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Chapter 10B

Tax Aspects of Real Estate and Real Estate Sales*

SCOPE

This chapter covers the fundamentals of the purchase, ownership and disposition of real estate and the federal, state and local tax issues they raise. It also provides an overview of the tax aspects of real estate transactions. This material deals with two types of taxes: federal income taxes and real estate taxes. §§ 10B.01-05 deal with income taxation. § 10B.01 explores federal income tax rules of general applicability, including capitalization regulations. § 10B.02 analyzes the federal tax treatment of environmental cleanup costs, particularly in light of the expiration of I.R.C. § 198. § 10B.03 focuses on the sale of a personal residence, including current developments related to the exclusion of gain on the sale of a principal residence. § 10B.04 considers installment sales, while § 10B.05 provides an overview of the principal limitations on tax shelters. § 10B.06 deals with property taxation. Changes resulting from the Protecting Americans From Tax Hikes Act of 2015 and other recent legislative developments are incorporated, including the permanent extension of certain expiring provisions.

Since state income taxation more often than not follows the concepts and principles of federal income taxation, this chapter will examine federal income tax law. The property tax materials in this chapter draw on statutes, regulations and judicial and administrative rulings from a variety of states. For the most part, property taxes are imposed at the county and municipal level. There is no federal property tax and little property taxation at the state level.[1]

RELATED MATERIAL IN THIS TREATISE

- For a pragmatic analysis of the federal tax consequences of real estate see P1.01–.15.
- For a discussion concerning governmental security interests see Ch. 39.
- For a discussion of section 1031 like-kind exchange, see Ch. 83A *below*.

References are to chapters, paragraphs or sections, and appendices; sections found in the Practice Guides

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[*] This chapter was revised by Patricia Hughes Mills, J.D., LL.M., Professor of Clinical Accounting and Academic Director of the Jennifer and James R. Parks Master of Business Taxation program at the University of Southern California's Marshall School of Business (Leventhal School of Accounting). This chapter was originally written by David F. Shores, Professor of Law, Wake Forest University School of Law, Winston-Salem, North Carolina.

[1] While it is not unusual for states to tax certain types of property (*see, e.g.*, Fla. Stat. Ann. §§ 199.023, 199.032, imposing a state level tax on intangible property), taxes on real estate are mainly imposed by local governmental units.

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are designated by the letter P (e.g., P1.04[2]).

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Appendix 10B-2 General Depreciation System—Nonresidential Real Estate

§ 10B.00 *Special Alert*: Impact on Real Estate of Tax Cut and Jobs Act *Enacted December 2017*[1]

Passed by Congress on Dec. 20, 2017 and signed by the President on Dec. 22, 2017, what is commonly referred to as the **Tax Cuts and Jobs Act**[2] ("**the 2017 Act**") has adopted several significant changes that will impact the taxation of real estate and its investors. Most of these provisions took effect at the beginning of 2018.

Like Kind Exchanges:

One change, while not directly impacting real estate, involves tax-deferred like-kind exchanges under Internal Revenue Code Section 1031. Prior to being amended, tax-deferred exchanges were allowed, within certain parameters, for any type of real property or personal property, including intangibles such as intellectual property. The properties exchanged simply had to be of "like kind," although certain types of assets, such as stock, partnership interests, or inventory, were not eligible for like-kind exchanges. For tangible personal property, the exchanged assets had to be within the same general asset class or within the same product class. In fact, the IRS provided safe harbors for programs exchanging multiple items of tangible personal property, such as leased vehicles.[3]

The Tax Cuts and Jobs Act has now limited the use of Code Section 1031 to only exchanges of real property (provided it is not held primarily for sale).[4] Thus, non-real estate assets — that is, personal property assets such as vehicles — are no longer eligible for tax-deferred exchanges. However, due to increased expensing amounts allowed under Code Section 179 and the expansion of bonus depreciation, a taxable sale of these items followed by a replacement purchase of similar items that can be substantially expensed may not negatively impact taxpayers in this situation.

