Tax Benefits of Ownership

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Chapter 1

The mortgage interest deduction (MID), a subsidy

Learning Objectives

After reading this chapter, you will be able to:

- advise homebuyers on the mortgage interest deduction (MID), the subsidy available to them when they use purchase-assist and equity financing to buy a first or second home;
- explain the distinction between itemized personal deductions and the standard personal deduction; and
- identify requirements for a homebuyer to qualify for use of the MID.

Key Terms

itemized deduction

mortgage interest deduction (MID)

qualified interest

Two residences, alternative deductions

A long-standing policy of the federal government is to encourage **residential tenants** to favor mortgaged homeownership, not renting, for their monthly expenditures on shelter. To shape this bias, the government uses the tax code to deliver an annual subsidy to buyers who **finance the purchase** of their principal residence or a vacation home. The social policy is propagandized through the news media using the slogan "The American Dream."

The homebuyer receives this mortgage subsidy in the form of an annual reduction in their income taxes allowed by the **mortgage interest deduction (MID) rules**. Tenants have no equivalent personal subsidy for the cost of their shelter.

mortgage interest deduction (MID)
An itemized personal deduction permitted for interest accrued and paid on mortgages secured by a homeowner's principal and second residence.

The MID creates an incentive to permanently own a residence, bound to it by title and a 30-year mortgage debt. One downside is the mortgaged homeowner and family have reduced job mobility and impaired financial flexibility.

itemized deduction
Deductions taken by a homeowner for allowable personal expenditures such as mortgage interest (MID) and state income and local property taxes (SALT) as itemized on Schedule A which reduce their taxable income and tax liability. Contrast with the standard personal deduction.

Homeowners process the MID as an **itemized personal deduction** subtracted from their **adjusted gross income (AGI).** The result is a reduced amount of taxable income, and in turn reduced tax liability.

When a mortgaged homeowner prepares their tax return, they have two alternatives for reporting personal deductions:

- *itemize* and total all their deductible expenditures — charitable gifts, medical expenditures, state income taxes, property taxes and home mortgage interest; or
- take the *standard deduction* (a fixed amount set at $12,000 for individuals, $18,000 for heads of household and $24,000 for married individuals filing jointly).[1]

When the amount of permissible itemized expenditures exceeds the amount of the standard deduction, it is beneficial for the homeowner to itemize their deductions.

The real estate-related itemized deductions a homeowner takes — reported on Schedule A — fall into two categories:

- the MID, a deduction of interest accrued and paid, limited to interest on up to $750,000 of combined mortgage principal;[2] and
- homeowner property taxes combined with state income tax, together limited to a total of $10,000.[3]

As a subsidy, the MID incentivizes individuals to own and finance the purchase or improvement of their principal residence and second home rather than renting. No mortgage financing, no interest deduction. Implicitly, mortgage payments are the economic equivalent of rent paid as tenants. However, tenants have no tax incentive to rent.

For a residential tenant considering a plan to minimize their future income taxes, the monthly payment on a purchase-assist mortgage as implicit rent goes beyond that of a mere substitute for renting. When itemized, mortgage interest paid reduces their taxable income – the reduction being the subsidy for homeownership.

The amount of reduction in taxes due to mortgage homeownership depends on the homeowner's tax bracket, which ranges from 10% to 37%. The tax bracket rate sets the subsidy amount received as the taxes avoided at the homeowner's tax rate on income equal to the mortgage interest paid on principal up to $750,000.

With the MID, interest accrued and paid on a home mortgage is deductible from income when the mortgage:

- funded the purchase price or the cost of improvements for the owner's principal residence or second home; and
- is secured by either the owner's principal residence or second home.[4]

1 Internal Revenue Code §63(c)(7)(A)]
2 IRC §163(h)(3)(F)
3 IRC §164(b)(6)
4 Internal Revenue Code §163(h)(3)(B)

The MID reduces the property owner's taxable income under both the **standard income tax (SIT)** and the **alternative minimum tax (AMT)** rules for setting the owner's income tax liability. The *AMT* is a supplemental income tax analysis targeting high-income earners who have a high ratio of SIT deductions.

Purchase/ improvement mortgages

Interest paid on lender and carryback sales mortgages which fund the **purchase or substantial improvement** of an owner's first or second home is deductible on combined mortgage principal up to $750,000 for an individual and couples filing a joint return. The mortgage balances are limited to $375,000 for married persons filing separately.

Thus, when principal collectively exceeds $750,000 for mortgage funds used to acquire, construct, or further improve a principal residence or second home, only the interest paid on the first $750,000 is deductible.

New improvements paid for with mortgage funds need to be substantial for interest on the mortgage to qualify for the MID. To qualify for MID, improvements must:

- add to the property's market value;
- prolong the property's useful life; or
- adapt the property for residential use.

Mortgage funds used to repair property and maintain its good condition do not qualify for funding of substantial improvements.[5]

Refinancing limitations

Homeowners often **refinance** an existing purchase-assist/improvement mortgage, especially during recessionary periods with lowered mortgage rates. Here, interest on the principal portion of the refinancing used to fund payoff of a MID mortgage qualifies for MID treatment. Conversely, interest paid on principal generated by refinancing which exceeded the payoff amount for the existing purchase-assist/improvement mortgage(s) does not qualify for the MID.

For example, a homeowner takes out a $500,000 mortgage to fund the purchase of their principal residence. The mortgage principal balance is now paid down to $400,000. The owner needs cash funds and refinances the residence, paying off the original purchase/improvement mortgage. As intended, the proceeds from the refinancing exceed the amount of the payoff demand on the MID mortgage.

In this scenario, interest on only $400,000 of the refinancing qualifies for MID reporting, unless the excess funds generated by the refinance funded substantial improvements to the residence.

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5 T204783

For interest on purchase-assist or improvement mortgage funds to be itemized as MID, the mortgages must be secured by the homeowner's **principal residence** or **second home**.

Qualifying the principal residence and second home

A *principal residence* is an individual's home when:

- the homeowner resides in it a majority of the year;
- the home is located close to the homeowner's place of employment and banks which handle the homeowner's accounts; and
- the home's address is used for tax returns.[6]

A *second home* is any residence selected by the owner. The selection may be changed from year to year and includes mobile homes, recreational vehicles and boats or real estate.

Second homes are often **rented out** during the year. When rented, the mortgage interest paid qualifies to be itemized as a MID when during the year the owner occupies the property for the greater of:

- more than 14 days; or
- at least 10% of the number of days the residence is rented.[7]

When the owner **does not rent** out their second home during the year, the property qualifies for the MID whether the owner occupies it or not.[8]

Any rental income the owner receives from a tenant occupant of the second home is reported as **investment/portfolio income** when the owner qualifies for the MID by occupying the property in excess of the 14-day/10% rule.

The owner may not treat a second home they have rented to tenants as a passive income category rental property when the owner's family occupies the property for more than the threshold 14 days or 10% of the days rented during the year. With the family use exceeding the threshold, the second home is reported as a portfolio income category asset and the home mortgage interest qualifies for the MID treatment.

Conversely, the owner may not report the property as a passive income category investment to write off interest on principal in excess of $750,000. Further, they may not take depreciation deductions on the second home much less deduct the cost of repair and maintenance. A property which qualifies as a second home is not a passive income category asset though it is a portfolio category investment.[9]

However, a second home, when purchased for personal use while held for a profit on resale, qualifies as investment (like-kind) property for exemption from profit taxes under IRC §1031.[10]

6 IRS Publication 523
7 IRC §280a(d)(1)
8 IRC §163(h)(4)(A)(iii)
9 IRC §§163(h)(4)(A)(i)(II); 280a(d)(1)
10 IRC §1031; IRS Private Letter Ruling 8103117

Taking the deductions

The MID is only allowed for interest which accrued and was paid during the tax year, called **qualified interest**.[11]

Procedurally, an owner deducts interest on first and second home mortgages from their adjusted gross income (AGI) as an itemized deduction to set their taxable income and thus their tax liability. In contrast, interest paid on business, passive/rental or portfolio investment mortgages reduces the owner's AGI as interest offsets income from assets and services within each income category before setting the AGI.

When a homeowner takes the standard deduction, the MID is not involved as it is taken only as an itemized deduction.[12]

The home as additional security

Consider a homeowner who mortgages the equity in their home to fund the down payment on the purchase of an income-producing property. They execute a note as evidence of a money debt owed a lender or carry-back seller who extends credit in lieu of a larger cash down payment.

The homeowner wants to avoid the MID limitation on mortgages secured by the principal residence or second home. They want to be able to write off all the interest paid on the note against future income from the property they purchased by executing the note.

qualified interest
Mortgage interest accrued and paid on up to $750,000 of mortgage principal used to fund the acquisition or improvement of the homeowner's principal residence or second home. The interest is itemized on Schedule A as an itemized personal deduction which reduces the homeowner's taxable income and tax liability.

To do this, the homeowner negotiates with the lender or carry-back seller to secure the note by **two separate trust deeds**: one as a lien on the home and the other as a lien on the property purchased. This is not a blanket trust deed covering two parcels, but two trust deeds each for a different properties for the same debt.

The lender or carry-back seller is satisfied with the financial risk regarding the loss of principal. They view the home secured by the trust deed as the primary source of recovery should the owner default on the note.

In addition to the owner's home, the note is secured by a second trust deed on the property purchased. The buyer needs justification for writing off the entire interest accrued and paid on the mortgage against income from the property purchased with the loan or carryback mortgage. Here, the home equity is used as **additional security** under a separate trust deed from the one secured by the investment property purchased to avoid the MID taint.

Only one debt for which there is one note, but two trust deeds each referencing the same debt owed. However, arranging a blanket trust deed describing both properties risks imposition of MID limitations which the owner wants to avoid.

Economic effects of the MID

While purportedly created to encourage low- to-middle-income households to become owners and benefit financially, the MID is mostly limited to disproportionately increasing the wealth of high-income homeowners.

11 IRC §163(h)(3)(A)
12 IRC §63; IRC §163(h)(3)(F)

Form 223

Supplemental Truth-In-Lending Section 32 Disclosure

SUPPLEMENTAL TRUTH-IN-LENDING SECTION 32 DISCLOSURE

Additional Disclosures for Reg Z Section 32

NOTE: This form is used by a mortgage loan originator (MLO) when processing an application for a consumer mortgage secured by the borrower's principle residence and the interest rate or points and fees exceed Regulation Z Section 32 threshold amounts, to provide a Reg Z Section 32 notice disclosing the total loan amount and Applicable Percentage Rate (APR) to the borrower.

DATE: ______________, 20______, at ____, California.

1. Prepared by ____

1.1 Address ____

1.2 Phone ______________________________ Email ______________________

Items left blank or unchecked are not applicable.

FACTS:

2. Lender identification ____

3. Borrower identification ____

4. Loan Broker identification ____

5. Account or application number ____

6. NOTICE TO BORROWER:

You are not required to complete this agreement merely because you have received these disclosures or have signed a loan application. If you obtain this loan, the lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan.

7. AMOUNT BORROWED:

The principal amount borrowed on the personal-use loan is $____________________.

7.1 The amount borrowed is the amount of the loan under the loan application.

8. ANNUAL PERCENTAGE RATE:

The annual percentage rate of the charges on the loan is __________%.

9. PAYMENTS:

Your regular monthly ___________________ payment will be $___________________.

10. FINAL/BALLOON PAYMENT:

Your final/balloon payment, if any, will be $______________________.

10.1 This payment is due more than five years after the loan is originated.

Borrower acknowledges receipt of a copy of this disclosure statement.

Date: _______________, 20______

Borrower's Signature: ____

Borrower's Signature: ____

FORM 223 03-11 ©2017 **RPI — Realty Publications**, Inc., P.O. BOX 5707, RIVERSIDE, CA 92517

High-income earners — who are more likely to own a home and have a greater sum of personal deductions — itemize their deductions instead of claiming the **standard deduction**.

Additionally, the size of the subsidy is directly proportional to the amount of the mortgage, and thus the associated property value. The wealthier the homeowner the greater the price they pay for a home and the larger the mortgage, and in turn the bigger the tax savings.

However, consider the ultimate beneficiaries of the MID as lobbyists for its continuance to include **homebuilders, sellers, brokers and lenders**. Without the income tax reduction for itemizing interest as the MID, the typical homebuyer overextends themselves to pay the price a seller asks for a property. Thus, without the MID refund, buyers are going to pay less for the same property as sellers are confronted with buyers who have no subsidy.

The MID operates to directly inflate home prices. Buyers taking out purchase-assist mortgages have more disposable income to spend on the same property due to the MID reduction in their income taxes. Essentially, buyers are reimbursed for overpayment to sellers by reduced income taxes through the MID.

However, most homebuyers have insufficient financial posture to be able to benefit by itemizing their deductions. Thus, most mortgaged homeowners of low-to-mid-tier priced housing no longer receive the subsidy, or as much subsidy, depending on the level of their wealth.

Worse for availability of the subsidy, the 2018 increase in the *standard deduction* greatly increased the likelihood most current or prospective homeowners will take the standard deduction, as opposed to itemizing their deductions. This shift decreases the availability of MID to benefit low- and middle-income households, a condition which tends to lower the price they can pay. This factor, while working to depress home prices, is offset by any trend in lower mortgage interest rates that increases the buyer's ability to borrow more mortgage money based on the same income.

Chapter 1 Summary

To encourage homeownership, the federal government offers an annual subsidy to homeowners called the mortgage interest deduction (MID).

When a mortgaged homeowner prepares their tax return, they can either itemize their deductions The MID is an itemized personal deduction taken for interest accrued and paid on mortgages secured by a homeowner's principal and second residence.

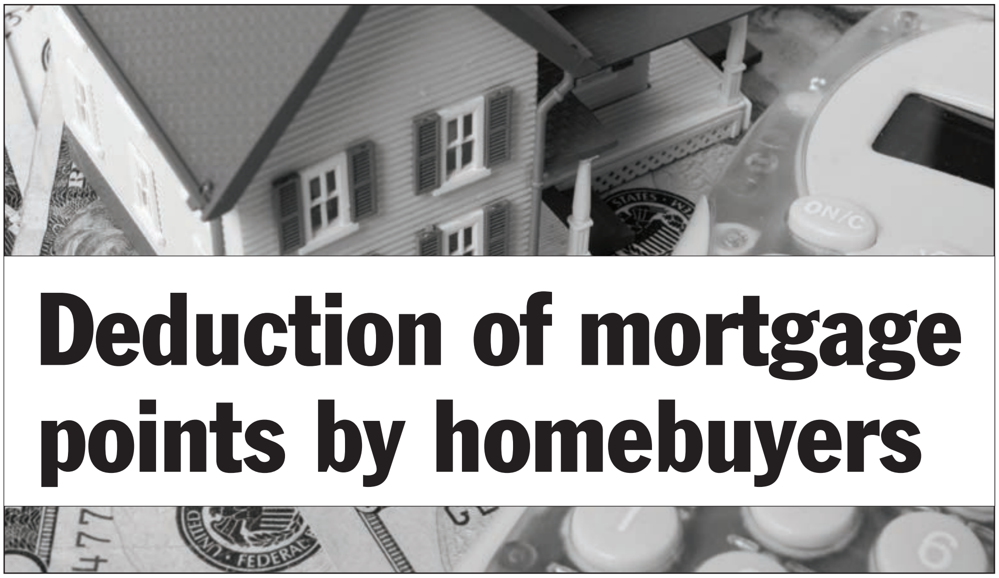
Itemized Deductions are deductions taken by a homeowner for allowable personal expenditures such as mortgage interest and state and local property taxes (SALT) as itemized on Schedule A which reduces their taxable income and tax liability.

Homeowners process the MID as an itemized personal deduction subtracted from their adjusted gross income (AGI). The result is a reduced amount of taxable income, and in turn reduced tax liability.

When the amount of permissible itemized expenditures exceeds the amount of the standard deduction, it is beneficial for the homeowner to itemize their deductions. When a homeowner takes the standard deduction, the MID is not involved as it is taken only as an itemized deduction. The MID operates to directly inflate home prices.

Chapter 1 Key Terms

Chapter 2



Deduction of mortgage points by homebuyers

Learning Objectives

After reading this chapter, you will be able to:

- analyze the income tax deductions a homebuyer or homeowner may take for the mortgage points and origination fees incurred on a purchase-assist, improvement or refinance mortgage.

Key Terms

adjusted gross income (AGI)
alternative minimum tax (AMT)
deduction
life-of-loan accrual
mortgage origination fee
net operating income (NOI)
nominal interest rate
operating expenses
par rate
personal-use mortgage
portfolio property
prepaid interest
principal residence

Prepaid interest exception allows write-off

Interest paid on mortgage principal **accrues daily** over the life of a mortgage. In contrast, payment of a mortgage holder's penalty charge accrues in its entirety as a lump sum amount, a bonus extracted by a lender due to the occurrence or failure of an event such as a prepayment or late payment penalty charge.

Mortgage interest accrued and paid by a property owner to be written off against income must qualify as either an **expense** or **deduction**, an accounting process which reduces the owner's taxable income. Tax reporting is structured with three sets of income category, each category with rules to determine whether interest payments on a mortgaged property qualify as an expense or deduction to reduce the owner's taxable income:

1. trade or business category income;

2. passive category income; and
3. portfolio category income

For example, consider a mortgage which funds the purchase or improvement of a property used to house the owner's **trade or business** activities. The business owner's payment of **accrued interest** on the mortgage principal is classified as an **operating expense** of the owner's trade or business. As an operating expense, the interest qualifies to be directly written off against the income of the business to determine the **net operating income (NOI)** of the business the owner operates.

net operating income (NOI)
The net revenue generated by an income producing rental property before accounting for mortgage PI payments or the depreciation allowance. NOI is calculated as the sum of a rental property's total operating income less the property's operating expenses. [See **RPI** Form 352 §4]

Now consider a mortgage originated to fund the purchase, improvement or carrying costs of a rental property – residential or commercial. The owner manages the property as the landlord or through a property manager. Tenants occupy the property under gross lease or rental agreements. As the Income property investment requires management it is classified as rental property and reported as a **passive income category** asset.

The payment of accrued interest on the property mortgage is written off as a *deduction* from the rental property's NOI – as is the depreciation allowance - to calculate the reportable income or loss from property operations and ownership. [See **RPI** Form 352]

deduction
An expenditure or allowance offsetting net operating income (NOI) or subtracted from adjusted gross income, both lowering the amount of taxable income.

The mortgage debt on a rental property is not incurred for the owner to occupy and operate a business on the property as occurs in their trade or business. With a rental, the property produces income and **operating expenses**, not the efforts of the owner. Thus, it is classified as a *passive income category asset.*

operating expenses
The total annual costs incurred to maintain and operate a property for one year. [See **RPI** Form 352 §3.21]

Further, consider the third type of property, one held primarily for long-term profit, such as a parcel subject to a ground lease, management-free net leased income property and unimproved land. This type of management-free investment property is classified and reported as a **portfolio income category** asset.

Accrued interest paid on a mortgage debt originated to fund the purchase, improvement or carrying costs of a **portfolio property** is written off as a *deduction a*gainst income and profit from all investments within the portfolio income category. Unlike passive income property, portfolio income category rules do not limit the interest (or depreciation) deduction to only the income from rental properties, a passive income reporting process called *tracking.*

portfolio property
Property held for investment that is management free, such as stocks, bonds, savings, notes, land not used in a trade or business, and rental properties under net leases.

The reportable income or loss for each of the income categories includes amounts of mortgage interest accrued and paid, whether classified as an expense item or an allowable deduction within each category. Importantly, the accounting within each of the three different income categories (business, passive and portfolio) are separately maintained before used to establish the owner's **adjusted gross income (AGI)**. As separately reported, the reportable income or loss within one category is not directly commingled with income or loss from any other category, until calculating the property owner's adjusted gross income.

adjusted gross income (AGI)
Gross income remaining from the three income categories after taking expenses and deductions.

The homeowner's mortgage interest is a personal deduction

A homeowner's payment of accrued interest on a home mortgage is not classified as within any of the income categories for business, passive or portfolio purposes. A mortgage that funds the purchase or improvement of an owner's **principal residence** or second home is classified as a **personal-use mortgage**.

Remember, interest paid on a personal-use mortgage is not tax deductible, with one major exception: a homeowner's **mortgage interest deduction (MID)**. Again, the MID exception is an itemized personal deduction for interest paid on mortgages made in *connection* with the purchase or improvement of a principal or second residence. [See Chapter 1]

Itemized personal deductions allow interest accrued and paid on the first and second home mortgages to be written off against the owner's *AGI* when calculating a homeowner's taxable income. The home mortgage interest is processed as a Schedule A itemized deduction and subtracted from the homeowner's AGI. These deductions directly reduce the owner's taxable income, but not their AGI.

Recall that governments **subsidize mortgaged homeownership** through the MID is equal in value to only the amount of reduction in annual income taxes the homeowner pays. The amount of tax savings ranges from 10% and 12% of the interest itemized by low-income homeowners, to 37% for high-income homeowners.

Thus, the wealthier a person is, with limitations, the greater the subsidy for mortgaged homeownership. Homeowners whose AGIs exceed $500,000 have limitations imposed on their itemized deductions due to **alternative minimum tax (AMT)** restrictions on allowable deductions.[1]

The housing policy, implemented by use of the MID, also benefits governments as homeowners typically require less government assistance in their elder years than renters. In theory, homeowners become more responsible local citizens as ownership restricts job mobility compared to renters and installs a pride-of-ownership tenants other than the very wealth do not have.

personal-use mortgage
A mortgage which funds a personal use such as the purchase or improvement of an owner's principal residence or second home, or the payoff of personal debt such as costs of education and healthcare or credit cards.

alternative minimum tax (AMT)
A supplemental income tax paid by taxpayers in higher income tax brackets.

nominal interest rate
The interest rate agreed to between a homebuyer and a lender as stated on a promissory note, also called the note rate. To be contrasted with par rate of interest.

Points of interest to homebuyers originating a mortgage

Points paid to a lender to originate a mortgage, sometimes called *discount points*, "buy down" the mortgage's **par rate** for the life of the mortgage to an interest rate negotiated and stated as the nominal rate in the note. "Points" is a distracting misnomer, as the charge is actually **prepaid interest**. A mortgage with no points means a higher **nominal interest rate** is stated in the note, the par rate or higher *premium rate*.

As *prepaid interest*, the property owner annually deducts a percentage of the points paid as they *accrue* during each month over the life of the mortgage, called the **life-of-loan accrual**, with one exception — the mortgaged housing subsidy. When the mortgage principal is prepaid, any remaining unaccrued prepaid interest — points — is deducted in the year of the payoff.

life-of-loan accrual
The monthly accrual of mortgage origination fee over the life of a mortgage.

1 IRC §55(d)(4)(A)(ii)

principal residence
The residential property where the homeowner resides a majority of the year.

The exception to the *life-of-loan accrual* reporting applies to mortgages used to fund the purchase or improvement of an individual's **principal residence**, but not a second home.[2]

The entire amount of the points paid on origination of a principal residence mortgage is, like the MID, reported as a **personal itemized deduction** in the year paid. The immediate deduction of all points paid in connection with a mortgage originated to finance the purchase or improvement of the taxpayer's primary home is a further government subsidy. The national housing policy, implemented by the tax code, is intended to encourage mortgaged homeownership in lieu of all-cash purchases or renting.

As a further refinement, the deductibility of the mortgage points in the year paid depends on who paid the points — the buyer, the seller or the mortgage holder.

prepaid interest
Interest paid which has not yet accrued.

par rate
The lender's base interest rate without any positive or negative adjustments producing a variation set as the nominal interest rate in a promissory note.

