity Fund
- Qualified Opportunity Zone Stock
- Qualified Opportunity Zone P/S Interest
- Qualified Opportunity Zone Business Property
Tax Deferral:

- Can elect to defer gain on sale or exchange of property to unrelated party, if reinvested in a Qualified Opportunity Fund within 180 days

- Basis = cost reduced by deferred capital gain
  - Held for 5 yrs, increase by 10%
  - Held for 7 yrs, increase by additional 5%

- Defer until earlier of sale or 12/31/2026
### 2019 Long-Term Capital Gains Rates

<table>
<thead>
<tr>
<th>Capital Gains Rate</th>
<th>Taxable Income Range</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Married Filing Jointly</td>
</tr>
<tr>
<td>0%</td>
<td>$0–$78,750</td>
</tr>
<tr>
<td>15%</td>
<td>$78,751–$488,850</td>
</tr>
<tr>
<td>20%</td>
<td>Over $488,850</td>
</tr>
<tr>
<td></td>
<td>Single</td>
</tr>
<tr>
<td></td>
<td>$0–$39,375</td>
</tr>
<tr>
<td></td>
<td>$39,376–$434,550</td>
</tr>
<tr>
<td></td>
<td>Over $434,550</td>
</tr>
<tr>
<td></td>
<td>Head of Household</td>
</tr>
<tr>
<td></td>
<td>$0–$52,750</td>
</tr>
<tr>
<td></td>
<td>$52,751–$461,700</td>
</tr>
<tr>
<td></td>
<td>Over $461,700</td>
</tr>
</tbody>
</table>
Issue 8: Sale of Real Estate

Gain/Loss = Amt realized – adjusted basis

Loss allowed to extent of gain plus the lower of:
1. $3,000 ($1,500 in the case of a married individual filing a separate return); or
2. the excess of capital losses over capital gains.
Section 1250 Property

- Includes residential rental property, commercial buildings, and general purpose barns
- Gain due to depreciation in excess of straight line is ordinary income (§ 1231 gain)
- Gain due to having claimed straight-line depreciation is called unrecaptured § 1250 gain (capital gain)
Issue 8: Sale of Real Estate

Exclusion of Gain on Principle Residence

- If qualified, can exclude up to $250,000 ($500,000 if MFJ)

- Three Tests:
  - Must have owned home for 2 of 5 yrs
  - Use home as principle residence for 2 of 5 yrs
  - Must be 2 yrs since last exclusion
Sale of Residence with Home Office

- Office in Dwelling
  - May qualify for §121 exclusion
  - Cannot claim exclusion for depreciation

- Office in Separate Building
  - Treat as 2 transactions
Thank You