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[1] This Special Alert was written by Patricia Hughes Mills, J.D., LL.M., Professor of Clinical Accounting and Academic Director of the Jennifer and James R. Parks Master of Business Taxation program at the University of Southern California's Marshall School of Business (Leventhal School of Accounting). Professor Mills is the author of previous tax updates in this treatise, including previous updates in Chapter 10B. Updates from this special alert will be incorporated into § 10B.01 through § 10B.06 where applicable below in a forthcoming update of the chapter. This Special Alert is adapted from an alert by the same name written for Real Estate Financing—Text, Forms, Tax Analysis (LexisNexis).

[2] P.L. 115-97.

[3] *See, e.g.*, Rev. Proc. 2003-39.

[4] IRC § 1031(a).

Of course, this change implies increased scrutiny over the definition of real property. While the Committee Report indicates that improved real estate and unimproved real estate will continue to be considered of like kind, state law may become a factor in determining whether an asset is "real property." While state law generally determines the classification of property rights as real or personal, the state law classification is not necessarily the sole determination of the definition of real property for purposes of Code Section 1031.[5]

This change applies to exchanges completed after Dec. 31, 2017. However, if the taxpayer is in the middle of a deferred exchange, a transition rule will allow the successful completion of the deferred exchange after Dec. 31, 2017.[6] Thus, as long as the first step in either a forward or reverse deferred exchange occurred before January 1, 2018, an exchange of personal property should still be respected, provided all the other requirements of Code Section 1031 are met.

Deductions for Home Mortgage Interest and Real Property Taxes:

Prior to the Tax Cuts and Jobs Act, a taxpayer could deduct a personal interest expense for "qualified residence interest," which was interest on up to $1,000,000 of debt used to acquire a principal residence and a second home ("acquisition indebtedness"[7]), as well as home equity debt of up to $100,000.[8] For tax years beginning after December 31, 2017, the ability to deduct interest on personal residences has been further limited. The new provision eliminates entirely the prior provision which allowed a deduction for interest on home equity loans regardless of the use of the proceeds.[9] With respect to acquisition indebtedness, the new law reduces the maximum amount which can qualify as acquisition indebtedness down to $750,000.[10] However, for acquisition indebtedness incurred before December 15, 2017, the $1,000,000 limit still applies.[11]

It should be noted that, although the deduction for all interest on home equity loans up to $100,000 has been eliminated, a home equity loan may still qualify as acquisition indebtedness. In IR 2018-32, the IRS issued guidance clarifying that a home equity

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[5] *See, e.g.* Pvt. Ltr. Rul. 201706009.

[6] P.L. 115-97, Act. Sec. 13303.

[7] Acquisition indebtedness is defined as indebtedness which is incurred in acquiring, constructing or substantially improving any qualified residence of the taxpayer, and which is secured by such residence. The term also includes refinanced debt but only to the extent that the amount of the refinanced debt does not exceed the original debt amount. IRC § 163(h)(3)(B).

[8] IRC § 163(h)(3).

[9] IRC § 163(h)(3)(F)(i)(I). This is the case regardless of when the debt was incurred (*i.e.*, there is no grandfathering of pre-2017 Act home equity loan interest).

[10] IRC § 163(h)(3)(F)(i)(II).

[11] Refinancing of pre-2018 debt will still be considered as incurred on the date of the original debt, meaning the higher limitations apply. In addition, the Conference agreement provides that a taxpayer who has entered into a binding written contract before December 15, 2017 to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, shall be considered to have incurred acquisition indebtedness prior to December 15, 2017 under this provision.

loan may qualify as "acquisition indebtedness" if the proceeds of the home equity loan are used to buy, build, or substantially improve the taxpayer's home that secures the loan. For example, interest on a home equity loan where the proceeds are used to build an addition to the taxpayer's home will be deductible, provided the total debt limits are not exceeded, whereas if the proceeds are used for personal expenses, the interest will not be deductible.