For example, a homebuyer applies for a mortgage to fund the purchase of a property they will occupy as their principal residence. The home will be the security for repayment of the mortgage. The mortgage holder is paid points — **prepaid interest** — for making a purchase-assist mortgage at an interest rate below the **par rate**. The mortgage holder will not withhold the points from the mortgage proceeds — a discount — or add them to the principal balance of the mortgage.

Instead, the points are paid by either the homebuyer from their separate funds, or by the seller from their net proceeds of sale as a condition in the purchase agreement negotiated by the buyer's agent.

In these buyer or seller payment situations, the homebuyer may write off the points paid to the mortgage holder as a **current itemized deduction** from their AGI. The deduction lowers their taxable income - the subsidy – reported for the year of acquisition, since:

1. the mortgage proceeds are used to purchase or improve the buyer's principal residence;
2. the mortgage is secured by the principal residence, with or without additional security;
3. the **Closing Disclosure** statement lists the points paid in non-economic terms such as "points," "mortgage origination fees," "mortgage discount" or "discount points," when computed in amount as a percentage of the mortgage;
4. the points were paid by the seller or from the buyer's separate funds, not by the lender as a discount or add-on to the mortgage principal;
5. the payment of points is an established business practice of mortgage holders in the area; and
6. the points paid do not exceed the amount generally charged for points in the surrounding area.[3]

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2 IRC §461(g)(2)

3 Internal Revenue Service Publication 936

When a mortgage funds the purchase or improvement and is secured solely by property other than the buyer's principal residence, such as business or investment property, the points are deducted pro rata over the life of the mortgage.

Mortgage points for business or investment properties

Likewise, points paid to finance the purchase or improvement of a second home are deducted annually as they accrue over the life of the mortgage. For example, points are paid on a purchase-assist mortgage for a vacation home, payable monthly with a 30-year amortization. Here, the points are deducted at the rate of 1/360th for each month annually as the prepaid interest — points — accrues.

Now consider the homeowner who takes out a home improvement mortgage secured by their principal residence. The homeowner pays the mortgage lender 2.5 points from their separate funds. One of the points is called a **mortgage origination fee** and is an amount paralleling the fee charged by other mortgage lender.

mortgage origination fee
A fee paid to a mortgage holder for originating a mortgage at a below-par interest rate, taxwise considered prepaid interest.

The owner also pays mortgage charges itemized by the mortgage holder to include administrative fees, processing fees, appraisal fees and title expenses. These charges are separate from the *mortgage origination* points. Itemized mortgage origination charges are service fees paid the mortgage holder to originate the mortgage, not points paid to buy down the note interest rate from the market's par rate to produce lower monthly mortgage payments.

May the homeowner also deduct these itemized mortgage service fees in the year they are paid?

No! Itemized mortgage fees reimburse the mortgage holder for costs incurred to originate the mortgage. Mortgage origination costs reimbursed by the borrower are not prepaid interest. Accordingly, they are not deductible either at the time paid or over the life of the mortgage.[4]

However, the mortgage service fees paid by the buyer when originating a purchase-assist or improvement mortgage on any type of real estate are *capitalized*, not expensed or deducted as are points. As capitalized, mortgage service fees are added to, and become part of, the buyer's cost basis in the property. Mortgage service fees are non-recurring costs incurred to acquire or improve property through mortgage funding, not daily recurring interest which is expensed or deducted when paid and accrued.[5]

Capitalized costs for originating a mortgage on property, other than the first and second home, are partially recovered as (tax-free) capital through the annual depreciation deduction. The capitalized amount allocated to land or otherwise not recovered through depreciation deductions is recovered as a return of invested capital when reporting the sale of the property.

Seller-paid points

Consider a homebuyer who lacks sufficient funds or the willingness pay the points required to originate a mortgage. During the buyer's negotiations

4 IRC §163; Rev. Proc. 94-27
5 **Lovejoy** v. **Commissioner of Internal Revenue Service** (1930) 18 BTA 1179

conducted by their broker and as a provision in their written offer submitted to purchase the property, the seller agrees to pay the points as requested by the buyer.

Here, the homebuyer may deduct the points the seller pay on the buyer's purchase-assist financing. However the purchase agreement or escrow instructions are worded, the seller does not actually pay the mortgage lender. Instead, the seller reimburses the buyer, indirectly. Procedurally, the homebuyer receives **cash back** from the seller when the seller agrees to pay the points. Here, the buyer receives a cash credit through escrow from funds accruing to the seller on closing so the buyer has funds in their escrow account to pay the points. Thus, the payment of points is treated as though the cash came from the buyer's separate funds.[6]

Further, in a *cash back* situation the buyer has actually paid less for the property in the amount of the cash back. To account for the cash back on the price paid, the buyer's cost basis in the residence is reduced by the dollar amount of the cash back, as shown on the escrow closing statement. Conversely, the seller who paid the points expenses the amount as part of their transactional costs of the sale. Thus, the seller's sales expense lowers their low-tax profit, not high-tax ordinary income by an interest deduction. Here, profits and ordinary income with their divergent rate brackets produce different tax amounts.

Lender-paid points

Consider a homebuyer who lacks sufficient funds to pay the points demanded by a mortgage holder. The seller refuses to advance the points without increasing the purchase price to cover any cashback.

To originate the mortgage, the lender agrees to increase the mortgage amount and withhold the points from the mortgage proceeds, a **discount**. Handled another way, the mortgage holder may advance the points and treat them as an **add-on** to the principal of the mortgage.

May the homebuyer deduct points paid or added on by the lender in the year the points are paid?

No! The homebuyer did not pay the points from separate funds, whether drawn from their own funds or received as cash back from the seller. The points were paid as a discount, or an add-on amount, to the mortgage. The points being prepaid interest arranged to be "paid" by the mortgage holder, may only be deducted annually as they accrue over the 360-month life of the 30-year mortgage.

Deduction of points on refinancing

Consider a homeowner who **refinances** a mortgage that funded the purchase or improvement of their principal residence. They pay the points for the refinancing from their separate funds.

6 Rev. Proc. 94-27

Here, the refinancing did not fund the purchase or improvement of the residence, even though it funded the payoff of a purchase or improvement mortgage. As a result, the points are written off annually over the life of the mortgage.

Occasionally, a homeowner pulls cash proceeds out of a refinance of their principal residence when using their separate funds to pay the lender origination points. The homeowner uses the **excess mortgage proceeds** to pay for home improvements. Here, the homeowner deducts a pro rata share of the points — equal to the percentage of the mortgage funds used to pay for improvements — in the year the points are paid.[7]

Later, when the homeowner sells their residence or refinances again, the unaccrued points paid on the existing mortgage which remain to be deducted are then deducted — itemized on Schedule A as a MID — as interest paid in the year of the sale or refinance. This deduction treatment applies on a sale whether the mortgage is assumed or paid off - *satisfied*.

Now, consider a homeowner who refinances their principal residence for the purpose of reducing their monthly payment and providing more disposable income. The monthly savings are then spent on home improvements, such as a roof replacement and remodeling of the kitchen and bathrooms (as occurs more frequently during a recession).

The homeowner deducts all the points they paid for refinancing in the year they refinanced as an itemized deduction on their federal income tax return. They claim the refinancing freed up money for the improvements and was thus a property improvement mortgage.

The **Internal Revenue Service (IRS)** disallows the deduction, claiming the refinancing merely funded the payoff of an existing mortgage on the property with no net mortgage proceeds for payment of improvements.

However, in this scenario, the deduction of all the points paid to refinance the existing mortgage is permitted. The refinancing was a mortgage the homeowner incurred *in connection with* the improvement of the property. The reduction in payments caused the homeowner to have funds to pay for the improvements they then made on the property.[8]

Refinancing short-term financing

A homebuyer executes a note secured by a trust deed lien on their principal residence to finance a portion of the purchase price paid for the residence. The note is either for a private loan or a seller carryback. The note calls for a balloon payment with a three-year due date for final payoff of the mortgage. This short-term mortgage is a *swing loan* which must be refinanced as the buyer intends for the home to be their long-term residence.

When the note becomes due, the homebuyer obtains permanent long-term financing. The short-term note is paid off with the proceeds of the permanent financing.

7 Revenue Ruling 87-22
8 Tax Court Summary Opinion 2005-125 (non-precedent)

The homebuyer deducts the entire amount of the points paid to originate the long-term refinancing in the year paid. They claim the permanent financing was part of their original scheme to finance the long-term ownership of their principal residence and was not mere refinancing.

The IRS claims the homebuyer may not deduct the points paid on the permanent financing since, to be entitled to an immediate deduction as a mortgage made *in connection with* the acquisition of the principal residence, the points must be paid on a mortgage which directly funds the actual purchase or improvement of the principal residence.

Here, the points paid on the long-term refinancing of a short-term balloon payment note are deductible in their entirety in the year the points are paid.

The existence of a short-term due date in the note originated as a purchase-assist mortgage was evidence that the homebuyer contemplated refinancing the short-term note *in connection with* their retaining the residence for long-term ownership.[9]

Any indebtedness incurred *in connection with* the **purchase or improvement** of a homeowner's principal residence qualifies the points paid up front to originate the mortgage for immediate deduction in the year paid.[10]

9 **Huntsman** v. **Commissioner of Internal Revenue** (8th Cir. 1990) 905 F2d 1182
10 IRC §461(g)(2)

Chapter 2 Summary

Over the life of a mortgage, interest paid on mortgage principal accrues daily. Mortgage interest accrued and paid by a property owner to be written off against income must qualify as either an expense or deduction, an accounting process which reduces the owner's taxable income.

Taxwise, three sets of income category rules determine whether interest payments on a mortgaged property qualify as an expense or deduction to reduce the owner's taxable income: trade/business income, passive income and portfolio income.

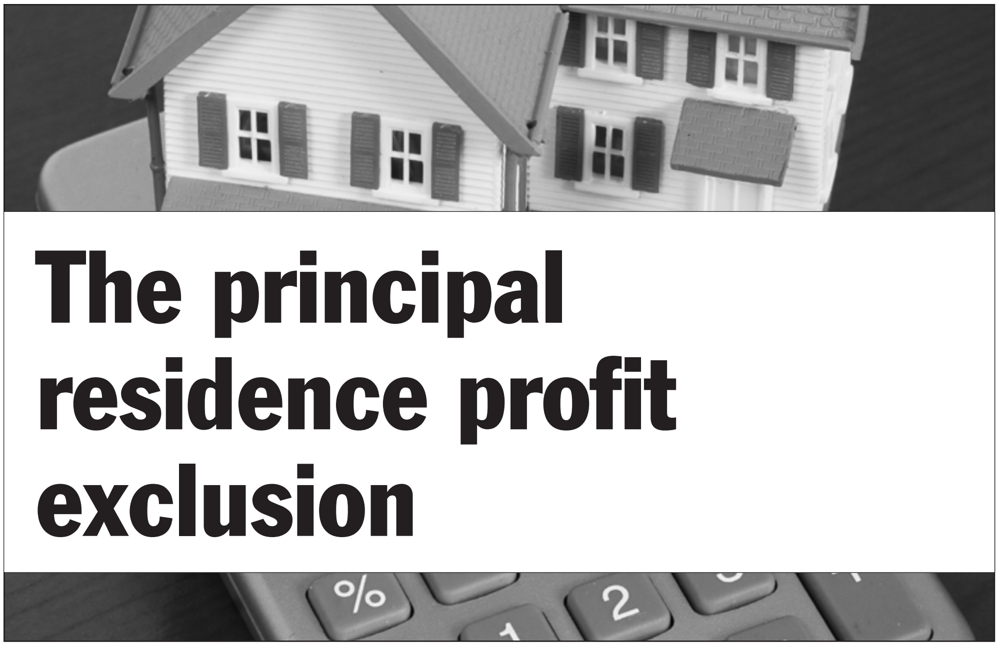
Each of the three different income categories are separately maintained before used to establish the owner's adjusted gross income. The reportable income or loss for each of the income categories includes amounts of mortgage interest accrued and paid, whether classified as an expense item or an allowable deduction within each category.

Points paid to a lender to originate a mortgage, sometimes called discount points, "buy down" the mortgage's par rate for the life of the mortgage to an interest rate negotiated and stated as the nominal rate in the note. "Points" is actually prepaid interest.

A mortgage with no points means a higher nominal interest rate is stated in the note, the par rate or higher premium rate. As prepaid interest, the property owner annually deducts a percentage of the points paid as they accrue during each month over the life of the mortgage, called the life-of-loan accrual, with one exception — the mortgaged housing subsidy. When the mortgage principal is prepaid, any remaining unaccrued prepaid interest — points — is deducted in the year of the payoff.

Chapter 2 Key Terms

Chapter 3



The principal residence profit exclusion

Learning Objectives

After reading this chapter, you will be able to:

- identify the profit on a sale of a homeowner's past or present principal residence which is excluded from taxation;
- recognize when a selling homeowner is eligible for a partial profit exclusion; and
- understand occupancy-to-ownership ratios as a reduction in the $250,000 exclusion.

Key Terms

§1031 reinvestment plan
cost basis
imputed owner
occupancy-to-ownership ratio
partial exclusion
principal residence profit exclusion
unforeseen circumstances
unrecaptured gain

Tax-free sale up to $250,000 per homeowner

Consider the sale of a residential property the seller occupies or previously occupied, in whole or in part, as their principal residence. The price is far greater than the price the seller paid for the property, their **cost basis** in the property.

The *cost basis* is used to determine the amount of profit — both capital gains and unrecaptured gains — a seller realizes on the sale of a property. An owner's cost basis comprises:

- the price and transactional costs the seller paid to acquire the property;

cost basis
The cost incurred to acquire and improve an asset subject to adjustments for destruction and depreciation, a term used primarily for tax reporting.

- the costs they incurred to renovate and improve the property; and
- any adjustments for depreciation deductions during periods the property was rented to tenants or a portion was dedicated for use as a home office.

The seller's listing agent is typically proactive about a client's tax issues on the sale of a property. Being the seller's principal residence, the agent checks the public records for the number of years the seller has owned the property and whether the seller has a homeowner's property tax exemption.

The agent establishes:

- the seller has been the vested owner of the property for **more than five years**;
- the seller has used the property as their principal residence for at least **two of the past five years**; and
- the public records reflect the seller has a **homeowner's property tax exemption**.

As a result, the agent informs the seller that each owner-occupant is qualified to take up to $250,000 in capital gains profit on the sale tax-free due to the **principal residence profit exclusion**.[1]

principal residence profit exclusion
A tax reporting exclusion of profit realized on the sale of the owner's principal residence limited to a maximum dollar amount and by an occupancy-to-ownership ratio.

Each owner-occupant occupied a portion or all of the property as their principal residence for at least two years during their last five years of ownership. Thus, the $250,000 profit exclusion is available even when:

- the seller originally acquired the property as a rental but has since occupied it;
- the seller having occupied the property now rents the property to tenants;
- the seller has taken depreciation deductions as their home office or rental property; or
- the property consists of two or more residential or mixed-use units.

The listing agent also checks out the availability of the §1031 exemption for profits allocated to a home office (business use) or separate rental space (investment property) on the property, or due to the property's present status solely as a rental. These analyses indicate whether the seller needs to consider the acquisition of another property to avoid the adverse tax impact on the net proceeds from the sale.

The §121 profit exclusion's array of tax issues

Questions the agent considers when advising on the tax aspects of a sale of property that is or was the seller's principal residence include:

- On the closing date of the sale, will the property qualify as the owner's **principal residence** under the two-out-of-five-year **principal residence requirement**?[2]

1 Internal Revenue Code §121
2 IRC §121(a)

- Who among the co-owners qualifies for up to $250,000 in profit exclusion as an **owner and occupant** for two out of the five years preceding the close of the sale under the principal residence rule?[3]
- When only one spouse is the vested owner, does the **non-vested spouse qualify** as an *imputed owner* by having occupied the property under the principal residence owner-occupant rule?[4]
- Is any homeowner disqualified due to a **profit exclusion** taken on the sale of a different principal residence which closed escrow within two years before the close of the sale on their current residence?[5]
- When the period of owner-occupancy is less than two years, will the profit on a sale be eligible for a **partial exclusion** because of *personal difficulties* which arose:
    - prior to completing **two full years** of ownership and occupancy; or
    - within two years after taking a profit exclusion on the sale of a prior principal residence?[6]
- What percentage of the profit taken on the sale based on the **occupancy-to-ownership ratio** qualifies for the $250,000 exclusion?
- Did the homeowner originally acquire their residence as a rental property to replace other property in a **§1031 reinvestment plan**, then later convert it to their principal residence, triggering a **five-year holding period** to qualify for the exclusion?[7]
- Has the homeowner **depreciated** a portion of the residence or the property as their home office or as a rental and if so, will the owner use some or all of the sales proceeds to purchase like-kind §1031 property to avoid reporting **unrecaptured gain**?[8]
- Is the owner an unmarried surviving spouse who has not owned and occupied the property as a principal residence for the two-year period but can qualify by **tacking** the deceased spouse's period of ownership and occupancy to the surviving owner's?[9]
- Has the owner been placed in a government-licensed facility due to their physical or mental incapacity to care for themselves after residing on the property for a period of at least one of the past five years and thus qualify by *tacking* the time spent in the facility during their ownership of the property to their actual occupancy to satisfy the principal residency rule?[10]

partial exclusion
A prorated portion of the principal residence profit exclusion available to a homeowner who sells due to personal difficulties.

occupancy-to-ownership ratio
A ratio of the years a homeowner has occupied a property as their principal residential to the years they have owned it. Used by the seller of a residential property to calculate the percentage of profit realized on the sale which qualifies for the principal residence profit exclusion.

§1031 reinvestment plan
A sales transaction of like-kind property which generates net sales proceeds, some or all of which the seller will use to purchase like-kind replacement property under Internal Revenue Code §1031. The cost basis and unrecaptured gains are carried forward to the property purchased and the seller avoids reporting some or all of the capital gains realized on the sale.

Principal residence exclusion, not for second residence

Occasionally, wealthier couples will have two or three residences they occupy at different times during the year, such as a seasonal or vacation home.

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3 IRC §121(b)
4 IRC §§121(b)(2), 121(d)(1)
5 IRC §121(b)(3)
6 IRC §§121(c)(1), 121(c)(2)
7 IRC §121(d)(10)]
8 IRC §121(d)(6)
9 IRC §121(d)(2)
10 IRC §121(d)(7)

Recall that profit on a sale of any home qualifies for the **principal residence profit exclusion** when the seller has:

- owned the property for at least five years; and
- occupied the property as their principal residence for at least two years during the five-year period prior to closing the sale.[11]

Factors which identify a property as the owner's principal residence include its:

- location near the owner's employment;
- use as the address listed on state and federal tax returns; and
- proximity to banks and professional services used by the owner.[12]

Profit exclusion for one or more owners

The amount of profit taken — *realized* — as a **capital gain** on a sale of real estate is set by subtracting the price and transactional costs paid to acquire the property from the net sales price they receive on its sale.

Consider an individual who owns and occupies a property as their principal residence for no more than 23 months before closing a sale of the residence at a profit. No personal difficulties triggered their need to sell the property.

Does the individual qualify for the profit exclusion?

No! The individual did not occupy the property for a total of two of the five years preceding the sale and no personal difficulties existed to shorten the qualifying time.[13]

Exclusion available to a married couple

A married couple **owns and occupies** a property as their principal residence for at least two of the five years prior to closing a sale of the property. Unless disqualified by other situations, they exclude an aggregate amount of up to $500,000 in profit taken on the sale, i.e., $250,000 per person.[14]

Alternatively, a husband and wife, one of which is the sole owner of a home as separate property, both occupy the property as their principal residence. Here, they **jointly qualify** for a combined $500,000 profit exclusion on the sale of the residence, when:

- both occupy the property for two years or more within the five-year ownership period prior to the sale;
- the couple files a **joint return** as a married couple for the year of the sale; and
- neither spouse has taken a profit exclusion on another principal residence within two years prior to the sale.[15]

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11 IRC §§121(a)

12 IRS Publication 523

13 IRC §121(a)

14 IRC §121(b)(2)(A)

15 IRC §121(b)(2)

However, one spouse is **individually disqualified** when they applied the principal residence profit exclusion to profits on the sale of a residence they sold within the two-years prior to closing the sale of their current residence. Here, the combined exclusion of up to $500,000 is not available. However, when the other spouse separately qualifies for an individual profit exclusion up to $250,000, they may claim the exclusion whether or not they are a vested owner.[16]

For example, the **sole owner** of a residence held as separate property and their spouse have both occupied the property as their principal residence for more than two of the five years preceding the sale of the residence.

Neither spouse claimed a profit exclusion on the sale of a principal residence which closed escrow within two years prior to closing the sale of their current residence. The couple files a joint return for the year of the sale.

Does each spouse qualify for the combined exclusion allowing the couple to exclude up to $500,000 of profit taken on the sale of the residence solely owned by one spouse?

Yes! The spouse who holds no ownership interest in the residence is classified as an **imputed owner**. Thus, the couple qualifies for the $500,000 profit exclusion since one spouse owns the residence and both occupied it as their principal residence.

imputed owner
Someone who for tax purposes is deemed to be a coowner of a principal residence but does not have a vested interest in the property.

The exclusion's spousal entanglements with two properties

Consider a husband and wife who each independently owned and occupied separate principal residences during the two-year period immediately prior to their marriage.

On marriage, both the husband and wife vacate their prior residences and relocate to a different residence. Each spouse now needs to sell their prior residence.

The husband sells his prior residence, realizing a profit. The couple files a joint return for the year of the sale.

Does the couple, now married, qualify for the combined exclusion of up to $500,000?

No! Only the husband qualifies to take the individual profit exclusion of up to $250,000 on the couple's joint tax return. The wife did not need to be a vested owner of the husband's residence to qualify the couple for the $500,000 profit exclusion. However, the wife was disqualified for failure to occupy the property as a principal residence for two of the five years prior to its sale.

Now consider a situation where the wife closes the sale on her prior residence within two years after the husband closes the sale on his. The husband does not qualify for any part of the exclusion on the wife's sale. The husband and wife file a joint return for the year the wife's residence sold, claiming the wife's $250,000 individual profit exclusion.

16 IRC §121(b)(2)(B)

Here, the wife qualifies to claim the individual profit exclusion on the couple's joint return. The husband's prior claim of an individual $250,000 profit exclusion within two years of the wife's sale does not disqualify the wife's claim to the individual exclusion. [IRC §121(b)(3)]

In contrast, consider a husband who, either prior to or after getting married, closes escrow on the sale of a solely owned principal residence and realizes a profit.

The husband owned and occupied the principal residence for more than two years during the five years prior to closing the sale. Here, the husband alone qualifies for and claims the profit exclusion on the sale.

Since their marriage, the husband and wife have occupied the wife's separate property as their principal residence for at least two years during the past five years.

Within two years after the husband closed the sale on which he took a profit exclusion, the residence owned by his wife is sold and escrow closed.

May the couple file a joint return and qualify for the combined profit exclusion of up to $500,000?

No, not both! Only the wife qualifies for an individual profit exclusion of up to $250,000 on their joint return.

Even though the husband met the (imputed) ownership and (actual) occupancy requirements for the property sold by his wife, the husband previously took a profit exclusion on the sale of his prior principal residence which closed within the two-year period preceding the closing of the sale of the wife's residence.[17]

Similarly, had the second residence sold been community property and not separately owned by the wife, only the wife would be allowed to take a profit exclusion on their joint return.

Here, the seller's agent needs to determine whether the closing of the sale on the residence they both occupied needed to be delayed to a date more than two years after the sale closed on the husband's residence. Had the close of escrow on the second sale been delayed, the couple would have qualified for the combined profit exclusion.

Residence unoccupied at time of sale

An individual or married couple need not occupy a property as a **principal residence** when they purchase the property or when they sell it to qualify for the $250,000 or combined $500,000 profit exclusion.

Consider a married couple who acquires a property and occupies it continuously as their principal residence for over two years.

17 IRC §121(b)(3)

Later, the couple buys another home and moves in, occupying it as their principal residence. The couple rents the old residence to a tenant, converting it into a rental property, and takes their annual depreciation allowance deduction.

Within three years of moving out of their prior residence, the couple closes a sale on the prior residence and takes a profit consisting of both capital gain and *unrecaptured gain* (depreciation). The couple files a joint tax return for the year of the sale.

unrecaptured gain
The accumulated annual adjustments to a property's cost basis for depreciation deductions which on a sale of the property are reported and taxed at greater rates than the rates for capital gain.

Here, the couple may take a $500,000 profit exclusion on the sale even though they did not occupy the property at the time of the sale. The couple **owned and occupied** the prior residence as their principal residence for at least two of the last five years. However, the amount of recaptured gain due to depreciating the property during the period it was rented is taxed on the sale.

Partial exclusion on a sale due to personal difficulties

At times, individuals or couples sell due to *personal difficulties* but do not meet the two-out-of-five-year ownership and occupancy requirement needed to claim the full amount of the profit exclusion. When personal difficulties bring about the decision to sell, closing the sale before two years of owner-occupancy, the homeowner qualifies for a prorate share of the $250,000/$500,000 profit exclusion as a **partial exclusion**.

The **partial exclusion** allows a homeowner to exclude from taxes all profit on the sale up to a prorated portion of the $250,000/$500,000 profit exclusion. The ceiling amount for partial exclusion is set by a ratio based on the fraction of the two years they were owner-occupants of the residence. Importantly, the proration is not applied to the amount of profit realized on the sale. The ratio is applied only to the total amount of profit excludable — a reduction of the $250,000/$500,000 exclusion ceiling, not a reduction in the profit available for exclusion.

To qualify for a partial exclusion, a **change in circumstance** due to personal difficulties needs to be the primary reason for sale of the property. Qualifying *personal difficulties* include:

- a **change in employment**, based on the seller's occupancy of the residence at the time of the job relocation and the financial need to relocate for the employment;
- a **change in health**, such as advanced age-related infirmities, severe allergies, or emotional problems; or
- **unforeseen circumstances**, such as natural or man-made disasters, death or divorce.[18]

unforeseen circumstances
Events not reasonably foreseeable by a homeowner which qualify the profit on the sale of a residential property for partial exclusion from taxation, such as a natural disaster, divorce or death.

Thus, when a homeowner sells due to personal difficulties, all profit taken on the sale is excluded from taxation up to the ceiling amount of the partial exclusion.[19]

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18 IRC §121(c)(2)(B); Revenue Regulations §1.121-3

19 IRC §121(c)(1)

However, when the principal residence is the subject of an exclusion and was acquired as a rental property in a §1031 transaction using §1031 money or in exchange, a **five-year holding period** exists before the principal residence profit exclusion is available.

The change of circumstances as reasons to sell

Factors used to determine whether the primary reason for the sale is a *change in circumstance* which qualifies the sale for a partial exclusion include:

- the need compelling the homeowner to relocate and sale of the principal residence both need to occur during the period of occupancy;
- a material change makes the property unsuitable as the principal residence;
- the homeowner's financial ability to carry the residence requires the residence be sold;
- the need to relocate arose during the occupancy of the residence sold; and
- the need to relocate was not foreseeable by the homeowner when they acquired and first occupied the principal residence sold.[20]

For example, a change in employment may qualify a homeowner for the partial exclusion even when the owner has not owned and occupied their principal residence for the full two-year period.

Employment compelling the homeowner to relocate can be based on:

- a required job relocation by their current employer;
- the commencement of employment with a new employer; or
- the homeowner is self-employed and they relocate of the place of business or commence a new business.

A sale is deemed to be due to a change in employment when:

- the new job location is more than 50 miles farther than the old job from the previous principal residence; or
- the seller was formerly unemployed, and the job location is at least 50 miles from the residence sold.[21]

For example, a homeowner is forced by their employment to relocate out of the area.

The homeowner has owned and occupied their principal residence for one year and six months — 75% of the necessary two-year occupancy period.

The homeowner sells their residence, taking a $40,000 profit.

When filing their tax return, the homeowner is eligible to exclude the entire $40,000 profit from taxation. Here, the entire profit realized is less than the

20 Rev. Regs §1.121-3(b)
21 Rev. Regs. §1.121-3(c)

$187,500 partial exclusion (75% of the $250,000 full exclusion). The same ratio applies to a couple's maximum $500,000 profit exclusion under the same circumstances.[22]

Chronic health issues which compel the homeowner to sell may also qualify the sale for a partial exclusion.

To qualify for health reasons, the owner seeking the exclusion is selling to facilitate the diagnosis, cure, or treatment of an illness or injury, or obtain or provide medical or personal care, for any of the following persons:

- the owner;
- the owner's spouse;
- a co-owner of the residence;
- a co-occupant residing in the owner's household as their principal place of abode; or
- close relatives, generally those descended from the owner's grandparents.

The owner's sale is also deemed to be due to health reasons when a physician recommends a change of residence.[23]

Unforeseen circumstances may be the primary reasons for the sale of the owner's principal residence, allowing use of the partial exclusion. Events classified as unforeseen circumstances do not include events the owner could have reasonably anticipated before they owned and occupied the residence.

The mere **preference** of the owner to own and occupy another property as their principal residence or the **financial improvement** of the owner permitting acquisition of a more affluent residence does not qualify the sale for the partial profit exclusion.

However, the sale is deemed to be due to unforeseen circumstances when:

- the residence is taken by involuntary conversion; or
- disaster (natural or man-made) or acts of war/terrorism affect the residence.

Further, the homeowner's sale is deemed to be due to unforeseen circumstances which are experienced by the owner, owner's spouse, co-owners, co-occupants, who are residents and members of the owner's household or close relatives, including:

- death;
- loss of employment resulting in unemployment compensation;
- inability to pay housing costs and basic living expenses for the owner's household;
- divorce or separation by court decree; or

22 IRC §121(c)
23 Rev. Regs. §1.121-3(d)(2)

- pregnancy with multiple births.[24]

Owned but not always occupied

An overriding limitation reduces by a percentage the amount of profit to which the exclusion ceiling applies when a property owner does not occupy the property as their principal residence during the entire period of ownership. The profit limitation apples even when the principal *residence requirement* is met. The result is only a prorate portion of the profit realized on the sale is excluded, while the $250,000/$500,000 exclusion is not altered.

The **percentage of the profit** that can be excluded on a sale is based on an **occupancy-to-ownership ratio** covering the entire period of ownership, not just five years.

Periods the owner is considered to have occupied the property as their principal residence include:

- any period of ownership prior to January 1, 2009;[25]
- any period of use as the owner's principal residence after January 1, 2009 prior to the sale; and
- any period after terminating their use of the property as a principal residence within five years prior to the sale.[26]

Consider an owner who purchases a property on January 1, 2005 for use as a second home. They begin occupying it as a principal residence on January 1, 2011. They move out on January 1, 2013, terminating their use of the property as their principal residence. The owner closes a sales escrow disposing of the property on January 1, 2015, taking a $300,000 profit.

How much of the $300,000 in profit can the owner exclude under the occupancy-to-ownership ratio since they did not continuously occupy the property during their 10 years of ownership?

On analysis, the owner meets the initial two-out-of-five-year principal residence requirement.

Further, the **period of ownership** of the property by the seller is ten years.

Of the ten years of ownership, the **period of occupancy** of the property as the owner's principal residence is eight years, based on:

- the four years prior to January 1, 2009, even though they did not occupy the property;
- the two years after January 1, 2009 when they actually occupied the property as their principal residence; and
- the two years after terminating their occupancy of the property as their principal residence up to the closing of the sale, even though they did not then occupy the property.

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24 Rev. Regs. §1.121-3(e)
25 IRC §121(b)(5)(C)
26 IRC §121(b)(5)(C)(ii)

Thus, the *occupancy-to-ownership* ratio is 8:10, representing the eight years of occupancy over the ten years of ownership.

Here, eight-tenths (80%) of the $300,000 profit on the sale is $240,000, the portion of the profit to which the exclusion is applied. As the **exclusion ceiling amount** of $250,000 is available to the owner, the occupancy-to-ownership ratio portion of the profit being less in amount is excludable from the owner's gross income.[27]

27 IRC §121(b)(1)

Chapter 3 Summary

A sale of any home qualifies for the principal residence profit exclusion when the seller has owned the property for at least five years and occupied the property as their principal residence for at least two years during the five-year period prior to closing the sale.

The amount of profit taken — realized — as a capital gain on a sale of real estate is set by subtracting the seller's cost basis in the property from the net sales price they receive. A partial exclusion is a prorated portion of the principal residence profit exclusion available to a homeowner who sells due to personal difficulties.

To qualify for a partial exclusion, a change in circumstance needs to be the primary reason for sale of the property.

Qualifying personal difficulties include: a change in employment, a change in health or unforeseen circumstances.

The mere preference of the owner to own and occupy another property as their principal residence or the financial improvement of the owner permitting acquisition of a more affluent residence does not qualify the sale for the partial profit exclusion.

Chapter 3 Key Terms


HOLLYWOOD
PRODUCTION
VRC
DIRECTOR
firsttuesday
CAMERA
DATE
SCENE
TAKE
3/22
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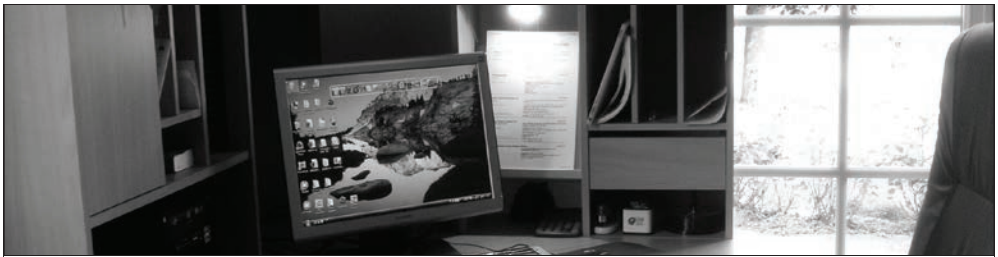

Chapter 4

Home office expenses as deductions from fees

Learning Objectives

After reading this chapter, you will be able to:

- identify the qualifying factors for a real estate licensee to write off direct and indirect expenses related to their home office;
- determine deductions available for mortgage interest and depreciation; and
- undertake the brokerage activities needed to classify a home office as a licensee's principal place of business.

Key Terms

direct expense	**indirect expense**
exclusive use	**principal place of business**
home office deduction	**regular use**

Qualifying for the home office deduction

Real estate licensees often work from their home when rendering brokerage services. Whether they rent or own, they may qualify to expense the costs of maintaining their home office as an offset against their trade/business income for services they render. Thus, they reduce their taxable income.

An active licensee qualifies for the **home office deduction** when:

- a portion of the home is *used exclusively* and *regularly* for the licensee's brokerage business; and
- the use of the home office meets one of three *business activity standards*.

Independent brokers, broker-associates, and sales agents

For tax purposes, a real estate licensee is considered self-employed, a fiction called an **independent contractor**, when:

- they are licensed as a broker or sales agent;

home office deduction
A deductible expense resulting from business use of a taxpayer's home.

direct expense
A deductible expense attributable to the home office area used exclusively for business.

indirect expense
An expense incurred in the upkeep and operation of a taxpayer's entire residence, a part of which is deducted as a business expense, the amount deductible based on the percentage of the area in the residence exclusively used as a home office.

- the compensation they receive is based on completed transactions, such as sales and other brokerage services (called **contingency fees**), in contrast to an hourly wage or salary; and
- the sales agent or broker-associate has a written agreement with their employing broker stating the licensee is an independent contractor for income tax purposes.[1]

Both broker-associates and sales agents employed as independent contractors, as well as independent brokers, qualify for the home office deduction under the same rules. When the licensee qualifies for the home office deduction, the deductible **home office expenses** include:

- the **direct expenses** attributable to the home office area used *exclusively* for business; and
- **indirect expenses** limited in amount to the percentage figure representing the portion of the square footage in the residence used as the home office.

Direct expenses, deductible as a brokerage business expense, include the cost of decorating and repairs made in the portion of the residence exclusively used as a home office.

All direct expenses are deductible from business income without allocation for the personal use of the remaining space in the residence.

Indirect expenses are costs incurred in the upkeep and operation of the entire residence. They are prorated and include:

- rent paid as a tenant;
- mortgage interest;
- real estate taxes;
- home insurance;
- utilities; and

1 Internal Revenue Code §3508(b)(1); see Figure 1

Deducting Business Expenses

Equipment purchased in connection with a business, even when the licensee operates the business out of a home office, is fully deductible in the year purchased. The equipment needs to be both ordinary and necessary to operate the home office. To be classified as necessary, equipment need not be indispensable. For example, a licensee purchases a printer for use in their home office. It is used to print contracts, disclosures, and other documents. The printer is both ordinary and necessary for the licensee's business. Thus, the cost of purchasing the printer is fully deductible.

Extraordinary expenses such as the purchase of a car for use during the course of business, are not fully deductible in the year the expense is made. Rather, costs for extraordinary expenses are recovered over a few years taking annual depreciation deductions.

However, when a car is used exclusively for business purposes, expenses such as gas and oil, repairs, insurance, or registration fees are deducted the year the expense is paid. [Internal Revenue Service Publication 535]

- maintenance.

The portion of indirect expenses deductible as a business expense is calculated based on the percentage of the square footage in the residence used as a home office.

For example, a licensee exclusively uses 300 square feet of their residence as their home office. The total area of the residence is 1,800 square feet. Thus, the licensee's home office is 16.7% of the total square footage of the residence.

The licensee's indirect annual expenses — incurred as ownership and operating expenses on the entire residence — include:

- $15,000 in mortgage interest;
- $2,000 in real estate taxes;
- $3,600 in utility payments; and
- $900 in insurance costs.

The total amount of indirect expenses is $21,500.

The licensee may write off $3,590.50 as indirect business expenses, 16.7% of the $21,500 residence expenses.[2]

In lieu of ownership expenses, when the licensee is a tenant in a home or apartment they use in part as their office, they write off a pro rata amount of the rent as a business expense.[3]

Expenses outside of the dwelling incurred for lawn care, pool maintenance or tree trimming cannot be deducted as business expenses. Further, expenses unrelated to the home office area incurred inside the house — such as the remodeling or maintenance of any area other than the home office area — are not deductible.[4]

Conversely, when the licensee paints and carpets only the home office area, the entire cost is deductible as an expense directly related to the home office.

However, before the licensee may deduct any of the home office costs as business expenses, the home office area needs to be **used exclusively** and **regularly** for their business.[5]

Lastly, and important, the cost to purchase or improve the residence which is allocate to improvements is recoverable as a business *depreciation deduction* allowed for the pro rata portion of the residence used as the business office. The depreciation deduction while reducing taxable annual income becomes unrecaptured gain which is taxed when the residence is sold, unless a replacement property is acquired with the sales proceeds in a §1031 reinvestment plan.

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2 Internal Revenue Service Publication 587

3 **Visin** v. **Commissioner** (2003) 86 TCM 279

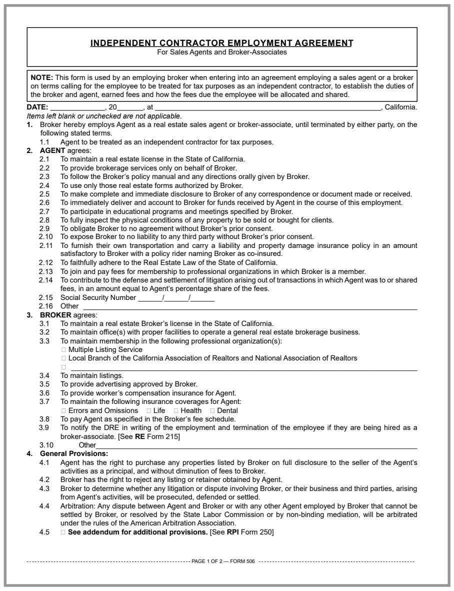
4 IRS Pub. 587

5 IRC §280a(c)(1)

Figure 1

Form 506

Independent Contractor Employment Agreement



INDEPENDENT CONTRACTOR EMPLOYMENT AGREEMENT
For Sales Agents and Broker-Associates

NOTE: This form is used by an employing broker when entering into an agreement employing a sales agent or a broker on terms calling for the employee to be treated for tax purposes as an independent contractor, to establish the duties of the broker and agent, earned fees and how the fees due the employee will be allocated and shared.

DATE: ______________, 20______, at ______________________________________, California.
Items left blank or unchecked are not applicable.

1. Broker hereby employs Agent as a real estate sales agent or broker-associate, until terminated by either party, on the following stated terms.
1.1 Agent to be treated as an independent contractor for tax purposes.

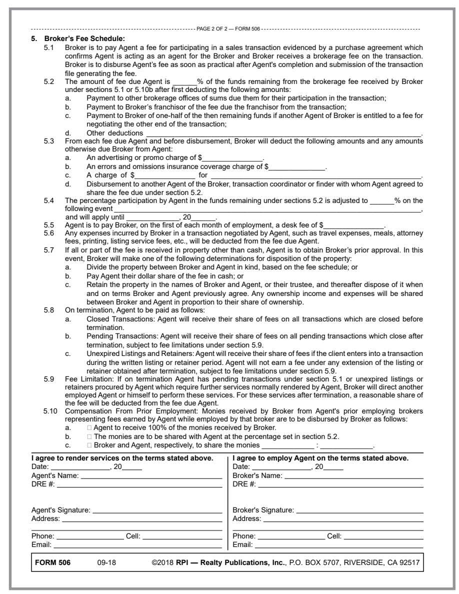
2. AGENT agrees:
2.1 To maintain a real estate license in the State of California.
2.2 To provide brokerage services only on behalf of Broker.
2.3 To follow the Broker's policy manual and any directions orally given by Broker.
2.4 To use only those real estate forms authorized by Broker.
2.5 To make complete and immediate disclosure to Broker of any correspondence or document made or received.
2.6 To immediately deliver and account to Broker for funds received by Agent in the course of this employment.
2.7 To participate in educational programs and meetings specified by Broker.
2.8 To fully inspect the physical conditions of any property to be sold or bought for clients.
2.9 To obligate Broker to no agreement without Broker's prior consent.
2.10 To expose Broker to no liability to any third party without Broker's prior consent.
2.11 To furnish their own transportation and carry a liability and property damage insurance policy in an amount satisfactory to Broker with a policy rider naming Broker as co-insured.
2.12 To faithfully adhere to the Real Estate Law of the State of California.
2.13 To join and pay fees for membership to professional organizations in which Broker is a member.
2.14 To contribute to the defense and settlement of litigation arising out of transactions in which Agent was to or shared fees, in an amount equal to Agent's percentage share of the fees.
2.15 Social Security Number ______/______/______
2.16 Other ______________________________________

3. BROKER agrees:
3.1 To maintain a real estate Broker's license in the State of California.
3.2 To maintain office(s) with proper facilities to operate a general real estate brokerage business.
3.3 To maintain membership in the following professional organization(s):
☐ Multiple Listing Service
☐ Local Branch of the California Association of Realtors and National Association of Realtors
☐ ______________________________________
3.4 To maintain listings.
3.5 To provide advertising approved by Broker.
3.6 To provide worker's compensation insurance for Agent.
3.7 To maintain the following insurance coverages for Agent:
☐ Errors and Omissions ☐ Life ☐ Health ☐ Dental
3.8 To pay Agent as specified in the Broker's fee schedule.
3.9 To notify the DRE in writing of the employment and termination of the employee if they are being hired as a broker-associate. [See **RE** Form 215]
3.10 Other______________________________________

4. General Provisions:
4.1 Agent has the right to purchase any properties listed by Broker on full disclosure to the seller of the Agent's activities as a principal, and without diminution of fees to Broker.
4.2 Broker has the right to reject any listing or retainer obtained by Agent.
4.3 Broker to determine whether any litigation or dispute involving Broker, or their business and third parties, arising from Agent's activities, will be prosecuted, defended or settled.
4.4 Arbitration: Any dispute between Agent and Broker or with any other Agent employed by Broker that cannot be settled by Broker, or resolved by the State Labor Commission or by non-binding mediation, will be arbitrated under the rules of the American Arbitration Association.
4.5 ☐ **See addendum for additional provisions.** [See **RPI** Form 250]

PAGE 1 OF 2 — FORM 506

For a full-size, fillable copy of this or any other form in this book that may be legally used in your professional practice, go to realtypublications.com/forms



PAGE 2 OF 2 — FORM 506

5. Broker's Fee Schedule:
5.1 Broker is to pay Agent a fee for participating in a sales transaction evidenced by a purchase agreement which confirms Agent is acting as an agent for the Broker and Broker receives a brokerage fee on the transaction. Broker is to disburse Agent's fee as soon as practical after Agent's completion and submission of the transaction file generating the fee.
5.2 The amount of fee due Agent is ______% of the funds remaining from the brokerage fee received by Broker under sections 5.1 or 5.10b after first deducting the following amounts:
a. Payment to other brokerage offices of sums due them for their participation in the transaction;
b. Payment to Broker's franchisor of the fee due the franchisor from the transaction;
c. Payment to Broker of one-half of the then remaining funds if another Agent of Broker is entitled to a fee for negotiating the other end of the transaction;
d. Other deductions ______________________________________.
5.3 From each fee due Agent and before disbursement, Broker will deduct the following amounts and any amounts otherwise due Broker from Agent:
a. An advertising or promo charge of $______________.
b. An errors and omissions insurance coverage charge of $______________.
c. A charge of $______________ for ______________________________.
d. Disbursement to another Agent of the Broker, transaction coordinator or finder with whom Agent agreed to share the fee due under section 5.2.
5.4 The percentage participation by Agent in the funds remaining under sections 5.2 is adjusted to ______% on the following event ______________________________________, and will apply until ______________, 20______.
5.5 Agent is to pay Broker, on the first of each month of employment, a desk fee of $______________.
5.6 Any expenses incurred by Broker in a transaction negotiated by Agent, such as travel expenses, meals, attorney fees, printing, listing service fees, etc., will be deducted from the fee due Agent.
5.7 If all or part of the fee is received in property other than cash, Agent is to obtain Broker's prior approval. In this event, Broker will make one of the following determinations for disposition of the property:
a. Divide the property between Broker and Agent in kind, based on the fee schedule; or
b. Pay Agent their dollar share of the fee in cash; or
c. Retain the property in the names of Broker and Agent, or their trustee, and thereafter dispose of it when and on terms Broker and Agent previously agree. Any ownership income and expenses will be shared between Broker and Agent in proportion to their share of ownership.
5.8 On termination, Agent to be paid as follows:
a. Closed Transactions: Agent will receive their share of fees on all transactions which are closed before termination.
b. Pending Transactions: Agent will receive their share of fees on all pending transactions which close after termination, subject to fee limitations under section 5.9.
c. Unexpired Listings and Retainers: Agent will receive their share of fees if the client enters into a transaction during the written listing or retainer period. Agent will not earn a fee under any extension of the listing or retainer obtained after termination, subject to fee limitations under section 5.9.
5.9 Fee Limitation: If on termination Agent has pending transactions under section 5.1 or unexpired listings or retainers procured by Agent which require further services normally rendered by Agent, Broker will direct another employed Agent or himself to perform these services. For these services after termination, a reasonable share of the fee will be deducted from the fee due Agent.
5.10 Compensation From Prior Employment: Monies received by Broker from Agent's prior employing brokers representing fees earned by Agent while employed by that broker are to be disbursed by Broker as follows:
a. ☐ Agent to receive 100% of the monies received by Broker.
b. ☐ The monies are to be shared with Agent at the percentage set in section 5.2.
c. ☐ Broker and Agent, respectively, to share the monies ____________ : ____________.