Taxpayers are cautioned, however, to ensure that the home equity loan secures the asset being purchased or improved in order for it to qualify as acquisition indebtedness. IR 2018-32 gives the example of a taxpayer who took out a $500,000 mortgage to purchase a main home (secured by that home), and then took out a $250,000 mortgage to purchase a vacation home. If the second loan is secured by the vacation home, then the interest on both residences qualifies as acquisition indebtedness since the total loans do not exceed $750,000. However, if the taxpayer had used a $250,000 home equity loan that was secured by the main home to purchase the vacation home, then the interest on the home equity loan would not be deductible (i.e., it would fail the requirement for "acquisition indebtedness" that the loan be secured by the residence being acquired or improved with those loan proceeds).

Although the original House bill also threatened to limit the home mortgage interest deduction to only the taxpayer's principal residence, thus eliminating any interest deduction for second homes, that change was dropped in the final bill.

Another personal deduction that taxpayers may find is limited is the ability to deduct local real property taxes.[12] Up through 2017, taxpayers were allowed an itemized deduction for state and local taxes, which included not only income taxes but also real and personal property taxes. However, under the 2017 Act, this total deduction will be limited to $10,000.[13] Thus, many taxpayers will find that the combination of their state income tax and their local real property tax likely exceeds $10,000, thereby losing the ability to deduct a portion of those taxes.[14]

Furthermore, prepayment in 2017 of a future year's tax will not result in a deduction in 2017. IRC Section 164(b)(6) provides that an amount paid before January 1, 2018 that is for a state or local income tax imposed for a taxable year beginning after 2017 is treated as paid in the year for which the tax is imposed. In fact, with respect to prepayment of real property taxes, the IRS issued Information Release IR 2017-210, which clarified that a prepayment of real property taxes is deductible in the year of prepayment only if the property tax is assessed in the year of prepayment. Thus, if payments normally due in 2018 are for property taxes assessed in 2017, a payment in

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[12] IRC § 164(a).

[13] IRC § 164(b)(6), as amended by Act § 11042.

[14] This limitation will not apply, however, to state and local taxes paid in carrying on a trade or business or in an activity described in IRC § 212 (a profit-making activity). Thus, state and local taxes that are deductible in computing income on a Schedule C business or a rental activity will still be allowed.

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2017 will be fully deductible. On the other hand, a taxpayer subject to AMT in 2017 will not get the benefit of such prepayment since state and local taxes are added back in computing alternative minimum tax.[15]

In addition, the doubling of the standard deduction,[16] the elimination of most casualty loss deductions,[17] and the elimination of miscellaneous itemized deductions may result in fewer taxpayers itemizing deductions,[18] and thus taking advantage of even the $10,000 state and local tax deduction.

As with many of the 2017 Act provisions, these changes to the home mortgage interest deduction and the state and local tax deduction is set to expire on January 1, 2026, when the provisions are scheduled to revert back to their pre-Act terms.

Depreciation and Expensing:

The Tax Cuts and Jobs Act has made several changes to the depreciation and expensing rules, some of which will affect real estate. Under pre-Tax Cuts and Jobs Act law, three types of building improvements qualified for a 15-year recovery period — qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property —rather than the longer lives typically required of real estate.[19] The new law eliminates the separate definitions of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, and allows a straight-line 15-year recovery period for one category called "qualified improvement property." The provision is effective for property placed in service after December 31, 2017.

Qualified improvement property is defined as any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date the building was first placed in service, but it does not include any improvement attributable to (1) the enlargement of the building, (2) any elevator or escalator, or (3) the internal structural framework of the building.[20] Thus, this change substantially expands the type of property eligible for this shortened depreciation period because it is not restricted to certain types of businesses as under prior law (*i.e.*, restaurant or retail property) nor to whether the property is leased or owned.