I agree to render services on the terms stated above.	**I agree to employ Agent on the terms stated above.**
Date: ______________, 20_____	Date: ______________, 20_____
Agent's Name: ____________________	Broker's Name: ____________________
DRE #: ____________________	DRE #: ____________________
Agent's Signature: ____________________	Broker's Signature: ____________________
Address: ____________________	Address: ____________________
Phone: ____________ Cell: ____________	Phone: ____________ Cell: ____________
Email: ____________________	Email: ____________________

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Exclusive use means no other use at any time

exclusive use
The use of a designated area in a residence only as an office, one of two conditions needed to qualify for a home office deduction.

Consider a licensee who uses a family room as their home office. The licensee's family also uses the family room to watch TV in the evenings and occasionally entertain guests on weekends.

Thus, the area in the licensee's residence set aside for the home office is not used *exclusively* for the brokerage business. Even though the personal use of the area occurs after office hours, no home office deduction is allowed.

The area dedicated to home office work does not need to be cordoned off or partitioned to qualify for **exclusive use.** One or two rooms, and possibly an extra bathroom, may serve as space for the home office.

In addition to the home office area being dedicated exclusively to business activities, the home office also needs to be used **regularly** by the licensee for conducting their business.

Regular use of the residence for most brokerage activity

Consider a licensee who maintains both a home office and an office in a commercial building. The licensee works, keeps their files, conducts most of their real estate sales business and is assisted by a part-time secretary or team member at the commercial office.

However, the licensee uses the home office four or five days each month in the evening to catch up on work they were unable to complete at the commercial office, such as reading real estate journals and studying course materials for license renewal or becoming a broker.

Here, no deduction may be taken for home office expenses. The area used as the home office is not *regularly used* in the course of the licensee's business. That it is used exclusively for their business is not decisive since exclusive use needs to be coupled with **regular use**.

> **regular use**
> The consistent repeated use of an area of a residence as a home office, one of two conditions needed to qualify for a home office deduction.

However, to take the home office deduction, the licensee's business conduct still needs to meet one of three standards:

- the home office is the **principal place of business** for the licensee;
- the home office is used as a place of business to **meet or confer** with clients; or
- the home office is located in a **separate structure** not attached to the residence.[6]

> **principal place of business**
> The location where a broker or agent conducts the majority of, or the most significant activities related to their business.

A licensee who claims they use their home office when they regularly meet and confer with clients needs to document the client conferences in a calendar or logbook, including:

- their clients' names;
- the date of each client meeting; and
- what they discussed or acted on.

A home office when located in a structure separate from the licensee's residence also qualifies for the deduction of business expenses. Examples include a garage apartment, casita, outbuilding or granny flat.

Principal place of business

To qualify for the deduction of home office expenses based on its use as their *principal place of business*, the licensee needs to perform most all or at least the most important of their **brokerage activities** while working in the home office, such as:

- prepare agreements, information disclosures, and marketing material;
- organize and schedule brokerage activities by email or phone;
- video conferencing marketing sessions; and

6 IRC §280A(c)(1)(A-C)

- regroup after collecting information, investigating property and records, and meeting with licensees, clients, and customers during the course of business.

The question becomes: among the different locations used by the licensee to perform business-related services, which is their principal place of business?

The location of the principal place of business is determined by comparing the significance of the real estate services performed as a licensee at various locations.

For doctors, treating patients is the most important aspect of their practice. Thus, the location where they treat patients is their principal place of business, which might be a laboratory, hospital, or care center.[7]

Consider a self-employed licensee who has no other office but their home office. They claim a home office deduction for the expenses incurred to operate an office out of a portion of their residence based on its use as their principal place of business.

The licensee calls clients, agents, and providers to schedule brokerage services from the home office. They also prepare, send, and receive all listing agreements, purchase agreements, other contracts, and disclosure documents at the home office. All the licensee's records and files plus their computer and other office equipment are located in the home office.

Regarding clients, the licensee meets them at their offices or residences, at restaurants or at the location of the real estate involved. Personal face-to-face meetings with clients are for reviewing documents, discussing the condition of the property – physical, title, operations, location, and disclosures – and the status of transactions, as well as obtaining signatures.

Other business activities conducted outside the home office include previewing property, attending marketing sessions and meeting with title officers, escrow officers, mortgage loan originators, home inspectors, property managers, maintenance services, government agencies and attorneys and accountants who represent clients. All of these activities are conducted at various places but are **scheduled** from the home office.

Does the licensee qualify to deduct their home office expenses as expenses incurred at their principal place of business?

Yes! Home office costs are an allowed expense deductible based on the use of the home office as the broker's principal place of business. The most important aspects of a brokerage practice are soliciting and coordinating client contacts, preparing agreements and disclosure statements, analyzing property data, and maintaining files and records, all of which are performed in the home office.

Obtaining signatures on documents, inspecting property, and meeting with others at locations outside the home office are essential, but not the most important aspects of the licensee's business.

7 **Soliman** v. **Commissioner of Internal Revenue** (1993) 506 US 168

Two offices — one for the public

A licensee with both a home office and a commercial office may qualify for the deduction of home office expenses.

Consider a licensee who maintains desk space in a downtown office with several other licensees, sometimes called a "cubby." The licensees using the downtown office share its maintenance and operating costs, such as employing a receptionist, contributing to rent, and paying for janitorial services and utilities for the premises.

The licensee pays a pro rata share of the costs based on the percentage of the space they use. The office provides the licensee with a "public" business address and a professional environment for meeting clients rather than coffee shops or the client's office or residence.

The licensee also has a home office. All their phone solicitations and contacts with clients and others while performing their brokerage services are made from the licensee's home office or while on the road. All agreements and disclosure forms are prepared at the home office and all of their records, files and office equipment are located at the home office.

Appointments to meet with clients or real estate affiliates or to show property are also made from the licensee's home office. They only use the downtown office as a "window" to meet clients before showing property, confer with them in person, or obtain their signatures on documents.

Here, the licensee qualifies to deduct expenses incurred at their home office from their business income. The importance of activities conducted at the home office and the time spent on carrying out those activities establishes the home office as their principal place of business.

Even though they have a commercial office for professional reasons, the most important parts of their work take place at the home office.[8]

Two offices — main office is downtown

Now consider a licensee who makes more substantial use of their commercial office than of their home office.

The licensee maintains a downtown office they use daily to solicit, make appointments with and meet clients. The licensee also arranges property inspections, escrow and title information, prepares agreements and disclosures, and maintains files at the downtown office.

The licensee's home office is used for bookkeeping, maintaining a real estate library. and studying. The licensee occasionally phones clients, receives calls and reviews documents at their home office. They spend one or two hours most evenings working in the home office.

Here, the licensee's use of the home office is insufficient to qualify the home office as their principal place of business.

8 **Beale** v. **Commissioner TC Memo** 2000-158

The licensee's most important activities — client contacts in person and by phone, creating marketing packages, and preparing agreements — take place and are filed primarily at the downtown office.

While bookkeeping and studying in the home office are essential to the licensee's ability to continue conducting a brokerage business, they are not the most important part of the business. Rendering services in the practice of real estate brokerage on behalf of clients is most important, and these services for the most part do not occur at the licensee's home office.[9]

Licensees and the home office

Although many brokers work independent of other licensees, broker-associates and sales agents always work as employees of the broker who hired them. Typically, they are provided desk space at their broker's office. However, the broker's employment and supervision of a licensee, mandated by state law, does not limit the ability of the broker-associate or sales agent to qualify for the home office deduction.

A prerequisite to qualifying for home office tax treatment requires a sales agent or broker-associate to be employed as an independent contractor with their broker. The independent contractor tax status of a broker-associate or sales agent is established by a written employment agreement between the licensee and the employing broker. The agreement states the licensee is considered an independent contractor and pays their own income taxes without the broker withholding. Nothing more is required to establish their independent contractor status, a concept limited in application to tax purposes only. [See Figure 1, **RPI** Form 506]

Limitations on deductions to fees for services rendered

Consider a real estate licensee who uses their residence as their principal place of business. Each year, the agent writes off their home office expenses as a deduction from their brokerage income.

The agent's real estate business suffered a net loss during the past year. Their business operating loss includes home office expenses.

When real estate business losses include home office expenses, the deduction of the loss is limited. Business losses cannot be taken to the extent they include home office expenses. Thus, no portion of the business loss reported may include home office expenses.[10]

9 Beale, *supra*

10 **King** v. **Commissioner TC Memo** 1996-231

Chapter 4 Summary

Real estate licensees who work out of their homes, whether rented or owned, may qualify to expense the costs of maintaining their home office as an offset against their trade/business income for the brokerage services they render.

An active licensee qualifies for the home office deduction when a portion of their home is used exclusively and regularly for the licensee's brokerage business and the use of the home office meets one of the three business activity standards. A direct expense is a deductible expense attributable to the home office area used exclusively for business.

An indirect expense is an expense incurred in the upkeep and operation of a taxpayer's entire residence which may in part be deducted as a business expense, the amount deductible based on the percentage of the area in the residence used as a home office.

The equipment needs to be both ordinary and necessary to operate the home office. Direct expenses, deductible as a brokerage business expense, include the cost of decorating and repairs made in the portion of the residence exclusively used as a home office. The entire amount of direct expenses is deductible from business income without allocation for the personal use of the remaining space in the residence.

However, to take the home office deduction, the licensee's business conduct still needs to meet one of three standards: the home office must be the principal place of business for the licensee, used as a place of business to meet or confer with clients or located in a separate structure not attached to the residence.

Chapter 4 Key Terms

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Chapter 5

The sales price

Learning Objectives

After reading this chapter, you will be able to:

- categorizes the many components which comprise the sales price of real estate.; and
- understand how the sales price for income-producing property is determined.

Key Terms

book value	**gross equity**
capital investment	**market value**

Different views, different analysis, different results

A seller's agent, as good practice, discloses the amount of **net proceeds** the seller can expect on a closing at the sales price under consideration. To accomplish this pricing disclosure as a critique for sales, the seller's agent initially prepares a **seller's net sheet** for review with the seller when presenting the listing agreement. The agent's calculations are based on the listing price the agent and seller agree upon for marketing the property.

Later, the agent repeats the net sheet analysis for each listing price modification approved by the seller, including submission of a buyer's purchase agreement offer.

To aid in preparing an estimate of the dollar amount of **net proceeds** a seller can expect to receive on a particular sales price, the agent fills out a form called a seller's net sheet. [See **RPI** Form 310]

Is the seller's awareness of the amount and nature of *net proceeds* they will receive on closing the only financial consequence the seller will experience on a sale? Is the amount of net profit on the sale the same as the seller's net proceeds?

Net proceeds and profits are unrelated concepts

The answer to both questions is no. The seller's **profit or loss** reported on a sale is always different in amount and unrelated to **net proceeds** received on the sales price paid by a buyer. However, the sales price is the common figure to begin calculating both net proceeds of a sale and the profit or loss on a sale. While the seller takes the net proceeds of a sale to the bank, the sales price may contain profit which creates a tax liability for the seller which diminishes the net proceeds — unless the profit is *tax exempt, excluded from taxes* or *tax deferred*.

Uninformed sellers frequently believe their profit is somehow related to the amount of net proceeds they receive on a sale; that their net equity in the property equals their profit. It does not. Typically, the net proceeds are greater than the amount of profit. However, the positive spread between the amount of net proceeds and profit is reduced or reversed by cash-back refinancing, as the debt on the property increased during ownership. While the equity in the property shrinks due to increased mortgage debt the profits remain the same.

The distinction: the seller's **equity** in a property and their **profit** on a sale are each derived by applying different data to the sales price — the **mortgage debt** and the seller's **cost basis**, respectively. On a sale, *debt* and *basis* are never the same.

Before breaking down the **sales price** into its component parts for tax reporting, several economic fundamentals of real estate ownership must first be understood:

- *capital investment* — made to acquire ownership and improve a property, evidenced by cash contributions, funds from loans, and cost basis carried forward from a sale in a §1031 reinvestment plan which comprise the owner's cost basis in the property from which depreciation deductions are made. In contrast, an owner's *capital interest* in a property is its current market value.
- *annual operating data* — ongoing property operations that generate income (rents) and expenses which are reported annually.
- *tax consequences* — brought about by acquisition, on-going ownership, and disposition of the property.

market value
The highest price a property will bring in a competitive and open market between a buyer and seller given time to act prudently and knowledgeably.

A property's sales price, also considered its **market value** and the owner's **capital interest**, is the only term common to all economic analysis regarding ownership of a home, business-use property or investment property (rental real estate and land held for profit on resale).

Agents advise and counsel clients on **material facts** enveloping a transaction they are negotiating. *Material facts* are aspects of a real estate transaction that if known might alter the economic behavior and decisions of the client.

Consider a first-time buyer of any type of property. Due to lack of knowledge and familiarity, they tend not to be inquisitive about:

- acquisition costs, though known and familiar to the broker;
- operating expenses, known to sellers and obtainable on request; and

- income taxes, known to brokers and salesagents.

The conduct of a first-time buyer is in direct contrast to the conduct of repeat buyers of a home, business-use property, or investment property. [See Form 306 accompanying this chapter; see **RPI** Form 311]

In any real estate transaction, a thoughtful agent gives their client advice on the tax consequences of the sale. This advice is, of course, limited to what is known by the agent, issues that might cause the client to consider further or different arrangements in a transaction.

Taking a profit that is not exempt or excluded from taxation creates a present or deferred tax liability on a sale. These are material facts. The payment of any profit taxes triggered by a sale diminishes the after-tax amount remaining from the net proceeds received on the sale.

gross equity
The portion of the market value of a property calculated by subtracting the amount of mortgage debt, unpaid property taxes and any bonded indebtedness secured by the property from the property's market value.

capital investment
The capital invested in a property, comprising cash and mortgage proceeds used to purchase, improve or carry the property, as well as any adjusted cost basis carried forward in the disposition of other property in a §1031 reinvestment plan.

Capital components of the sales price

A seller interested in disposing of a property quickly breaks out their sales price into **debt** and **equity**, flipsides of the capital interest coin. It is the equity in the property the seller is cashing out, no matter how the buyer might be funding payment of the sales price.

To calculate the seller's **gross equity** in the property, the **amount of debt** encumbering the property is deducted from the sales price. Again, mortgage debt is not used to determine the seller's profit on a sale (except for short sales in negative-equity situations). [See Figure 1]

In another distinction, a seller's present **capital interest** in a property is synonymous with the determination of the property's current market value. Brokers advising an income property owner logically determine the amount of the owner's capital interest in the property by, well, *capitalizing* the property's NOI at current rates of return experienced by like-type property — an appraisal approach. The resulting capitalized value of the property becomes the price the seller seeks from a buyer, representing the total sum of the seller's capital interest in the property.

An owner's *capital interest* is defined as either:

- the sum of the dollar amount of the property's current mortgage debt and perceived equity; or
- the property's current fair market value set at the current annual rate of return on like-type properties — say, 6.5% — when inflation is low and investment opportunities are not readily available – called a seller's market.

The seller's *capital interest* in a property today is neither equivalent nor related to the seller's previous **capital investment** in the property made years earlier. A seller's c*apital investment* is the amount they paid for the property, comprised of cash and mortgage proceeds used to purchase, improve or cover negative cash flow to carry the property, as well as any cost basis carried forward in a §1031 reinvestment plan. Capital invested sets the cost basis in a property and is also called **book value**.

book value
The value of an asset expressed for accounting purposes as the original cost of acquisition and capital improvements, minus accumulated depreciation and destruction, also known as cost basis. Contrast with current market value.

Form 306

Property Expense Profile

PROPERTY EXPENSE PROFILE

Prepared by: Agent ______________________ **Phone** ______________________
Broker ______________________ **Email** ______________________

NOTE: This form is used by an owner and their sales or leasing agent when preparing a marketing package for the sale of a one-to-four unit residential property or the lease of any type property and disclosing the property's operating costs, to prepare a worksheet to be handed to prospective buyers and tenants for their review of the monthly property operating costs and deposits they will likely incur on taking possession of the property.

DATE: ____________, 20_____, at ______________________________________, California.

1. **PROPERTY TYPE** ______________________________
   1.1 Location ______________________________
   1.2 Expense figures are estimates reflecting:
      a. ☐ current expenses of occupancy/ownership.
      b. ☐ forecast of anticipated expenses of occupancy.
2. **MONTHLY OPERATING EXPENSES:**
   2.1 Electricity . . . . . $__________
   2.2 Gas . . . . . $__________
   2.3 Water . . . . . $__________
   2.4 TV (cable/satellite) . . . . . $__________
   2.5 Phone . . . . . $__________
   2.6 Internet . . . . . $__________
   2.7 Trash . . . . . $__________
   2.8 Sewage . . . . . $__________
   2.9 General obligation bonds . . . . . $__________
   2.10 Lawn/Gardening . . . . . $__________
   2.11 Maid/Housekeeping . . . . . $__________
   2.12 Pool/Spa . . . . . $__________
   2.13 Homeowners' Association (HOA) . . . . . $__________
   2.14 Maintenance and repair . . . . . $__________
   2.15 Property management services . . . . . $__________
   2.16 Insurance ______________ . . . . . $__________
   2.17 Taxes ______________ . . . . . $__________
   2.18 Other ______________ . . . . . $__________
   2.19 **Total Operating Expenses** $0.00
   2.20 Monthly Loan Payment (Principal and Interest). . . . . $__________
   2.21 Total Monthly Expenses $0.00
3. **DEPOSITS:**
   3.1 Rental security deposit . . . . . $__________
   3.2 Electricity deposit . . . . . $__________
   3.3 Water deposit . . . . . $__________
   3.4 Sewage and rubbish deposit . . . . . $__________
   3.5 Gas service deposit . . . . . $__________
   3.6 Phone service deposit . . . . . $__________
   3.7 Other ______________ . . . . . $__________
   3.8 **Total Deposits** $0.00

OWNER: I have read and approve this information.
Date: ____________, 20____
Owner's Name: ______________________ Signature: ______________________

Date Prepared: ____________, 20_____
Broker: ______________________
CalBRE #: ______________________
Agent: ______________________
CalBRE #: ______________________
Phone: ______________ Cell: ______________
Fax: ______________________
Email: ______________________

PROSPECTIVE BUYER:
I have received and read a copy of this estimate.
Date: ____________, 20_____
Name: ______________________
Signature: ______________________

FORM 306 06-17

Tax components in the sales price

Taxwise, the seller, in discussions with their agent, breaks down the **sales price** into **basis** and **profit,** flip sides of the tax coin. With the profit figure, the agent can determine the income tax liability created by the sale they are negotiating. The short formula for setting profit: *price minus basis equals profit.*

As an economic function, a tax analysis of a property's price contributes nothing to the process for setting the price. It is a lagging event, precipitated as a **consequence of the sale.** Neither a seller's remaining basis nor the profit sought plays any role in setting the market price a buyer may be willing to pay for a property. However, profit does, all too often, play a peculiar role of seller reminiscence. This environment creates a **money illusion**, which frequently distorts the seller's opinion of current market value.

Buyers deciding on a price to pay are not concerned with the seller's **basis and profit.** These are elements of state and federal tax reporting affecting only the seller as a taxpayer when property is disposed of. A buyer never acquires the seller's basis, and a seller's basis (or profit) never aids a seller or buyer when establishing a property's value.

Again, a seller's remaining cost basis in a property is never equal to the remaining mortgage debt. But deducting basis from the net sales price does set the seller's profit.

On acquiring property, its cost basis is established as the total of all the expenditures related to the purchase of the property and the improvements necessary to use it or attract tenants, called **placing the property in service**. During the period of ownership prior to resale, a property's cost basis is adjusted periodically due to depreciation, hazard losses and further improvements.

Taxwise, the cost basis remaining at the time of resale is deducted from the net sales price to determine whether a profit or loss has been **realized** by the seller. Whether the profit realized is taxed, called *recognized,* is a separate issue.

Editor's note — When the purchase price paid for a property includes the equity or net sales proceeds from disposal of §1031 like-kind real estate, the basis in the property purchased is set by the remaining cost basis in the property sold (not its sales price) which is carried forward and adjusted for additional contributions or the withdrawal of money (net cash boot) and differences in the amount of existing debt (mortgage boot) on the properties.

Value altering activities

Additional improvements made by an owner of rental property, sometimes called **sweat equity,** contribute to a property's value when they bring about an increase in rents. Thus, expenditures for the **cost of improvements** are added to the basis in the property. Conversely, expenditures by the owner for upkeep, maintenance, repair, and operations of the property are **operating expenses** deducted from rental income. While operating expenses add nothing to the cost basis in the property, they do maintain — and often increase — the amount the owner can demand for rent. However, the value of the owner's capital interest in the property is often increased by value-creating maintenance they write off and, for a sale, the price increased and with it the profit (the owner's time and effort taxed at a lower rate).

Net cash proceeds from **refinancing** or equity financing which are not used to purchase or improve property do not contribute to the cost basis (or affect the property's value).

The **depreciation allowance** reducing the cost basis represents an annual return to an owner (from rents) of a percentage of their capital contributions allocated to improvements on the property. Accordingly, the **cost basis**, being the total of all capital contributions, is reduced each year by the recovery of capital from rents through the annual depreciation allowance deducted from the NOI to report income or loss from operations.

Chapter 5 Summary

A seller's agent discloses the amount of net proceeds the seller can expect on a closing at the sales price under consideration. To accomplish this pricing disclosure as a critique for sales, the seller's agent initially prepares a seller's net sheet for review with the seller when presenting the listing agreement. The agent's calculations are based on the listing price the agent and seller agree upon for marketing the property.

The seller's profit or loss reported on a sale is always different in amount and unrelated to net proceeds received on the sales price paid by a buyer.

The seller's equity in a property and their profit on a sale are each derived by applying different data to the sales price — the mortgage debt and the seller's cost basis, respectively.

On a sale, debt and basis are never the same. A property's sales price, also considered its market value and the owner's capital interest, is the only term common to all economic analysis regarding ownership of a home, business-use property or investment property (rental real estate and land held for profit on resale).

Market value is the highest price a property will bring in a competitive and open market between a buyer and seller given time to act prudently and knowledgeably. In any real estate transaction, a thoughtful agent gives their client advice on the tax consequences of the sale.

This advice is, of course, limited to what is known by the agent, issues that might cause the client to consider further or different arrangements in a transaction.

Chapter 5 Key Terms

Chapter 6

Income categories set the AGI

Learning Objectives

After reading this chapter, you will be able to:

- identify the three income categories for segregating the income, profit and loss resulting from property ownership;
- apply the rules for offsetting net income and losses in each category; and
- discuss a client's adjusted gross income (AGI) derived from their income category results.

Key Terms

active management

passive income category

passive ownership

portfolio income category

suspended loss

tracking

trade or business income category

The many types of income

To analyze an owner's annual reporting of real estate operations, financing, and sales, it is essential to understand the three income categories for income tax reporting, sometimes referred to as income pots. Each category sets the accounting and reporting procedures for the income, profit and loss incurred by properties classified as within the category. Collectively, income, profit and loss are called **income**. [See Figure 1]

When an agent's estimate of the owner's annual income tax liability is prepared, the owner's income from all sources needs to first be classified as belonging in one of three **income categories**:

- The **trade or business income category –** income from professional trade or owner-operated business opportunities, which includes real estate owned and used to operate the trade or business;[1]

trade or business income category
Income, profits and losses from the taxpayer's trade or owner-operated business, sales inventory, and real estate used to operate the trade or business.

1 Internal Revenue Code §469(c)(6)

passive income category
Income, profits and losses from rental real estate operations and sales, and from businesses not operated by the owner or co-owner.

- The **passive income category** – income and profits from managed rental property investments and business opportunities owned or co-owned but operated by others;[2] and
- The **portfolio income category** – income and profits from management-free investments.[3]

Each income category encompasses a separate classification of real estate based on its type and use for generating income, profit, or loss. The particular vesting employed by the owner or co-owners to hold title does not determine income category. Thus, vesting is not relevant for category classification, unless a C corporation, taxable trust or the estate of a deceased person is the owner-operator. These are taxed separately from their owners who are shareholders and beneficiaries.

For example, the ownership of a **rental** (e.g., the average tenant occupancy exceeds 30 days) by a limited liability company (LLC) is not a trade or business of the LLC or its owners, called members. Each member of the LLC reports their pro-rata share of the income from a *rental operation* as passive category income, since an LLC is a **pass-through entity**, also called a *disregarded entity*.

An LLC is treated as a partnership unless it elects to be taxed as a C Corporation, which eliminates any *pass-through entity* treatment. Thus, as in any partnership, income of an LLC is "passed through" to the members, who are in turn liable for any income tax.[4]

Conversely, property management services rendered by an individual who is a broker on behalf of rental owners constitute a trade or business category activity for the broker. Not so for the owner, as the property is a passive investment no matter who manages it.

Mutually exclusive income for no commingling with losses

The three income categories are mutually exclusive of one another. Simply put, losses from one category cannot be used — **commingled** — to directly offset income or profit in another category. Each category is annually tallied separately to establish the end-of-year income or loss within that category.

The reportable end-of-year *income or profit* within all income categories are, before considering any reportable losses, initially added together to start the process of establishing the owner's **adjusted gross income (AGI)**. The handling of reportable annual loses as an adjustment to AGI is different for each income category.

For a business income category, all **reportable losses** are fully subtracted to reduce the AGI in the year incurred. No limitation or carryforward treatment exists for trade or business losses.

In contrast, *reportable losses* in the passive income category do not automatically reduce the AGI the year they are incurred. Unless the owner

2 IRC §469(c)(1)
3 Revenue Regulations §1.469-2T(c)(3)
4 IRC §701

otherwise qualifies, passive losses are carried forward within the category, allocated only to the properties generating the category loss for use in future years, called a **suspended loss.**

suspended loss
An operating loss incurred on passive income category rental property that is not recognized in the tax year incurred but is carried forward for use in future years to offset operating income or profit on a sale only from the property incurring the loss.

Suspended rental operating losses are deductible in future years when used to offset operating income or sales profit from the property which generated the loss, called **tracking**.

tracking
The separate accounting record of the operating income, expenses, and deductions for each assessor-identified parcel of real estate classified as passive category property.

When a sale of rental property occurs and the suspended loss carried forward is greater than the profits on the sale, the operating loss remaining *spills over* to reduce the AGI. This lack-of-profit situation may exist when a property becomes obsolete or is subject to extensive reduction in local population of renters.

However, and critically, the owner of passive category rental property may write off the loss in the year it occurs when the owner's activities qualify rental losses for either:

- a **real estate related business** loss *adjustment* to lower their AGI; or
- a **$25,000 rental loss deduction** from AGI to lower their taxable income. [See Chapter 7]

The *tracking* of operating income or loss for each assessor-identified parcel of passive category property owned by the taxpayer is unique to the passive income category. No commingling of income from one property with the losses of another property is allowed. With tracking, each separately assessed parcel of rental property the investor owns is accounted for independent of all other parcels of rental property the investor owns, except for multiple ownerships within the same complex or project.

Tracking maintains the integrity of requiring suspended losses to only offset future income or profit from the property generating the operating loss. The tracking requirement does not exist in the business or portfolio income categories.

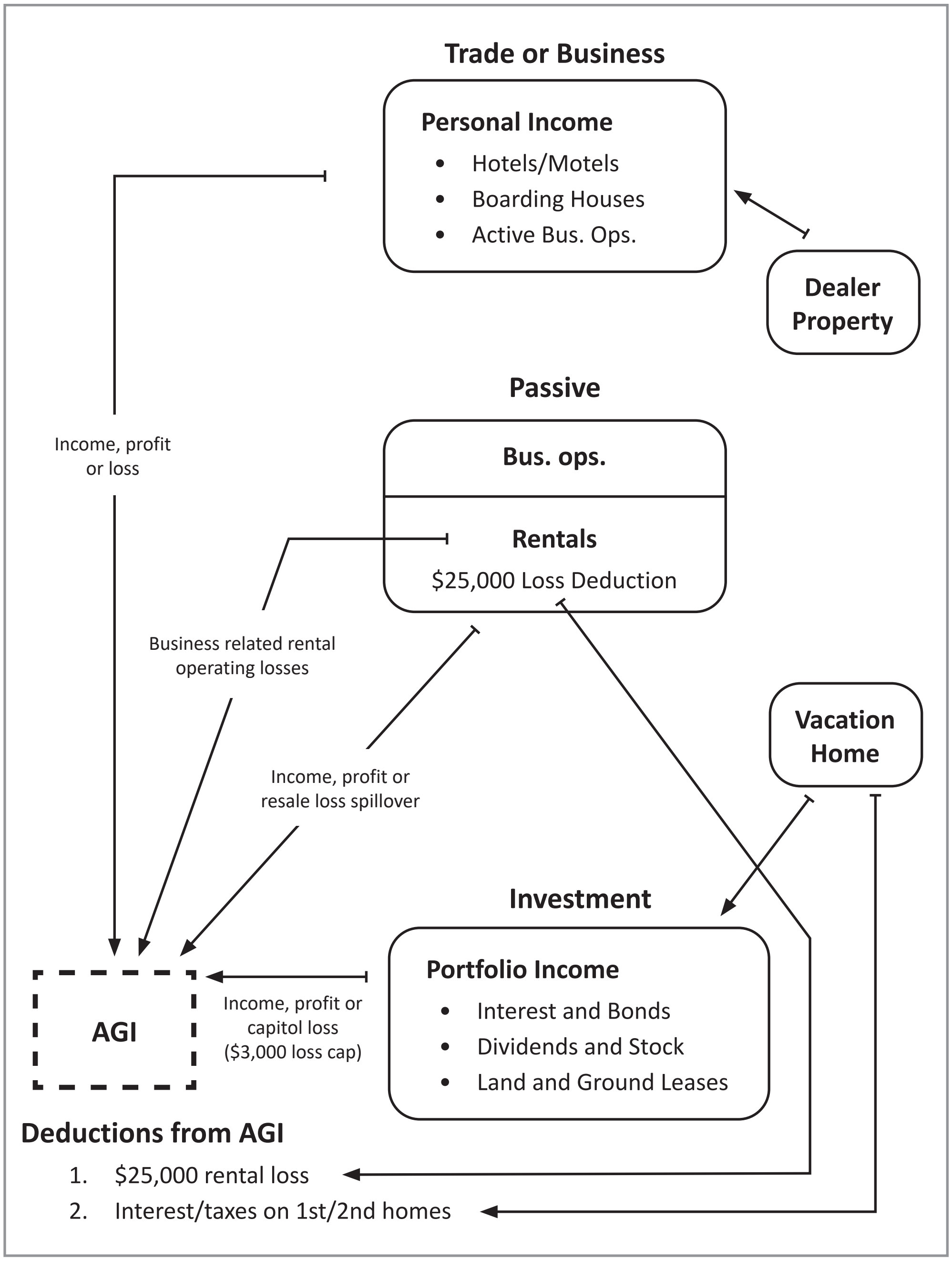
Portfolio losses remain portfolio losses

In contrast, **portfolio investments** — such as management-free income property with net leases and unimproved land held for profit on resale — are batched to calculate the annual income from all properties in the portfolio category. The portfolio category also includes intangibles such as stocks, bonds, and mortgages.

When assets in the *portfolio category* collectively produce an annual operating loss, that operating loss is **carried forward** within the category to offset portfolio category income or profits in future years. An end-of-year portfolio category loss cannot be subtracted to reduce the owner's AGI, but for a $3,000 amount. However, unlike passive income accounting, no tracking of operating losses for each separate property takes place. Portfolio assets are commingled *within* the category for simplified accounting.

Figure 1

Adjusted Gross Income (AGI) Categories



Again, for offsetting between categories, the end-of-year income, profits and losses are first totaled within each category. The totals from each category are then brought together (subject to limitations on passive or portfolio losses) to establish the owner's AGI.

For the owner's agent to analyze and estimate the owner's annual **income tax liability** resulting from a sale of real estate, two major tax components need to be estimated:

- the owner's *AGI,* derived from net annual operating income and sales profits generated within each income category, less permissible losses; and

- the owner's *taxable income*, derived by subtracting from their AGI the owner's itemized or standard personal deductions, exemptions, and any $25,000 rental property operating loss deduction.[5]

The trade or business income category

Trade or business income includes:

- earnings from an individual's trade or business and real estate used to operate their trade or business, including ordinary income from the sale of parcels held in inventory as a subdivider, builder, or dealer;[6]
- income and losses from the individual's business opportunity (sole ownership, partnership, LLC or S corporation) and the real estate owned and used in the business, when the individual is a material participant in the management of the business;[7] and
- income and losses from the individual's owner-operated hotel, motel, or inn operations (sole ownership, partnership, LLC or S corporation) with average occupancies of 30 days or less, when the individual is a material participant in management.[8]

The passive category for rentals actively managed

An individual's income property operations (excluding business category hotels, motels, inns, and portfolio income from management-free net leases), referred to by the IRS as **rental income**, are accounted for within the passive income category.

The passive income category includes:

- rents, expenses, mortgage interest, depreciation from annual operations, and profit and losses from sales of residential and commercial **rental real estate** with an average occupancy of more than 30 days (inclusion of a property's income requires **active management** under rental or gross lease agreements); and
- income or losses from **business opportunities** owned or co-owned, but not operated or managed by the owner or co-owner, called **passive ownership**.[9]

active management
The responsibility of a rental property owner under a rental or gross lease agreement to care for and maintain their rental real estate, needed to qualifying a property's income and expenses to be classified as passive category income.

passive ownership
Ownership of a business without materially participating in its management.

Income received from rental operations is often referred to as passive income. Ironically, for income property to be a rental, and thus reported in the passive income category, the owner needs to be obligated to **actively manage** the property.

To be considered involved in the *active management* of a property, the landlord needs to have some legal responsibility to care for the property under their rental or lease agreements, typically called gross leases. When the landlord has no contractual responsibility for care and maintenance of the property the income property becomes a portfolio category property. This

5 IRC §469(i)
6 IRC §469(c)(6)(A)
7 IRC §469(c)(1)
8 Rev. Regs. §1.469-1T(e)(3)(ii)(B)
9 IRC §469(c)

occurs in a long-term net lease agreement where the tenant agrees to care for and maintain the property and structures and pay all property operating expenses.

And for active management of a rental property, the owner who further qualifies as a *material participant* in its management may write off all rental operating losses for the year against income from all categories. The passive losses written off by a material participant reduce their AGI and, in turn, their taxable income.[10] [see Chapter 8]

The portfolio category

portfolio income category
Unearned income from interest on investments in bonds, savings, stocks and mortgage notes, and income, profits, and losses from management-free net-leased income property and unimproved land held for profit on resale.

Investment income, profits and losses taken by an individual, referred to as **portfolio income** by the IRS, includes:

- interest earned on bonds, savings accounts and secured or unsecured notes (such as carryback trust deeds notes, trust deed loans, and interest on delayed §1031 reinvestment funds);
- annuities, dividends, and royalties from personal property investments (such as stocks, bonds, and commodities); and
- income from the ownership of land subject to ground leases, management-free net leased real estate, and unimproved land held for profit on resale.[11]

10 IRC §469(c)(7)
11 IRC §469(e)(1)(A)

Chapter 6 Summary

Collectively, income, profit and loss are called income. When an agent's estimate of the owner's annual income tax liability is prepared, the owner's income from all sources needs to first be classified as belonging in one of three income categories:

- the trade or business income category – income from professional trade or owner-operated business opportunities, which includes real estate owned and used in the owner's trade or business.
- the passive income category – income and profits from managed rental property investments and business opportunities owned or co-owned but operated by others
- the portfolio income category – income and profits from management-free investments.

Each income category encompasses a separate classification of real estate based on its type and use for generating income, profit, or loss.

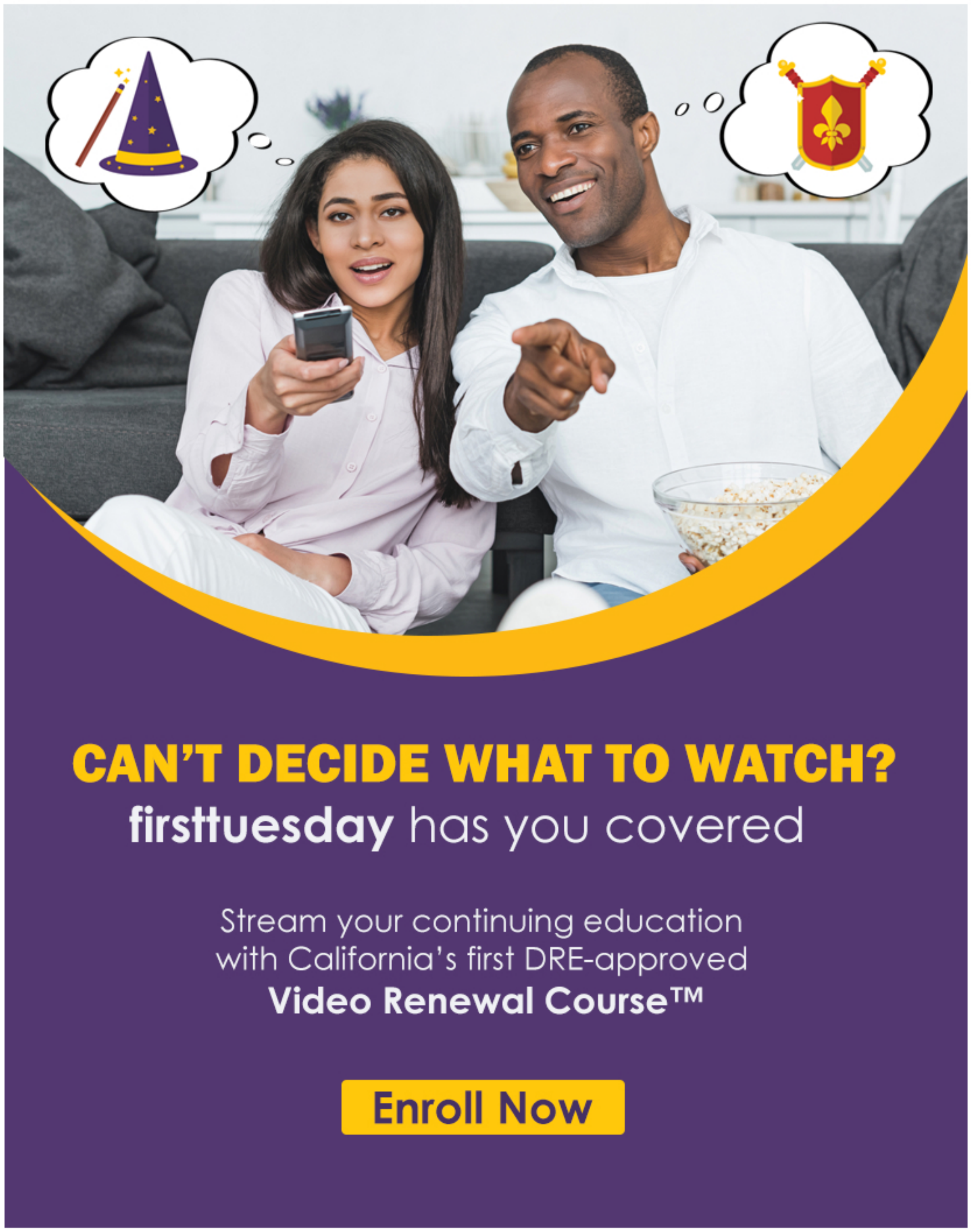
The three income categories are mutually exclusive of one another. Simply put, losses from one category cannot be used to directly offset income or profit of another category.

Each category is annually tallied separately to establish the end-of-year income or loss within that category. The reportable end-of-year income or profit within all income categories are, before considering any reportable losses, initially added together to start the process of establishing the owner's adjusted gross income (AGI).

The handling of reportable annual losses as an adjustment to AGI is different for each income category. Suspended rental operating losses are deductible in future years when used to offset operating income or sales profit from the property which generated the loss, called tracking.

When a sale of rental property occurs and the suspended loss carried forward is greater than the profits on the sale, the operating loss remaining spills over to reduce the AGI. Tracking maintains the integrity of requiring suspended losses to only offset future income or profit from the property generating the operating loss.

Chapter 6 Key Terms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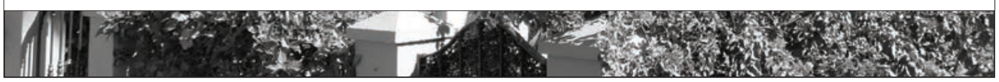
Chapter 7

Avoiding dealer property status



Learning Objectives

After reading this chapter, you will be able to:

- distinguish ordinary income assets, such as dealer property inventory, from real estate classified as investment property or trade or business assets.
- understand how to avoid dealer property treatment for a property sold.

Key Terms

§1031 investment property

alter ego

capital asset

cash-out transaction

liquidation theory

ordinary income asset

trade or business asset

Classification of property based on the owner's use

Real estate held by an owner primarily for investment and profit is classified as a **capital asset**. *Capital assets* include real estate:

- actively operated as a rental property investment, a passive income category property;
- held as a management-free investment for income or profit, a portfolio income category property; and
- the owner's principal residence, a portfolio category property.[1]

Capital assets do not include trade or business assets or inventory. Property classified as a **trade or business asset** includes real estate:

- used to house or facilitate the operation of a trade or business;
- qualified for depreciation when improved; and
- owned for more than one year.

capital asset
Real estate held by an owner as their principal residence or for investment, excluding properties held as inventory for sale to customers or for productive use in a trade or business.

1 Internal Revenue Code §1221

trade or business asset
Real estate used to house or facilitate the ongoing operation of a trade or business.

Capital assets, excluding a principal residence and *trade or business assets,* are also classified as **investment properties** which qualify as like-kind property for §1031 profit exemption treatment. The sole distinction between §1031 investment property and §1031 trade or business property is that property used in the operations of a business is subject to a one-year holding period before it qualifies as **§1031 property**.

§1031 investment property
Business-use and investment real estate which qualifies the owner to exempt profit realized on its sale from income taxes by acquiring like-kind property in a §1031 reinvestment plan.

Real estate which qualifies as §1031 property, whether held for investment or for productive use in a business, may on the sale of the property be replaced without taxation of profit by the acquisition of other §1031 property — rather than cashed out — called a §1031 reinvestment plan. Participation in a §1031 reinvestment plan by the seller of §1031 property exempts the profit realized on its sale from taxation.[2]

On the other hand, real estate held as inventory for sale to customers of the owner's trade or business is an **ordinary income asset**, more commonly called **dealer property**.[3]

ordinary income asset
Real estate held by an owner primarily as inventory for sale to customers in the ordinary course of the owner's trade or business, called dealer property.

An *ordinary income asset* typically includes inventories bought and actively sold for income in a business. **Inventory** includes:

- properties actively managed as subdividable land;
- lots sold in cash-out sales by a developer (versus a carryback sale); or
- properties acquired by an individual with the intent to routinely resell them rather than hold for long-term investment purposes.

Ordinary income assets are properties acquired with the intent to resell them as an ongoing buy-and-sell transactional activity. Typically, this buy-and-sell conduct involves flipping properties acquired at foreclosure sales or short sales, or in a market driven by momentum.[4]

When *dealer property* is sold at a price exceeding its cost the owner receives taxable ordinary income. Dealer property is inventory, not a capital investment, and its turnover by sale at a price exceeding costs generates ordinary income, not profits. Earnings from properties the owner intends to resell in an ongoing entrepreneurial activity do not constitute capital gains. Dealer property and other inventory items sold as merchandise in a trade or business are not classified as §1031 like-kind property.[5]

In a tandem result, dealer property sold on credit in a seller-financed carryback sale does not qualify for installment sale **deferred reporting** of profit since earnings on the sale of inventory produce ordinary income, not capital gains. Thus, ordinary income is reported and taxed in the year the carryback sale closed, with exceptions for deferral of ordinary income on the carryback sale of:

- farms;
- vacant residential lots; and

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2 IRC §1031
3 IRC §64, §1231(b)(1)(B)
4 **Little** v. **Commissioner of Internal Revenue** (9th Cir. 1997) 106 F3d 1445
5 IRC §1031(a)(2)

- short-term time shares.[6]

Conversely, the profit taken on a carryback sale of investment or business property is prorated and allocated between the amount of cash sales proceeds and the principal amount of the carryback note. The remaining cost basis in the property sold is likewise prorated. The taxation of the profit allocated to the note's principal is deferred, leaving calculation of the tax liability to future years when principal on the note is received.[7] [See Chapter 16]

cash-out transaction Selling a like-kind §1031 property without a concurrent reinvestment plan for acquiring a like-kind §1031 replacement property to exempt profit realized on the sale from taxes.

Typically, IRS challenges asserting dealer property treatment arise when an individual sells multiple properties in a recurring process structured as **cash-out transactions** rather than as a continued investment in replacement real estate in the form of a §1031 reinvestment plan.

Dealer property vs. investment or business assets

Whether real estate is dealer property or an investment or business asset depends on the circumstances existing throughout the entire period of ownership, from the purchase to the ultimate resale of a property.

Also, the ownership of property vested as an individual's is analyzed differently for dealer property status than the ownership vested in an entity (LLC, limited partnership, or corporation) co-owned as a syndicated investment by two or more individuals. When an entity is the vested owner of a property, such as land held for investment, the *entity's intentions* and conduct during its ownership are tested using the factors which determine dealer property status.

Individuals who benefit from the entity's earnings do not own the property, though they certainly control its activities. With a separate vesting, an individual's business activities with dealer or investment property are not at issue when establishing the entity's intentions and conduct.

Properties managed by the owner as dealer property

Ownership factors which distinguish dealer property from investment property include:

- the owner's intentions when acquiring the property (to either cash out/profit on its resale as soon as possible or hold it as a long-term investment opportunity for income);
- the owner's intentions as manifested while owning and operating the property;
- the duration of ownership period before advertising or listing the property for sale;
- use of the property at the time of sale;
- the frequency, continuity, and substance of the vested owner's sales of other properties;

6 IRC §453(l)
7 IRC§§453(b)(2)(A)

- the extent of advertising for buyers, listing the property for sale, other promotional sales activities, and earnings from the sale of similar properties by the owner;
- the time and effort devoted to the sale of the property by the owner;
- the extent of subdividing, construction of improvements, planning, zoning efforts, arranging to bring in utilities, etc. for the property; and
- the nature and extent of the owner's regular business as related to the sale of the property.[8]

The initial takeaway: No single factor is conclusively for or against dealer status. The frequency and substantiality of the owner's sales of comparable properties play the most important role. Is the owner in the business of selling this type of real estate to cash-paying customers?

For example, an owner sells several single-family residences (SFRs) in cash-out sales over an extended period of time. Each property sold was held by the owner for a relatively short period of time. Here, the real estate is more likely to receive dealer status — since it resembles inventory sold to consumers — rather than be classified as property held for income or as an appreciable investment (no-sweat equity enhancement) before a cash-out sale occurs.[9]

The more frequently the owner demonstrates they intend to buy, build (or renovate) and sell property for a quick cash sale, the more likely real estate sold under these conditions will be considered dealer property. Think flipping as an occupation. [Little, *supra*]

Conversely, when an owner intends to buy, build, and maintain a continuing investment in real estate for a period of years, the real estate is a **capital asset**. Its resale for cash after a few years of ownership qualifies the earnings on the sale to be reported as profit, not ordinary income.