In addition, the 2017 Act changes the definition of "qualified real property" eligible for expensing under Code Section 179.[21] Formerly, Section 179 expensing was

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[15] IRC § 56(b)(1).

[16] IRC § 63(c)(7). The 2018 standard deduction is $24,000 for joint filers ($12,000 for single filers).

[17] IRC § 165(h)(5).

[18] IRC § 67(g).

[19] The current MACRS recovery periods of 39 years and 27.5 years for nonresidential and residential rental property, respectively, remain in effect.

[20] IRC § 168(e)(6) as amended by Act § 13204.

[21] IRC § 179 allows for the deduction in full of certain asset purchases, rather than capitalizing and depreciating such assets over time, subject to certain limitations. Subject to certain phase-outs, that amount was increased by the 2017 Act from $500,000 to $1,000,000. See IRC § 179(b)(1).

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allowed for the qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, as described above. Now, the new expanded definition of "qualified improvement property" is eligible for Section 179 expensing. In addition, under prior law, roofs, built-in HVAC systems, built-in fire protection and alarm systems, and built-in security systems were often considered building components and not eligible for Section 179 expensing. However, the Tax Cuts and Jobs Act now allows these types of structural components to be expensed if they are improvements to non-residential real property that are placed in service after the date that the property itself was placed in service.[22]

Limitation of Deduction of Business Interest:

The 2017 Act includes a new limitation on the deduction of business interest.[23] Specifically, a deduction for business interest will be disallowed to the extent it exceeds the sum of (1) the taxpayer's business interest income for the year, (2) 30% of the taxpayer's adjusted taxable income for the year, and (3) the taxpayer's floor plan financing interest for the year.[24]Any interest deduction disallowed under this provision can be carried forward indefinitely and treated as business interest paid in the succeeding tax year.

However, this provision does not apply to an "electing real property trade or business."[25] The definition of an electing real property trade or business is pulled from the passive loss limitations of Code Section 469, which includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.[26] The IRS has yet to publish the time and manner for making this election, but the Code does indicate that once made, the election is irrevocable.[27]

Casualty and Disaster Losses:

The Tax Cuts and Jobs Act has made a number of changes to casualty and disaster losses. Firstly, personal casualty losses are no longer deductible unless they are attributable to a federally declared disaster.[28] Thus, the loss of an individual's personal use property, such as a personal residence, through fire, for example, would no longer give rise to a deduction unless the loss was part of a federally declared disaster. Like many of the 2017 Act provisions, this change takes effect for tax years beginning after December 31, 2017 and before January 1, 2026.

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[22] 21 IRC § 170(f).

[23] For this purpose, business interest is defined as any interest paid or accrued on indebtedness properly allocable to a trade or business, but does not include investment interest. IRC § 163(j)(5). The new provision contains an exception for certain small businesses. *See* IRC § 163(j)(3).

[24] IRC § 163(j)(1).

[25] IRC § 163(j)(7)(A)(ii). The election out is also available for an electing farming business. *See* IRC § 163(j)(7)(A)(iii) and (C).

[26] 469(c)(7)(C).

[27] IRC § 163(j)(7)(B).

[28] IRC § 165(h)(5).

For casualty losses that are attributable to a federally declared disaster,[29] a deduction is allowed to the extent that it exceeds 10% of the taxpayer's adjusted gross income.[30] However, the 2017 Act also provides relief for disasters that occurred in 2016 and 2017 by eliminating the 10% of AGI limit, thus allowing for a greater deduction for taxpayers affected by federally declared disasters in those years. In addition, those losses can be claimed on top of the standard deduction, benefitting those taxpayers who do not otherwise need to itemize their deductions.[31]

Excess Business Losses:

The Tax Cuts and Jobs Act removed a former limitation on deducting excess farm losses, and added a disallowance for "excess business losses" for non-corporate taxpayers.[32] Essentially the excess farm loss limitation has been expanded to taxpayers engaged in any business. An excess business loss is defined as the excess, if any, of (1) the taxpayer's aggregate deductions for the tax year from the taxpayer's trades or businesses, over (2) the sum of (a) the taxpayer's aggregate gross income or gain for the tax year from such trades or businesses, plus (b) $250,000 (or $500,000 for a joint return).[33] Any loss disallowed under this provision is treated as part of the taxpayer's net operating loss that can be carried forward to later years.[34]

This limitation operates similarly to the passive loss limitations, but now applies to active business income also. Thus, this provision limits the ability of non-corporate taxpayers to use trade or business losses against other sources of income, such as wages, interest, dividends, and capital gains. In addition, these rules apply at the partner or shareholder level for flow-through business income and deductions.[35]

As with many of the Tax Cuts and Jobs Act provisions, this rule applies for tax years beginning after December 31, 2017, and before January 1, 2026.

§ 10B.01 Federal Income Tax Considerations of General Applicability

[1] Introduction

Most federal income tax issues relating to real estate concern gain or loss realized on sale, or deductions for expenses incurred in connection with real estate. Special issues can arise with respect to certain types of transactions (such as like-kind

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[29] This is defined as a disaster determined by the President to warrant federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. *See* IRC § 165(i)(5).

[30] IRC § 165(h)(2).

[31] P.L. 115-97, § 11028,

[32] IRC § 461(l). This provision will apply to taxpayers operating as sole proprietors or non-corporate owners of partnerships, LLCs, or S corporations.

[33] IRC § 461(l)(3). These amounts will be adjusted for inflation after 2018.

[34] Note that for losses arising in tax years beginning after December 31, 2017, an NOL may generally only reduce 80 percent of taxable income (IRC § 172(a)) and may generally only be carried forward (IRC § 172(b)).

[35] IRC § 461(l)(4).

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exchanges and installment sales)[1] or certain types of property (such as a personal residence). However, this section deals only with rules of general applicability.

[2] Some Basic Concepts: Gain, Loss and Capital Recovery

Gain or loss on sale is determined under Section 1001 of the Internal Revenue Code of 1986 (unless otherwise indicated, all statutory references in this section are to the Internal Revenue Code of 1986, as amended, hereafter referred to as the "Code"). The main idea of Section 1001 is that income should be taxed only once. Thus, if taxpayer T earns $1,000 as salary taxed at 20%, and uses after-tax earnings of $800 to purchase Blackacre, T should not be taxed again if Blackacre is subsequently sold for $800. If Blackacre is sold for $1,000, a gain of $200 should be reported, and if the selling price is $600 a loss of $200 should be realized. Whether the loss can be recognized (*i.e.,* claimed as a deduction against income) depends upon whether Blackacre was purchased for personal reasons (for example, a lot on which T planned to construct a personal residence), or to earn a profit.[2]

As will be seen, many income tax issues are affected by whether the taxpayer holds the property for personal or profit reasons. The important point for present purposes is that a taxpayer who sells property never has a taxable gain unless the amount received exceeds his or her investment in the property, called "basis" in the Code.[3] The starting point in determining basis is cost. In our simple example, the taxpayer's basis in Blackacre is $800, and a sale for $1,000 will produce an $800 tax-free recovery (or return) of capital (or basis) and a $200 gain.

A sale is not the only way in which a taxpayer's investment in property might be

(Text continued on page 10B-7)

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[1] *See* § 10B.02 regarding environmental cleanup costs; § 10B.03 regarding the sale of a personal residence; § 10B.04 regarding installment sales; and § 10B.05 regarding limitations on tax shelters. Chapter 79G *below* deals with condemnations and other involuntary conversions, and Chapter 83A *below* deals with like-kind exchanges. For comprehensive coverage *see* Glynn, Federal Taxes Affecting Real Estate (Matthew Bender).

[2] *See* I.R.C. § 165.

[3] I.R.C. § 1012.