Again, the dealer property issue arises only on a cash-out or carryback sale of the property. The dealer property taint is eliminated when proceeds from the sale are reinvested in a §1031 reinvestment plan. Buying like-kind replacement property continues the owner's investment in real estate.

The intended purpose for acquiring a property

An individual's **original motivation** for purchasing a property is one of the factors used to classify the property as either a capital asset or inventory.

For example, a trust deed (TD) investor bids at a foreclosure sale to acquire title to property on which they hold a trust deed. As the high bidder, the investor becomes the owner. The property consists of two or more parcels. The TD investor as the new owner decides to sell the property as individual parcels in a piecemeal disposition. The sale of parcels separately is their best way to receive the highest price to recover cash on a failed trust deed investment.

8 **Mathews** v. **Commissioner of Internal Revenue** (6th Cir. 1963) 315 F2d 101

9 **Suburban Realty Company** v. **United States** (5th Cir. 1980) 615 F2d 171

The TD investor's primary plan was to foreclose, acquire the property if the high bidder, then resell the property to liquidate their security interest under the trust deed lien they held on the property. Thus, they avoid operating lender-owned real estate (REO) properties.

Does the sell-off of the real estate as separate parcels mean the real estate was held as dealer property?

No! The trust deed investor's intention on acquisition of the property was to protect and preserve their security interest in the property represented by the trust deed they held. The investor promptly resold the property to obtain cash and remain as an investor in trust deed notes, not to acquire real estate for resale to consumers.[10]

Ownership intentions and management of a property

Use of real estate during the period of ownership is likewise a significant indication of the property's status as inventory or an investment or business asset when it is sold.

For example, a builder buys a parcel of real estate and constructs an apartment complex on it. The property now produces income for the builder, who takes depreciation deductions.

After owning and operating the apartment, the builder sells the property and acquires a larger complex as a replacement property in a §1031 reinvestment plan.

Here, the real estate built and sold is a capital asset, not dealer property. The builder's purpose at both the time of purchase and throughout their period of ownership is evidence of their intent to buy, build and operate the property as an income-producing investment.

Most importantly, the seller **reinvested** the net sales proceeds from the sale to acquire a like-kind §1031 property as a replacement. They did not cash out and use their net sales proceeds to buy land, construct improvements and sell the completed project to replicate the trade or business of a developer and builder.

That the builder constructs improvements on the property to alter or enlarge its use does not throw the property into the dealer category without more evidence of dealer activity, such as its early liquidation in a cash-out sale.[11]

When an owner continuously buys, constructs improvements and sells the properties after they attain the level of occupancy necessary to successfully market them and cash out, the real estate is dealer property. The improvement and sale of properties as a source of annual earnings constitutes inventory available for purchase by customers of the builder's trade or business.[12]

Tract development of lots and construction of residential property for sale to the public are classic dealer property situations. In contrast, an owner who

10 **Malat** v. **Riddell** (1966) 383 US 569

11 **Heller Trust** v. **Commissioner of Internal Revenue** (9th cir. 1967) 382 F2d 675

12 **Bush** v. **Commissioner TC Memo** 1977-75

acquires real estate as a rental investment expends little time and effort to sell it compared to the time they spend actively managing their ownership of it. By the time they cash out and realize a profit, the period of management by the owner compared to the short marketing effort demonstrates the property is held as a capital asset for operating income, not as inventory to generate earnings by selling it.

Dealer income is derived from the activities of a business, such as continuously acquiring properties in foreclosure or at foreclosure sales, fixing them up or refinancing the debt, then "flipping" them in a resale as soon as earnings can be realized.

With flipping, the owner's earnings are mostly derived from improvement or activities to cure deferred maintenance or obsolescence to prepare the property for resale. The property's value increased due to the owner's value-adding activities. The increased value was not due to asset inflation and local appreciation which flow to a property owned and operated over the long haul.

Acquired to resell and reinvest

Consider an investor who acquires ownership of a property at a price significantly below current market value or in a §1031 reinvestment plan. The property was acquired under one of the following purchase arrangements:

- the exercise of an option to purchase or a right of first refusal held by the investor;
- the liquidation of a development corporation owned solely by the investor;
- a purchase agreement with a distressed seller; or
- as a §1031 replacement for property the investor sold after years of depreciation deductions.

Before acquiring the property, the investor determines they are unwilling to retain ownership and the property will be resold quickly in its condition at the time of purchase. The investor lacks the ability (or willingness) to finance their long-term ownership or to develop the property to its highest and best use and increase its value. Thus, the investor takes a profit resulting from their low-cost basis compared to current market value.

To accomplish a prompt resale, the investor lists the property for sale with their broker, who originally assisted them in the purchase of the property. Importantly, the listing states any purchase agreement entered into is to be conditioned on locating and acquiring suitable replacement property for a §1031 reinvestment.

The broker locates a buyer willing to purchase the property on listed terms and conditions. Within a few months after the owner enters into an agreement to sell the property, the broker locates an investment property suitable for the investor to acquire. As a result, the owner closes the sales escrow based on instructions calling for the investor's net sales proceeds to be made payable and delivered to either a purchase escrow they have opened to acquire a replacement property or a §1031 trustee. The contingency calling for the purchase of other property is waived. [See **RPI** Form 172-2]

Escrow closes. The investor has accomplished their goal by completing the prompt resale of the property they decided not to keep as a long-term investment, realizing a profit on its resale as intended.

After closing the sale and within 180 days, the investor acquires ownership to a replacement property they had identified prior to expiration of the 45-day §1031 replacement property identification period.

The investor reports the two transactions on their tax return for the year of the sale, a requirement, as a reinvestment of their net sales proceeds from the sale of §1031 property "held for investment." They report the profit realized on the sale was exempt from taxation under IRC §1031.

When a property is owned for a very short period of time, and held from the moment of acquisition with the intent to sell it for a profit and use the sales proceeds to buy a replacement property, does the property sold qualify as §1031 property? Is the profit realized exempt from tax reporting?

Yes to both! The investor both owned and possessed the property and did not construct improvements from the moment they closed escrow on its purchase. Further, and most importantly, they **reinvested** the sales proceeds in §1031 real estate and did not liquidate their investment in the real estate by cashing out on the sale. Thus, the property sold was not part of a business conducted to sell property to customers. It was to continue owning real estate, just not the property the investor had acquired and deemed unacceptable to retain.

§1031 property has no holding period

To be §1031 properties, the investor needs to have held the property sold and to hold the property purchased:

- for investment (either passive or portfolio income category property); or
- for productive use in a trade or business, qualifying as §1031 property on holding ownership for one year.

In a §1031 transaction, investment property ownership has no **holding period** before it may be sold or exchanged to qualify as §1031 like-kind property. To hold property which qualifies as §1031 like-kind property requires the person selling and conveying it to merely own and possess the property for any length of time.

The requirement that §1031 property be owned for investment purposes is satisfied by:

- avoiding a cash-out sale, called *liquidation*; and
- reinvesting the sequestered net sales proceeds by the timely identification and acquisition of like-kind property.

The required continuation of an investment in real estate necessary to qualify for the §1031 profit tax exemption is manifested by acquiring ownership of a replacement property with the intent to make money as its owner, called investment real estate.[13]

Segregating investment property

Consider a real estate dealer who maintains a business of buying and selling real estate for their own account. They now want to qualify the profit taken on the sale of some properties they own for capital gains treatment. The properties are rentals and have been held as investments.

To be considered capital assets, the properties need to have been **segregated** in all manner possible from their dealer inventory. To meet this objective, it is helpful that the investment properties are a type distinguishable from their dealer property inventory, e.g. single family residence (SFR) inventory vs. apartments or commercial properties or land. Segregation begins at the time a property is acquired by taking steps to establish ownership activities consistent with a long-term investment property.

To this end, dealer properties the operator acquires are vested in the name of an entity solely owned by the dealer, such as an LLC, limited partnership, corporation, or brokerage DBA ("doing business as"). On the other hand, title to rental and investment properties are vested in the owner's name or the name of a separate LLC formed solely with the stated purpose in the LLC's operating agreement to hold title on acquisition of investment property.

To further support the segregation of titles and accounting, the operator needs to hold ownership of the investment properties for several years before their sale, not just the one year holding period threshold required to convert the earnings on the sale of a capital asset from short-term to long-term capital gains — profit taxed at differing rates.

Improvements which increase the market value of the property are to be made when the property is acquired or during the early period of ownership, if at all. When improvements are made at or near the time of resale, the seller appears to have made them in contemplation of a sale, with the intent to convert ordinary income from construction efforts (or sweat equity) into profits for capital gains treatment. Recent property improvements subject the property to dealer property status.

Meanwhile, the dealer continues to actively market their dealer properties for sale in their real estate business. In contrast, the investment properties are not listed for sale, not marketed for sale, and in no way held out for sale until obvious investment intent has been established. When the properties are sold, the net proceeds are reinvested in replacement properties as a **continuing investment** in real estate under a §1031 reinvestment plan. Reporting the sale of a property and purchase of a replacement property for a §1031 exemption from profit taxes demonstrates the properties were treated as capital assets.

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13 **Bolker** v. **Commissioner** (9th Cir. 1985) 760 F2d 1039

Separate bank accounts, accounting records, business entities (for vesting) and management records also help distinguish property held for investment purposes from those held as dealer inventory.

The liquidation theory for capital gains treatment

Consider an owner who advertises to locate a buyer to acquire property the owner held for investment. Here, any staging of the property needed to successfully market and sell it does not automatically deny capital gains treatment when the history of ownership demonstrates it has been held for investment.

A **liquidation theory** provides an exception to the rule prohibiting an owner's time and effort spent improving or developing investment property so it may be disposed of (which normally produces ordinary income) to be converted into profit for capital gains treatment.

liquidation theory
When, to facilitate the sale of investment property, the owner develops it only as necessary to cash out their capital interest in the property and still qualify the profit for capital gains treatment.

The subdivision of land or buildings into lots or units, the construction of minor capital improvements, sales promotion or frequent and continuous sales will not result in dealer status for a property when:

- the owner's original investment intention or business use of the property has been established;
- the owner's developmental activities are reasonably necessary for an orderly disposition of the property; and
- the development, improvement and promotional actions are not excessive as the minimum activities necessary to dispose of the property.[14]

To apply the *liquidation theory* to the sale of an investment or business use property, the owner needs to avoid a level of activity that may be characterized as having the sole purpose of increasing the property's market value rather than simply making the property marketable. These efforts may be improvement activities such as the conversion of a building by simply mapping it as a condominium subdivision and concurrently selling off individual units without also upgrading or adding amenities or other renovation. Liquidation activities are simply basic necessities required to induce a buyer or buyers to acquire the property through piecemeal disposition when no market for the property otherwise exists.

Development and promotional activities beyond those necessary to fully realize a property's inherent investment value —- the owner's capital interest in the property — will jeopardize treatment of profit as a capital gain.

Use of semi-independent developers

Consider the owner of a parcel of real estate with a final subdivision map. The owner enters into an agreement with a building contractor to develop and promote the sale of finished lots. The owner retains title to the property, but supplies all construction funds the builder needs to complete the

14 **Oace** v. **Commissioner** (1963) 39 TC 743

grading and offsite improvements. On completion of the grading and offsite improvements, the lots are sold. The owner conveys title directly to buyers and cashes out.

The builder never holds title but performs all construction work and conducts all marketing activities. Under the joint venture agreement, the owner receives a set dollar amount as the price for each unimproved lot and a return of the construction funds advanced with interest. The remainder of the sales proceeds goes to the builder.

The owner claims their conduct avoids dealer status for the property since the owner did not personally perform any value-increasing activities and the risk of added value due to the improvements was with the builder.

Here, the builder is acting as the owner's agent, whether under contract or a joint venture, partnership, or other profit-sharing arrangement. The dealer activities of an agent or partner are imputed to their principal or partner — here the owner of the property. Thus, the development of property for sale to costumers is inventory in the hands of the owner – dealer property – due to the conduct of the owner's agent barring earnings from sales to qualify for capital gain treatment.[15]

Use of a controlled corporation

A better method for ensuring a property the owner intends to develop and sell qualifies as a capital asset is to sell the property to a corporation controlled by the owner.

An owner sells investment property to their controlled corporation at a price that includes a profit for the owner. The profit is reported and taxed as a capital gain. The corporation on acquiring title to the property undertakes the development and promotes the sale of developed parcels to members of the public. The property, by its improvement to create additional value, is dealer property.

The corporate business is to earn income from construction done solely for the purpose of immediately reselling property. The net income realized by the corporation, however, is limited by its high cost basis in the property, a result of the corporation's purchase of the property from the owner.

In these arrangements, the corporation needs to be adequately capitalized by the issuance of stock (for cash), purchase-assist financing or a construction loan. It may not be a shell used to provide the owner with limited liability for the risks of construction and borrowing.[16]

Any corporate stock issued to the owner must be for consideration other than the property they have sold to the corporation, such as cash. The stock may not be issued in payment for any portion of the sales price of their property (which is an IRC §351 tax exempt exchange).

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15 **Pointer** v. **Commissioner** (1969) 419 F2d 213

16 **Bradshaw** v. **U.S.** (1982) 683 F2d 365

When the corporation is wholly owned and controlled by the property owner, or corporate formalities are ignored, the corporation is arguably the owner's **alter ego**. Earnings by an *alter ego* corporation from the development of a property are attributed to the owner. Thus, the two-step transaction (sale and development/resale) is collapsed into one ownership activity and all earnings are taxed as the owner's self-employment trade or business income.

alter ego
A corporation or LLC whose earnings and assets are used directly for the personal advantage of its owner, resulting in insufficient separation between the owner and the corporation or LLC to shield the owner from personal liability for the entity's debts.

Corporate formalities, such as shareholder meetings and meetings of the board of directors, need to be carried out regularly.

Also, the purchase price paid by the corporation for the yet-to-be-developed property needs to reflect the property's current appreciated value — the owner's capital interest in the property before development — not the value to be added by any future development and promotional activities of the corporation. An excessive sales price — exceeding the value set by an appraiser of the undeveloped property — may result in the owner being charged with receiving the increase in value brought on by development. Thus, the corporation will be characterized as the owner's agent, and its activities imputed to the owner to disallow capital gain treatment.

Once the property is developed, the corporation receives, reports, and pays taxes on the ordinary income generated by the improvements and promotionally increased value of the property. The owner does not report any part of the sales price paid by the corporation for their property as ordinary income. Conversely, any income they receive from corporate development activities is for holding stock they acquired by investing cash in the corporation.

Chapter 7 Summary

Capital assets are real estate held by an owner primarily for investment and profit and do not include trade or business assets. Real estate held as inventory for sale to customers of the owner's trade or business is an ordinary income asset, more commonly called dealer property.

Inventory includes:

- properties actively managed as subdividable land;
- lots sold in cash-out sales by a developer (versus a carryback sale); or
- properties acquired by an individual with the intent to routinely resell them rather than hold for long-term investment purposes.

Whether real estate is dealer property, or an investment or business asset depends on the circumstances existing throughout the entire period of ownership, from the purchase to the ultimate resale of a property. No single factor is conclusively for or against dealer status. The frequency and substantiality of the owner's sales of comparable properties play the most important role. An individual's original motivation for purchasing a property is one of the factors used to classify the property as either a capital asset or inventory.

Chapter 7 Key Terms

Chapter 8

Mortgage interest write-offs on business and investment properties

Learning Objectives

After reading this chapter, you will be able to:

- apply the different interest expense and deduction rules peculiar to each income category for the reporting of interest paid on a mortgage; and
- discuss when mortgage interest is expensed or deducted.

Key Terms

aggregating	**net investment income (NII)**
capital expenditure	**paid and accrued rule**

Mortgage funds used to purchase, improve, or carry costs

A **paid and accrued rule** requires interest an owner pays on a mortgage to accrue before it may be written off against income. Prepaid interest may not be written off until the year it accrues.[1]

The only exception to the *paid and accrued rule* applies to points paid for mortgages which funded the purchase or improvement and encumber the borrower's principal residence.[2] [See Chapter 2]

The mortgage interest write-off rules are concepts based in part on the subtle accounting distinction between whether interest, when written off, is **expensed** or **deducted** from some or all income within a category. For example, interest accrued and paid on a mortgage which funded a trade or business category property is *expensed* from total income within the category as a business operating item to establish the net operating income (NOI) for the business.

paid and accrued rule
Interest paid on a mortgage needs to accrue before it may be expensed or deducted from income.

For passive category rental property mortgages, interest accrued and paid is *deducted* only from the encumbered property's NOI due to *tracking*. It is not an expense incurred to operate a rental property. For mortgages which funded a portfolio category property, interest accrued and paid is *deducted* from the portfolio category's net investment income (NII) after the NII has been established, the same treatment as the interest deduction from a rental property NOI.

A property owner's ability to write off interest involves questions about the tax treatment of interest, including:

- Which expenditures incurred on a mortgage constitute the payment of interest?
- Which property's income or when category income may be offset by the payment of interest?
- What other income is offset by a net operating loss caused by the payment of interest?

Points upfront as prepaid interest

An investor or business owner pays a lender charges to originate a purchase-assist mortgage. To pay the mortgage origination charges, the investor or business owner has three available sources:

- funds they hold as the buyer;
- funds accruing to the seller on the sale of the property; or
- a discount or addition by the lender to the principal amount of the mortgage.

Recurring and non-recurring charges an investor pays on a mortgage include:

- mortgage origination fees and closing costs;
- points; and
- interest.

The fees and costs a buyer pays to originate a mortgage are non-recurring costs. They are incurred to acquire capital to fund the purchase or improve property, called **capital expenditures**.

capital expenditure
An expenditure incurred to fund the purchase, improvement, or carrying costs of real estate.

As costs of acquisition or improvement, *capital expenditures* incurred to originate a mortgage are added to the buyer's cost basis in the property, a treatment called *capitalizing*. The expenditure is a cost incurred to acquire funding to buy the property, not to operate it.

As capitalized, acquisition costs are added to the property's cost basis and recovered by the buyer as a tax-free return of invested capital through:

- a depreciation allowance taken by the owner annually over a capital recovery period as an operating expense from gross income or deduction from net operating income; or
- a deduction from the net price received on a sale of the property for any cost basis remaining to determine profits on the sale.[3]

3 **Lovejoy** v. **Commissioner** (1930) 18 BTA 1179

In contrast, mortgage points are a prepaid interest charge. The amount of the points represents the *present worth* of a portion of the total interest otherwise paid by the owner over the life of the mortgage at the par rate of interest when originated. [IRC §461(g)]

To write off interest prepaid up front as points, a pro rata amount of the points is written off annually over the life of the mortgage as it accrues. An exception exists for points paid on mortgage funds used to purchase or improve a **principal residence.** The homebuyer may deduct from their AGI the entire amount paid as points in the year of purchase. [See Chapter 2]

The payment of points —regardless of who paid them — is treated the same as any other prepaid interest. The portion of prepaid points accruing annually is written off against income.

To avoid a conflict with the lender's annual 1098 interest paid filing, an owner reports the points separately from the reporting of other interest payments.

Economically, the interest write off shifts liability for income taxes from the property owner to the mortgage holder for the portion of the mortgaged property's income used to pay interest.[4]

Since mortgage points are written off prorate as they accrue over the life of the mortgage, a cash-poor buyer, such as a first-time homebuyer, might logically negotiate to add the points to the mortgage balance, amortized and paid in future years when personal income is higher. Thus, the buyer retains their cash for another day. The adding of points to the mortgage balance is either directly by the lender or indirectly by the seller kicking back the amount from the purchase price funded by the lender.

The use of mortgage funds controls expensing or deducting

Interest paid and accrued on a mortgage does not directly offset the owner's personal income. The source of income offset by writing off mortgage interest payments is determined by the income category of the property purchased, improved or carried by the mortgage funds.

To write off the payment of mortgage interest, the mortgage proceeds need to be used in connection with a property in one of the three income categories: the trade of business income category, passive income category, or portfolio income category.[5]

Mortgage proceeds may be used to fund:

- property acquisition;
- property improvement;
- carrying costs of ownership; or
- refinancing an existing mortgage.

The expenditure of mortgage proceeds to accomplish *personal objectives* disqualifies interest payments as a write off against any income. However, an exception exists for interest paid on mortgage funds used to purchase or improve a first or second home. [See Chapter 1]

4 26 CFR §1.163-8T(a)(4)

5 26 Code of Federal Regulations §1.163-8T(c)

Occasionally, the only connection a property has with a mortgage is to provide security for funds advance to pay for obligations unrelated to the property. Here, the mortgage proceeds do not fund a *use connected* with the secured property. To determine the income category in which the interest may be written off, identify the property purchased, improved or refinanced using the mortgage funds.

Rental property interest deductions

Interest paid on a debt — such as a mortgage that funded the purchase, improvement or carrying costs of rental property — is *deductible* only from the NOI produced by the rental property purchased, improved, or carried by the mortgage funds. Interest, along with depreciation, is deducted annually from the rental property's NOI to establish the property's reportable operating income or loss. The debt may be unsecured, or it may be secured by any property including the owner's personal residence or second home.[6]

To deduct interest from a rental property's NOI, the mortgage proceeds or carryback debt need to be *used in connection* with the property.[7]

Interest is *deductible* annually from a rental property's NOI based on the percentage of the mortgage proceeds or principal in a carryback note used to fund:

- the purchase of the rental;
- the improvement of the rental;
- the carrying costs of operating the rental, called negative cashflow property; or
- the refinancing of the principal balance remaining on existing mortgages which funded the purchase, improvement or carrying costs of the property.[8]

While deducted from NOI, passive category interest deductions are not limited to the amount of the property's NOI. Thus, interest deducted from the NOI may bring about an annual reportable loss for ownership — even more likely when added to amounts of capital recovered by the depreciation deduction.

Interest paid on debts used in connection with a rental property is fully deductible from the property's NOI. When the interest amount deducted exceeds the NOI, a reportable loss is incurred on the property.

Further, an annual reportable loss resulting from rental property ownership offsets reportable operating income from other passive category assets. The sum of the reportable operating income and losses of all assets within the passive income category is the category's total income. Totaling profit or loss for the year from all sources within the passive category is called **aggregating**.

aggregating
Combining the reportable operating income and losses from all sources within the passive income category.

6 **Alexander** v. **Commissioner**, TC Summary Opinion 2006-127
7 26 CFR §1.163-8T(c)
8 IRC §163(h)(2)(B)

Portfolio category investment property interest deductions

Interest paid on mortgages used to fund the purchase, improvement, or carrying costs of *portfolio properties* is deductible from investment category income.[9]

In application, interest paid on mortgages and carryback notes which funded the purchase, improvement or carrying costs of portfolio category investments, such as land held for profit and management-free, net-lease income property, is written off as a *deduction* from **net investment income (NII)**. As a result, mortgage interest offsets interest earned on savings accounts, trust deed notes or bonds, stock dividends and profits and rents from ground leases to lower reportable income in the portfolio category.[10]

net investment income (NII)
Income less expenses related to portfolio category assets. For real estate investors, this includes income, profits and losses from the operations and sales of management-free, net-leased rental property, land held for profits on resale, and interest-bearing assets.

Annual portfolio reportable losses may not be used as an adjustment to reduce the investor's AGI. Like suspended losses in the passive income category, portfolio operating losses are carried forward but unlike suspected losses offset any portfolio income in future years. However, portfolio losses do not offset income or profits from the business or passive income categories.[11]

Further, portfolio operating losses are not tracked like suspended losses, which limit use of the suspended losses to offset future income only from the property which generated the suspended loss.[12]

The NII for portfolio category reporting is the sum of gross income less expenses. Interest accrued and paid, and any property depreciation allowance are not expenses incurred by portfolio investments. They are deductions from the NII to determine the portfolio income or loss for the year.[13]

Trade or business interest expense

In an owner's trade or business, interest paid on mortgages used to purchase or improve property, conduct the business, or carry real estate held or used in the business is a business expense. Here, as a cost of doing business, interest accrued and paid is subtracted — expensed — from gross income to reduce the NOI of a business operation.

Interest paid in a business is not a deduction from NOI as it is for mortgages on passive category and portfolio category investment properties. There, mortgage interest is treated as an expense of capital borrowed to purchase an investment. For a business, borrowed money represents the business's working capital to maintain inventory and receivables.[14]

Business operations include the use of real estate in the production of business income unlike ownership of a rental property which itself generates income in the rental market. No limitations or ceilings are imposed on the amount of interest charges a business may expense — unlike suspended losses on passive category property and reportable losses carried forward in the portfolio category, brought on by interest write-off limitations.

9 IRC §163(d); 26 CFR §1.163-8T(a)(4)(i)(E)
10 IRC §163(c)
11 **Talchik** v. **Commissioner** TC Memo 2003-342
12 IRC §163(d)(2)
13 IRC §§163(d)(4), 469(e)(1)(A)(i)(III)
14 26 CFR §1.163-8T(a)(4)

Finally, any aggregate trade or business category loss reduces the owner's AGI without limitation. When a business loss exists, the entire business loss offsets other income and profits reported in the passive and portfolio categories for the year to establish the owner's AGI.[15]

15 IRC §163(h)(2)(A)

Chapter 8 Summary

The mortgage interest write-off rules are concepts based in part on the subtle accounting distinction between whether interest, when written off, is expensed or deducted from some or all income within a category.

A property owner's ability to write off interest involves questions about the tax treatment of interest, including:

- Which expenditures incurred on a mortgage constitute the payment of interest?
- Which property's income or when category income may be offset by the payment of interest?
- What other income is offset by a net operating loss caused by the payment of interest?

Interest paid and accrued on a mortgage does not directly offset the owner's personal income. The source of income offset by writing off mortgage interest payments is determined by the income category of the property purchased, improved or carried by the mortgage funds.

To write off the payment of mortgage interest, the mortgage proceeds need to be used in connection with a property in one of the three income categories: the trade of business income category, passive income category, or portfolio income category.

Chapter 8 Key Terms

aggregating .... **pg. 70**
capital expenditure .... **pg. 68**
net investment income (NII) .... **pg. 71**
paid and accrued rule .... **pg. 67**

Chapter 9

Depreciation deductions mature as an unrecaptured gain tax

Learning Objectives

After reading this chapter, you will be able to:

- advise clients on the purpose of depreciation deductions allowed an owner of improved property to withdraw invested capital from income;
- explain the distinction between the two classes of profits taken on a sale of improved property; and
- discuss the unrecaptured gain an owner takes on the sale of improved property and reports as taxable due to depreciation deductions.

Key Terms

annual property operating data sheet (APOD)

appreciable asset

depreciation

depreciation deduction

depreciation schedule

property appreciation

Cost of improvements recovered: a return of invested capital

Owners of improved investment property or property used in a trade or business annually recover a portion of the acquisition and improvement costs they allocate to the improvements as a write off against operating income. The annual recovery is called a **depreciation deduction.**

The deduction is an allowance for the decline in a property's value — the owner's *capital interest* — brought on by age, physical deterioration, or functional or economic obsolescence of its improvements.[1]

1 Internal Revenue Code §167(a)

depreciation deduction
The annual before-tax withdrawal from income, deducted from the NOI of a rental property, expensed from trade of business income, or deducted from the NII for portfolio investments, to provide a return of invested capital allocated to property improvements which reduces the owner's cost basis in the property. To be distinguished from a return on capital.

depreciation
Loss of property value brought on by age, physical deterioration, or the functional or economic obsolescence.

property appreciation
The portion of the increase over time in a property's market value exceeding the rate of inflation.

Depreciation deductions from income is both:

- an investment fundamental; and
- a tax reporting activity.

Depreciation is often conceptualized by investors and their brokers as converting a portion of a property's NOI into tax-free *spendable income* — disposable earnings for the owner produced by an investment in improved property. The perception depreciation produces tax-free earnings is an extension of the belief real estate always increases in value over time. But if property did, depreciations deductions serve no purpose except as a loophole for income to escape taxes.

However, the viewing of depreciation as providing the owner with spendable income, not as an untaxed withdrawal of invested capital, overlooks the *economic function* of depreciation. Capital invested to purchase improved property or improve a property needs to be withdrawn over a period to time to mitigate the uninsurable risks of loss inherent in any immobile asset such as improved property.

Climate change, natural disasters, out-migration, shifting demographic demands for use or occupancy of property are risks depreciation is intended to cover. An annual recovery of capital — not rents labeled spendable income — is dictated by prudence to be set aside by an investor as capital for further reinvestment.

Also misleading in the context of the withdrawal of capital are the unrelated aspects of **asset inflation** and **property appreciation.** These monetary and demographic driven rises in the value of a property are commonly viewed as fully offsetting the dollar value of actual physical obsolescence and deterioration of property improvements.

Realistically, the aging of property absolutely has an adverse effect on a property's comparative value and is the economic underpinning for depreciation schedules. And yes, they may well during periods of prosperity annual exceed the adverse effect of aging on the property. But this mixes the need for recovery of invested capital with profit from a property's increase in value. They are different, and the owner is entitled to both – though the profit might not be realized the depreciation deduction is always there.

Consider that over time, the tandem effects of *inflation* and *appreciation* factors tend to drive up the amount of rental income for a property competitively maintained and located in an area with stable or rising demographics. To distinguish between these two valuation factors, rental income increases for some properties rise beyond the rate of annual consumer inflation which is due to the appreciation factor.

Inflation is a monetary measure tied to the decline in purchasing power of the dollar. It simply buys less from year to year. When all economic conditions remain the same for a location, personal income and amounts paid as rent tend to keep pace with consumer inflation. In turn, as rents go up, so goes property value, a function of applying capitalization rates to a property's NOI.

When rent increases exceed inflation, the excess is brought about solely by local demographics, not the decline in the purchasing power of the dollar. As rents experience an annual increase beyond the rate of consumer inflation, the property appreciates in value. Rather than because of inflation, the rent increased because of an increase in the number of people living in the area or simply because the rise of personal income in the area exceeded the rate of inflation. Thus, the rent, and in turn the property price, not only keep up with consumer inflation, but enjoyed appreciation by more dense and wealthier locate population.

This dual, hyper-inflated rent situation is especially observable, and likely justified when a property is excessively maintained or renovated which sums are typically expensed, not capitalized. Rent increases lift the dollar value of the property in tandem. As pricing is a function of applying capitalization rates to NOI, a rental property investor does not unreasonably label the untaxed return of capital via the depreciation deduction as spendable income. That is, until the day a risk of loss becomes apparent and trends reverse, as during a recessionary period or out-migration condition (again, demographics).

Personal property used in the production of business income or provided with rented property best demonstrates the effect of depreciation. While personal property quickly depreciates over time, improved property is usually managed and maintained to eliminate any wear, decay or outdated features which when not corrected contribute to a decline in the property's rental income and thus its dollar value.

In contrast to the defined purpose of depreciation deductions, properly maintained rental property is correctly considered an **appreciable asset** by investors. Historically, property tends to be a hedge against future declines in the purchasing power of the dollar. Especially in California with its value-enhancing infrastructure and institutions, mild climate, unique geography, and use-restrictive zoning. In contrast, personal property is often referred to by investors as a depreciable or **wasting asset**.

appreciable asset
A tangible collectible, such as property held for investment or productive use in a business, the value of which increases over time at a rate greater than the rate of consumer inflation.

Depreciation schedules

Each separately assessed parcel of improved property has its own **depreciation schedule**. The *depreciation schedules* for different types of improved property apply identically to property in all three income categories. All depreciable property, whether owned by an individual, partnership, limited liability company (LLC) or corporation, uses the same depreciation schedules.

However, an owner of a residential dwelling used as the owner's principal residence – a personal use - does not have a depreciation schedule and may not take depreciation deductions on the dwelling. Without depreciation deductions, a homeowner may not reduce their taxable income to recover any part of the price they paid when they own a principal residence or second home.

depreciation schedule
The number of years over which an owner's capital investment in a trade or business, passive, or portfolio category property is recovered as an annual expense or deduction from income, limited to the portion of cost basis allocated to property improvements.

Two classes of depreciable property have been established to determine the use of depreciation schedules:

- residential; and
- commercial.[2]

Further, the depreciable *residential* class of properties is divided into two categories:

- vacation residences rented to transient guests when occupied during the year by the owner's family for no more than 14 days or 10% of the days rented, whichever is greater; and
- all other residential rentals.
- The other class, improved *commercial* properties, includes:
- trade or business property;
- rental property other than residential rentals; and
- depreciable portfolio category property other than residential rentals.[3]

Lastly, two sets of depreciation schedules exist and apply to all depreciable property:

- a standard depreciation schedule (SDS) for use with standard income tax (SIT) reporting; and
- an alternative depreciation schedule (ADS) for use with alternative minimum income tax (AMT) reporting.

SIT vs. AMT depreciation schedules

All depreciation tables used to report income are fixed annual figures which set the scheduled life of the improvements, called the **straight-line** method. The two IRS depreciation schedules for each SIT and AMT reporting are mandated for use based on the type of property involved:

- residential rental property — the 27.5-year SDS or the 40-year ADS; and
- commercial property — the 39-year SDS or the 40-year ADS.[4]

annual property operating data sheet (APOD)
A worksheet used to gather income and expenses on the operation of an income producing property for an analysis of the property's suitability for investment.

Consider a broker preparing an **annual property operating data sheet (APOD)** to figure a buyer's after-tax benefits during their first 12 months of ownership for the proposed purchase of an income-producing property. Typically, the broker uses the 27.5-year SDS for residential and 39-year SDS for commercial property, not the 40-year ADS for both. The SDS produces a faster and thus greater annual recovery of the investment than the ADS, resulting in greater tax benefits and if you want, greater spendable income sought be investors.

An owner using the SDS reporting schedule for their SIT calculations may switch to the ADS at any time during their ownership of any improved parcel of property. However, once the 40-year ADS schedule is chosen, the owner may not revert to the SDS for depreciating the parcel.[5]

2 IRC §168(e)(2)
3 **World Publishing Company** v. **Commissioner** (1962) 299 F2d 614
4 IRC §§168(c), 168(g)(2)
5 IRC §168(g)(7)

A rental property owner who does not qualify as being in a real estate-related business uses the ADS in place of the SDS to reduce or avoid a buildup of *suspended operating losses.* These losses are limited for future use to offsetting income from only the single property generating the loss.

The owner with a highly leveraged acquisition of a rental property typically incurs an operating loss during the first years of ownership. The owner with no reportable operating income from other rental properties or passive business ownership is, unless otherwise qualified, unable to use the new acquisition's annual reportable operating loss in the year of the loss. [See Chapter 8]

On a passive category property, a rental property operating loss may not be used as an adjustment to lower the owner's AGI, again unless otherwise allowed. This bar prevents commingling a passive loss with income from business or portfolio categories, unless the owner qualifies for either:

- the real estate-related business adjustment which permits rental losses to reduces the AGI; or
- the $25,000 rental loss deduction which is subtracted from the adjusted gross income when setting the taxable income. [See Chapter 6]

The use of the SDS produces less reportable income (or a greater loss) than the use of the AMT 40-year depreciation schedule.

Land and improvement allocation

As always, the purchase of *fee ownership* in a parcel of improved property includes both land and buildings. However, only the cost of depreciable improvements may be deducted for capital recovery through depreciation schedules. The buyer's cost of acquisition allocated to land is not depreciable.[6] [See **RPI** Form 355]

On the purchase of improved property, an allocation of the cost of acquisition and improvements – cost basis – is made between land, improvements and any personal property acquired in the transaction. The amount allocated to improvements is recovered annually over 27.5, 39, or 40 years as previously reviewed.

Consider a resident farmer. The amount paid for the farm is allocated based on the ratio of the respective values of the farmhouse occupied by the owner as their residence and the land and improvements that will be used in their agri-business. The farmhouse as their principal residence may not be depreciated. The portion of the cost of acquisition allocated to a farmhouse receives the same non-depreciable treatment given to the cost of land, but for a different reason — the farmhouse residence is for the personal use of the farmer.[7]

To recover the entire cost of an investment property acquisition through depreciation deductions, a buyer acquires a *leasehold ownership interest* as a tenant under a ground lease, not a fee ownership interest in the property.

6 26 CFR §1.167(a)-5

7 Revenue Regulations §1.167(a)-6(b)

Typically, further improvements are constructed by the tenant on land they leased. Occasionally, existing improvements are occupied by the current tenant under a ground lease or master lease. An investor purchases the tenant's leasehold right under an assignment of the tenant's possessory interest in the lease. [See Form 596 accompanying this chapter]

Taxwise, the tenant's entire price paid to acquire the ground lease plus the cost to construct any leasehold improvements, is depreciable under the applicable residential or commercial schedule of 27.5, 39 or 40 years. Depreciation begins mid-month for the month the improvements are purchased or completed.[8]

The depreciation of trade fixtures owned by a business is controlled by personal property depreciation schedules, not real estate schedules.

Depreciation recaptured on a sale taxed up to 25%

On the sale of depreciable property, the profit taken is set by the formula:

net price – basis = profit

When an improved property is sold, the depreciation deductions taken during ownership transform into taxable profit, but not a type of profit that is a capital gain.

Thus, on a sale the remaining cost basis is deducted from the net sales price producing two types of profits, called *gains*. These gains are taxed at different rates. The portion of the profit on a sale resulting from accumulated depreciation is classified as *unrecaptured gain*, taxed at ordinary income rates up to a maximum rate of 25%.[9]

Any amount of profit remaining beyond the price originally paid for the property and cost of improvements is classified as *capital gains*. Obviously, the amount of depreciation reported on a sale as unrecaptured gain is limited to the total profits on the sale.[10]

For example, a property purchased years ago for $500,000 has a depreciated (remaining) cost basis of $100,000. The owner sells it for $1,000,000, generating a profit of $900,000.

Here, the $900,000 profit represents:

- the $400,000 in depreciation deductions taken, which reduced the cost basis below the original cost of acquisition and improvements; and
- $500,000 in actual dollar value increase in the sales price over the original cost of acquisition and improvements.

Thus, on a sale at a price exceeding the remaining cost basis, the profit taken up to the price originally paid for the property ($400,000 in depreciation) is taxed as unrecaptured gain up to 25%.[11]

8 IRC §§168(d)(2), 168(i)(6)(A)
9 IRC §§1(h)(6), 1250(c)
10 IRC §§1(h)(1)(E), 1250(c)
11 IRC §§1(h)(1)(E), 1250(c)

Form 596

Assignment of Lease

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

ASSIGNMENT OF LEASE

By Tenant/Lessee

NOTE: This form is used by an escrow officer or tenant when the buyer of a tenant's leasehold interest in a property takes possession and assumes the tenant's rights and obligations under a rental or lease agreement, to transfer ownership of the tenant's leasehold interest to the buyer.

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

1. This assignment transfers the Lessee's interest in the lease dated _______________________, 20__________,
- 1.1 entered into by ____, as the Lessor, and
- 1.2 ____, as the Lessee,
- 1.3 recorded on _________________________, ______, as Instrument No. _________________________, in the records of ____ County, California,
- 1.4 regarding real estate referred to as ____ ____.

AGREEMENT:

2. Lessee hereby assigns all of Lessee's interest in the above described lease to ____, as the Assignee.

3. Assignee hereby assumes and agrees to timely perform all Lessee's obligations under the lease.
- 3.1 This assumption by Assignee is made for the benefit of Landlord under the lease.
- 3.2 If Assignee or its successors default in performance of this assumption and Lessee not be released from Lessee liability on the lease, the amount of the default will be a lien in favor of Lessee on the Lessee's interest and Lessee may elect to foreclose on the interest assigned to Assignee under California Civil Code §§2924 et seq.
- 3.3 The Assignee will indemnify Lessee against any claim, liability, loss, costs, attorney fees, and other damages incurred by Lessee under the lease.
- 3.4 If an action is instituted to enforce this assumption the prevailing party to receive their attorney fees.

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**RPI** Form 251]	☐ See attached Signature Page Addendum. [**RPI** Form 251]
Date: _____________, 20______	Date: _____________, 20______
Lessee: ___________________________________	Assignee: ___________________________________

A notary public or other officer completing this certificate verifies only the identity of the individual who signed the document to which this certificate is attached, and not the truthfulness, accuracy, or validity of that document.

STATE OF CALIFORNIA
COUNTY OF ____
On ______________________ before me, ____
(Name and title of officer)
personally appeared ____,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

(This area for official notarial seal)

Signature: ____
(Signature of notary public)

FORM 596 03-15 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA

The profit taken that represents the dollar increase in the price of the property over the original cost of acquisition and improvements is taxed at the current 15% and 20% long-term capital gains tax rates, controlled by the owner's tax bracket for the year of sale. The capital gain is not adjusted for inflation to reflect lost purchasing power and is taxed as the nominal dollar of profit realized on the resale price of the property.[12]

12 IRC §1(h)(1)]

Chapter 9 Summary

Depreciation is the loss of property value brought about by age, physical deterioration, or functional or economic obsolescence. Owners of improved rental property or property used in a trade or business annually recover a portion of the acquisition and improvement costs they allocate to the improvements as a deduction taken from the property's net operating income (NOI).The annual recovery is called a depreciation deduction.

Depreciation deductions from income is both: an investment fundamental and a tax reporting activity. Depreciation schedules are the number of years over which an owner's capital investment in a trade or business, passive, or portfolio category property is annually recovered as an expense or deduction from income, limited to the portion of cost basis allocated to property improvements. Each separately assessed parcel of improved property has its own depreciation schedule.

The depreciation schedules for different types of improved property apply identically to property in all three income categories. All depreciable property, whether owned by an individual, partnership, limited liability company (LLC) or corporation, uses the same depreciation schedule. Two classes of depreciable property have been established to determine the use of depreciation schedules: residential and commercial.

Chapter 9 Key Terms

Chapter 10

Commingling rental losses with other income – via work-arounds

Learning Objectives

After reading this chapter, you will be able to:

- advise on the use of rental operating losses to offset business income, portfolio income and profits by implementing qualifying activities; and
- distinguish rental operating losses qualified to reduce the AGI from rental losses qualified as a deduction from AGI to reduce taxable income.

Key Terms

material participant	**owner-operator**
occupancy rule	**reportable operating loss**

The part-time landlord and full-time real estate agent

Consider a real estate licensee who owns rental properties and renders services to clients as an agent in a brokerage business. The licensee works 30 hours a week on their brokerage activities, including preparing and advising clients and interacting with others on behalf of clients. The licensee also spends an average of ten hours a week on management and overseeing the care and maintenance of rentals the licensee owns.

The licensee's management activities as owner of the rentals include advertising, interviewing prospective tenants, checking tenant credit, reviewing prior rental history, and preparing and signing lease agreements. The licensee also collects rents and arranges for others to make all repairs and maintenance.

At the end of the year, the licensee has a reportable net operating loss from rental activities — a passive income category loss.

May the licensee use the passive category loss from their rental operations to offset reportable income from their brokerage business and interest earned on savings and notes they hold?

Yes! An owner who *renders services* acting either for their own account as a landlord, investor, developer or builder, or on behalf of others as a real estate licensee, qualifies for their rental operating losses to offset their business income and portfolio income. The passive category loss used to offset income in another category reduces the owner's adjusted gross income (AGI).[1]

The rental operating loss glitch overcome

Recall that residential and commercial income property with an average occupancy of more than 30 days, called rental property, is classified as passive income category property. All rental property income, expenses and deductions from operations and ownership, plus any profit or loss on a sale, while tracked separately for each property are aggregated and reported in the passive income category.

Operating losses reported for one rental property in the passive category first offset operating income and sales profits reported by other rental properties. Any operating loss not offset by income from other properties in the passive category spills over within the category to offset income from pass-through business opportunities. Pass-through business income is received from partnerships, limited liability companies (LLC) or S corporations operated by someone other than the owner or co-owner of the businesses.

When rental operating losses remain after offsetting income from all sources within the passive category, the rental operating losses are reallocated pro-rata back to the rental properties generating the losses, called *suspended losses*. Suspended losses may only offset income or profit from operations or sale of the property carrying the suspended losses. Thus, the suspended losses may not offset future reportable operating income generated by another property.

However, the rental property owner avoids the suspension of rental losses by annually qualifying to use the rental losses as either:

- an adjustment to reduce their AGI; or
- a deduction from the AGI of up to $25,000 annually to reduce taxable income.

Consider a married couple who incurs a **reportable operating loss** on their rental property, a mixed-use property of residential and commercial rentals. Neither spouse is in a business related to real estate. The spouse who is unemployed manages the couple's rentals.

Because the couple's AGI exceeds $150,000, the couple does not qualify to deduct any part of their loss from their AGI using the capped $25,000 annual operating loss deduction rules. If they qualified, the loss would reduce their taxable income.[2]

reportable operating loss
A passive category loss resulting from operating expenses, depreciation deductions and interest deductions for passive category properties, which exceeds income in the category is carried forward as a suspended loss unless the owner qualifies to offset income in trade or business and portfolio category income or reduce taxable income as a deduction.

1 Internal Revenue Code §469
2 IRC §§469(i)(3)(A)

However, either spouse, independent of the other, may separately qualify their rental operating loss as an adjustment reducing the AGI in their joint return. With one spouse qualifying for the loss writeoff, any professional income they report on their joint return is offset by the rental property operating loss.[3]

To begin to qualify their rental operating losses to reduce their AGI, the unemployed spouse first needs to assume all duties as the manager of the couple's rentals. To qualify, the spouse needs to spend sufficient time performing real estate activities as both:

- an **owner-operator** of a real estate-related business; and
- a material participant in the management of the rental property they own.[4]

owner-operator
An owner of rental property in the passive income category who renders professional real estate services, manages property, or invests in real estate for their own accounts and collectively spends a minimum amount of time on real estate-related activities.

A real estate-related business is your future

For a landlord to be in a real estate-related business, they must be:

- an **owner-operator** of their rental properties acting on their own behalf and not through an agent;
- an agent representing clients in real estate transactions; or
- a builder.

Real estate activities qualifying as a real estate-related business include:

- development or redevelopment;
- construction or reconstruction;
- acquisition;
- conversion;
- renting;
- operation;
- management;
- leasing; or
- brokerage.[5]

A landlord qualifies as the *owner-operator* of a real estate-related business by meeting two criteria:

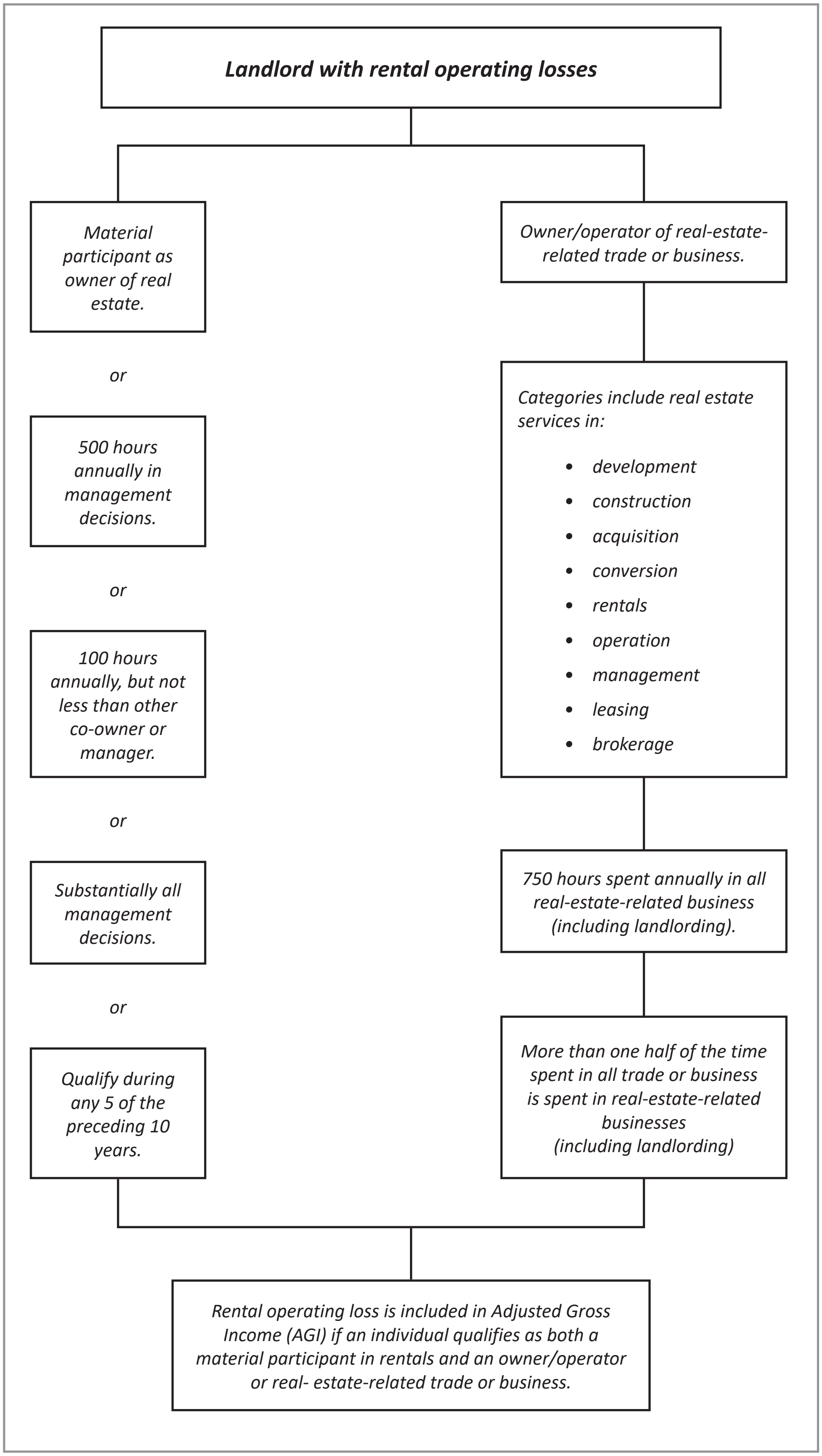
- the business renders professional real estate services, or manages, invests in or develops real estate for their own account; and
- the landlord spends a threshold amount of time in the real estate-related businesses. [See Figure 1]

Consider a landlord who spends sufficient time acquiring, managing, or leasing their own rentals. Although the landlord qualifies as working in a real estate-related business, operating income or losses related to their rental properties are still classified in the passive category, even when they are an owner-operator of rental property.

3 IRC §469(c)(7)(B)
4 IRC §469(c)(7)(B)
5 IRC §469(c)(7)(C)

Figure 1

Landlord with rental operating losses



As rental activities, the owner need do nothing more than own the rentals under gross lease arrangements to be a material participant in their operations. However, when the owner is extensively involved in any rental operations, they are *further* classified as in a real estate-related business – which is not a business activity but is a rental activity).

When the landlord's business and rental activities qualify as real estate-related, adjustments allowed to the AGI include their rental operating losses. Without the real estate-related business classification, rental property losses resulting in a passive category reportable loss become suspended losses, available only to offset future income from the property generating the loss and are barred as an adjustment to AGI. However, when the landlord spends sufficient time on their duties as a landlord, their rental operations alone will qualify them as in a real estate-related business. [See **RPI** Form 351]

In practice, the landlord may use their rental operating losses to offset business or portfolio category income when they:

- spend more than half their total time spent rendering all types of services rendering real estate-related services (property management, development, or general brokerage); and
- spend more than 750 hours of the entire year in real estate-related businesses (a 15-hour weekly average).[6]

To determine whether an individual spends sufficient time in businesses related to real estate, they combine time spent in all their various real estate-related activities.

The disqualifying ratio of services unrelated to real estate

Consider a medical professional who is married and owns several rentals. The individual averages 30 hours weekly attending to patients and 15 hours weekly tending to their rental properties. The individual's spouse is uninvolved in the acquisition and management of the rentals.

While the professional has an annual reportable income from their trade, the rentals produce an overall *reportable operating loss*.

Does the individual qualify to offset other income with the rental operating loss?

No! The individual did spend 750 hours during the year (15 hours weekly) actively participating in a real estate-related business. However, the amount of time spent as a landlord was not more than half of the total time spent tending to patients and managing rentals, called *rendering services*.

Also, time spent overseeing one's portfolio category investments (trust deed notes, management-fee net leased properties, land held for profit) does not qualify as professional services, much less services rendered in a real estate-related business.

6 IRC §469(c)(7)(B)

The landlord's material participation grab bag

Now consider a practicing professional who is married and owns several rentals as community property. The professional's spouse works more than 15 hours weekly acquiring and managing the rentals. The spouse has no other job and the couple files a joint return.

Does the couple qualify as owner-operators in a real estate-related business due to the spouse's rental property activity?

Yes! For married couples filing jointly, one spouse may independently satisfy the **material participation** requirements. Separately, one spouse can qualify the couple as owner-operators of a real estate-related business.

material participant
An owner of rental property in the passive income category who participates in its management or a real estate profession on a regular and substantial basis.

However, to use the couple's rental operating losses to offset other income, the unemployed spouse, as the manager of the rentals, needs to *materially participate* as a landlord in the rental operations, in addition to rental ownership activities.

To qualify as a material participant, the managing spouse meets *one* of the following criteria:

- time spent handling the rentals exceeds 500 hours annually (about ten hours weekly);
- time spent handling the rentals exceeds 100 hours annually (about 2 hours weekly), but is not less than the amount of time spent by any other co-owner or property manager;
- the managing spouse's rental activities includes substantially all management of the rentals; or
- either spouse individually qualified during any five of the preceding ten years.[7]

In this ownership example, the managing spouse makes all decisions in connection with the management of the rentals, establishing material participation by meeting any one of the criteria for material participation. Thus, the couple uses the operating loss to reduce their AGI and offset professional income earned by the employed spouse. The result is a reduction in their taxable income, and amount of taxes owed.

Material participation — the call for action

Consider an income property owner whose primary occupation is not a real estate-related business. The property owner participates in the operation of their rental property, and also spends time "on call" when they are not actively managing the rental property. When "on call," the owner remains ready to do emergency work for the operation of their rental property.

The property owner keeps a log of time spent operating the rentals, totaling 750 hours for the year, including "on call" time.

Is the property owner entitled to report rental income losses under the passive income category to offset other income by an adjustment to their AGI?

7 26 Code of Federal Regulations §1.469-5T(a)

No! "On call" activity does not qualify as material participation in the operation of rental property. Thus, the property owner is left with less than the 750 required hours needed to qualify as a material participant and write off rental losses as a reduction in AGI.[8]

The 500-hour landlord

Consider a real estate licensee who works full time conducting their brokerage business and co-owns rental properties with a small group of investors in a syndicated pass-through entity.

The licensee reviews and approves tenants, prepares lease agreements and collects and deposits rents. Time spent managing the rentals is at least ten hours weekly on average. While they have no property managers, one of the investors spends more time than the licensee does in the management of the rentals.

The rentals generate a reportable operating loss for the year, due to depreciation, interest deductions and vacant units.

May the licensee write off their share of the rental operating loss to offset their brokerage income even though the co-owner is more involved in management than the licensee?

Yes! First, as a licensee operating a real estate brokerage service, they qualify as rendering services in a real estate-related business. Secondly, the licensee qualifies as a material participant in the operation of the rentals since they separately spend more than 500 hours of the year on the management of their units — no matter how the equity ownership is structured or financed.

Thus, the licensee applies their share of the rental losses as a reduction to their AGI offsetting brokerage income — an adjustment to AGI, not the $25,000 limit deduction. The co-owner, for the same reason, also qualifies to write off their share of rental loss against other income.

The over-100-hour landlord

Now consider a licensee who owns rentals and works 40 hours weekly in their brokerage business. The licensee reports their brokerage income for tax purposes as an independent contractor.

The licensee handles all aspects of management and operation of the rentals and arranges for maintenance and repair. The licensee spends an average of six hours weekly operating the rentals.

The licensee also employs an on-site resident manager who averages less than six hours a week — deciding what repairs to make and which potential tenants qualify to lease.

May the licensee write off rental operating losses against their real estate sales income?

8 **Moss** v. **Commissioner** (2010) 135 TC 365

Yes! Employment in real estate as an independent contractor, whether acting on their own or as an employee of a broker, qualifies as rendering services in a real estate-related business.

Also, the licensee's landlord activities meet one of the standards which alone establishes material participation. The licensee as an owner worked more than 100 hours annually on their rentals. Critically, the resident manager does not spend more hours actively managing the rentals ("on call" or doing repairs and maintenance does not count as management time) than the licensee does.

Now consider a licensee who owns both a brokerage business and income-producing real estate. The licensee works approximately 40 hours weekly on their brokerage business.

The licensee's time spent on the management and maintenance of the rental is relatively minimal, averaging six hours monthly. The licensee handles all aspects of the management and operation of the rentals, except for maintenance and repairs, which a handyman does. The handyman works more hours monthly on maintenance of the rentals than the licensee does managing them.

May the licensee use any rental operating loss to offset other income from their brokerage business?

Yes! The licensee may use any rental operating loss to offset other income as an adjustment to their AGI. Here, the licensee performed substantially all the management of the units. Maintenance and repairs, which the handyman performs, are not management activities.

Five out of ten years spent landlording

Consider a developer who owns several rentals. In most years, the developer works an average of 25 hours weekly on development projects and 15 hours weekly managing their rentals.

The developer qualified as a material participant in the management of their rentals during each of the past four years. However, they did not qualify for one year before that and qualified in the two prior years — a total of six out of the last ten years.

In the current year, sales of new houses were up. Consequently, the developer worked 40 hours (or more) weekly on their development business. A property manager was hired to operate the rentals, leaving the developer only marginally involved in their operations. The developer's business showed a reportable income for the year, but their rentals produced a reportable operating loss.

May the developer use their rental operating loss to offset their business income?

Yes! Although the developer was not a material participant in the day-to-day decision-making process of managing their rentals this year, they did qualify as a material participant in the operations of the rentals during at least five of the last ten years.

The $25,000 limited deduction – there when all else fails

To be classified as passive income category property, rentals need to be occupied by tenants for an average of more than 30 days. The 30-day **occupancy rule**, coupled with the owner's **active participation** in its operations, locks reporting of a property's income, expenses, interest, and depreciation in the passive income category as rental income. [See IRS Form 1040, Schedule E]

occupancy rule
Rental properties are passive income category property when tenant occupancies average more than 30 days.

When rental operating losses remain after aggregating all income and profits within the passive category, a landlord qualified as an *active participant* in the management of their rentals may deduct the rental losses from their AGI in amounts up to $25,000 annually to reduce their taxable income. This is not a reduction in the AGI amount, but a deduction from AGI for a reduction in taxable income and thus the year's tax liability.

To be an "active" participant means a landlord by contract is primarily — and legally — responsible for performance of services, maintenance, and management of the rentals. This arrangement is typically agreed to with a tenant under rental or gross lease agreements.

Also, a brokerage firm may exclusively handle all the rental activities as the agent of the landlord leaving the landlord uninvolved in the property operations. Here, the landlord by contractually agreeing to perform any level of maintenance under agreements with the tenant qualifies the rental property as a passive income category asset. Thus the landlord may use the $25,000 deduction to reduce their taxable income.

When a management-free **net lease** situation exists as in, say, an industrial income property, the agreement shift all property care and maintenance to the tenant. The agreement leaves the landlord with no active management to perform. This lack of landlord management responsibility places the income property in the portfolio income category. To report an income property in the passive income category the landlord needs to enter into a **gross lease** agreement with the tenant.

The $25,000 rental operating loss deduction which reduces taxable income is available to landlords who do not qualify as material participants for the passive category rental operating loss adjustment to the AGI. However, the landlord does not need the $25,000 loss deduction when they qualify as a material participant since they use their rental operating losses as an *adjustment* to reduce their AGI.

Chapter 10 Summary

An owner who renders services acting either for their own account as a landlord, investor, developer or builder, or on behalf of others as a real estate licensee, qualifies for their rental operating losses to offset their business income and portfolio income.

The passive category loss used to offset income in another category reduces the owner's adjusted gross income (AGI). For rental properties to be passive income category property, the tenants need to occupy it for an average of more than 30 days.

Residential and commercial income property with an average occupancy of more than 30 days, called rental property, is classified as passive income category property.

Rental property income, expenses and deductions from operations and ownership, plus any profit or loss on a sale, are aggregated and reported in the passive income category.

Operating losses reported for one rental property in the passive category first offset operating income and sales profits reported by other rental properties. When rental operating losses remain after offsetting income from all sources within the passive category, the rental operating losses are reallocated pro-rata back to the rental properties generating the losses, called suspended losses.

Chapter 10 Key Terms

Chapter 11

$25,000 ceiling on rental loss deduction

Learning Objectives

After reading this chapter, you will be able to:

- advise budding landlords on the availability of the annual $25,000 deduction to subsidize passive income category losses due to rental operations; and
- explain how phase-out rules reduce the maximum loss deductible as a landlord's personal income rises beyond thresholds.

Key Terms

active participant

Subsidizing annual operating losses

Recall that losses remaining in the passive income category due to rental operating losses are treated as one of the following:

- an *adjustment* reducing the owner's AGI, permitted when the owner qualifies as being in a real estate-related business [See Chapter 10];
- a *deduction* from the AGI to lower the owner's taxable income, permitted when the owner qualifies for the $25,000 rental loss deduction; or
- a *suspended loss* remaining on the books of the rental properties generating the passive category loss.

To annually deduct up to $25,000 of a passive category operating loss from their AGI, an investor needs to qualify as an *owner-operator* of rental property.

To qualify as an owner-operator for use of the $25,000 deduction, an investor needs:

- an aggregate passive income category loss resulting from owning and operating income properties at a loss;

active participant
An owner-operator of rental property who owes a duty to tenants under rental and gross lease agreements for the care and maintenance of the property and retains ultimate authority over key landlord decisions.

- status as an **active participant** in the management of the rental property; and
- an AGI of no greater than $150,000.[1]

Landlords who fail to qualify as *material participants* to reduce their AGI, such as failing to classify as in a real estate-related business, are allowed to reduce their taxable income up to $25,000 of their the passive category rental operating loss though use of the rental operating loss deduction. A landlord with the status of a material participant in management of their rentals does not need the $25,000 loss deduction. They take their rental operating losses as an *adjustment* to reduce their AGI.

Rental loss deduction qualifications for an owner

However, to qualify for the rental loss deduction from AGI an investor needs to **actively participate** in the management of their rentals as an owner-operator.[2]

To be an *active participant*, the investor need only be contractually obligated for the care and maintenance of the property and retain control over key landlord decisions. This responsibility does not require daily, weekly, or monthly contact with the properties or never when a property manager is employed by the investor.

Rental and gross lease agreement provisions used by a property manager impose a duty on the investor to maintain the property which duty may be delegated to a manager to perform as the investor's agent. Gross leases require the investor to provide services as well as maintain the property.

When a management-free **net lease** situation exists as in, say, an industrial income property, the agreement shifts the obligations of ownership to the tenant for maintenance, utilities, insurance premiums and property taxes. The agreement leaves the landlord with no active management to perform by themselves or a property manager. Thus, the investor merely receives monthly rent or serves 3-day notices to collect delinquent rent. However, the lack of landlord management obligations places the income property in the portfolio income category along with interest bearing assets.

Any property management agreement an owner enters into with a property owner is an *agency agreement*. In spite of any prior notice provisions it may contain, the investor may terminate it at any time. Thus, the investor has no loss of control over management's duties imposed by gross lease agreements to manage the property.

Also, the investor's ownership interest may be vested in joint tenancy, tenancy-in-common, community property, a partnership, or an LLC. However, the investors with a fractional co-ownership interest of less than 10% does not qualify for the loss deduction, regardless of how the ownership is vested.[3]

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1 IRC §469(i)
2 IRC §469(i)(6)
3 IRC §469(i)(6)(A)

Form 353

Comparative Analysis Projection (CAP)

COMPARATIVE ANALYSIS PROJECTION (CAP)

Prepared by: Agent ____________ Phone ____________
Broker ____________ Email ____________

NOTE: This sheet contains confidential information for clients who own or are acquiring income property.
For Owners: This illustrates the effect of different loan amounts and projects the tax benefits and rate of return.
For Buyers: This compares available properties to one another.
The conclusions and projections developed on this form depend on the accurate preparation of backup sheets.

DATE: ____________, 20______. Prepared by ____________.
CLIENT: ____________. Client's Property: ____________

A. PURPOSE:
- a. ☐ Property selection/comparison
- b. ☐ Ownership projection for years
- c. ☐ Debt leverage by refinance
- d. ☐ Equity performance review

B. BACKUP SHEETS ATTACHED:
- a. ☐ Annual Property Operating Data Sheet [See **ft** Form 352]
- b. ☐ Estimate of Seller's Net Proceeds [See **ft** Form 310]
- c. ☐ ____________

	– A –	– B –	– C –
1. PROPERTIES ANALYZED	______	______	______
1.1 Year analyzed	20____	20____	20____
2. PROPERTY VALUATION:			
2.1 Fair market value	$____	$____	$____
2.2 Less loan	(–)$____	(–)$____	(–)$____
2.3 Less sales costs	(–)$____	(–)$____	(–)$____
2.4 NET EQUITY(§2.1 – §2.2 and – §2.3)	$ 0.00	$ 0.00	$ 0.00
3. SPENDABLE INCOME/DEFICIT: (annual)			
3.1 Gross operating income	$____	$____	$____
3.2 Operating expense	(–)$____	(–)$____	(–)$____
3.3 Net operating income (§3.1 – §3.2)	$ 0.00	$ 0.00	$ 0.00
3.4 Loan payments	(–)$____	(–)$____	(–)$____
3.5 SPENDABLE INCOME/DEFICIT (§3.3 – §3.4)	$ 0.00	$ 0.00	$ 0.00
4. INCOME-TO-VALUE: (annual)			
4.1 Fair market value (§2.1)	$____	$____	$____
4.2 Net operating income (§3.3)	$ 0.00	$ 0.00	$ 0.00
4.3 RATE OF RETURN (§4.2 ÷ §4.1)	____%	____%	____%
5. REPORTABLE INCOME/LOSS: (annual)			
5.1 Net operating income (§3.3)	$ 0.00	$ 0.00	$ 0.00
5.2 Interest	(–)$____	(–)$____	(–)$____
5.3 Depreciation	(–)$____	(–)$____	(–)$____
5.4 REPORTABLE INCOME/LOSS	(+or–)$ 0.00	(+or–)$ 0.00	(+or–)$ 0.00
6. CLIENT INCOME TAX ASPECTS:			
6.1 Reportable income/loss (§5.4)	(+or–)$ 0.00	(+or–)$ 0.00	(+or–)$ 0.00
6.2 Client's tax bracket	(x) ____%	(x) ____%	(x) ____%
6.3 TAX LIABILITY OR REDUCTION	(+or–)$ 0.00	(+or–)$ 0.00	(+or–)$ 0.00
7. RETURN ON EQUITY: (annual)			
7.1 Spendable income/deficit (§3.5)	(+or–)$ 0.00	(+or–)$ 0.00	$ 0.00
7.2 Loan principal reduction (§3.4 - §4.2)	(+)$ 0.00	(+)$ 0.00	(+)$ 0.00
7.3 Income tax liability (§6.3; reverse the + or –)	(+or–)$ 0.00	(+or–)$ 0.00	(+or–)$ 0.00
7.4 Annual fair market value adjustment (____% of §2.1) (estimated appreciation/inflation)	(+)$____	(+)$____	(+)$____
7.5 DOLLAR RETURN ON EQUITY(after taxes)	$ 0.00	$ 0.00	$ 0.00
7.6 Percent return on net equity (§7.5 ÷ §2.4)	____%	____%	____%

FORM 353 03-11

For low-income housing, an owner need not be obligated by leasing agreements to actively participate in operations of the rental to qualify for the loss deduction. The low-income housing rule is designed to encourage ownership and construction of low-income housing by using the tax code to subsidizing wealthier, risk-averse investors in syndicated ownership vehicles.[4]

Partnership tax treatment

Partners of a limited partnership or members of an LLC who report using Form 1065 do not qualify as active participants.[5]

4 IRC §469(i)(6)(B)
5 IRC §469(i)(6)(C)

By definition, a limited partner or LLC member is an uninvolved passive-investor, not an operator burdened with the contractual responsibility of active management.

Unlike general partners, LLC managers and tenants-in-common (TIC) co-owners, investors not obligated to participate in the operation of the rental units are also denied use of the rental loss deduction.

Similarly, a syndicated TIC ownership, promoted and controlled by the promoter as a "cradle-to-grave" investment arrangement managed by the promoter, does not qualify the investors as active participants.

Also, owners of property leased out to tenants on ground leases — or other net-lease agreements without some care and maintenance imposed on the owner — do not qualify for the loss deduction. Remember, these properties are portfolio category income properties, not owner-operated passive category properties.

Phase out of the deduction

Finally, a phase out of the entire $25,000 amount leaves the highest income earner without use of the deduction. To qualify for the maximum benefit of the $25,000 rental operating loss deduction, the investor's AGI may not exceed a threshold of $100,000. For owners of low-income rentals, however, the $100,000 annual threshold rises to $200,000.[6]

When the investor's AGI exceeds the $100,000 threshold, the amount permitted as the deduction drops by 50% of each dollar of AGI exceeding the $100,000 threshold. Thus, an investor with a $150,000 or greater AGI may not use any part of the $25,000 as an operating loss deduction.[7]

For example, a person with an AGI of $125,000 - $25,000 above the $100,000 threshold amount – may deduct up to $12,500 of their rental property operating losses. Any loss remaining which is not deductible becomes suspended losses allocated pro rata and retained on the books of the rental properties generating the operating losses – for use as a write off in future years against those property's income.

6 IRC §469(i)(6)(B)

7 IRC §469(i)(3)

Chapter 11 Summary

To annually deduct up to $25,000 of a passive category operating loss from their AGI, an investor needs to qualify as an owner-operator of rental property. To qualify as an owner-operator for use of the $25,000 deduction, an investor needs:

- an aggregate passive income category loss resulting from owning and operating income properties at a loss;
- status as an active participant in the management of the rental property; and
- an AGI of no greater than $150,000.

However, to qualify for the rental loss deduction from AGI an investor needs to actively participate in the management of their rentals as an owner-operator. An active participant is an owner-operator of rental property who is contractually responsible to tenants for the care and maintenance of the property and retains authority over key landlord decisions.

To be an active participant, the investor need only be contractually obligated for the care and maintenance of the property and retain control over key landlord decisions. This responsibility does not require daily, weekly, or monthly contact with the properties or never when a property manager is employed by the investor.

Chapter 11 Key Terms

active participant .... pg. 92


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Chapter 12

Taxable income taxed in descending order of rates

Learning Objectives

After reading this chapter, you will be able to:

- explain the process for determining profits and taxes on property sales;
- identify the differing tax rates for income and profits in real estate ownership and sales; and
- inform clients in sales transactions about tax reporting consequences.

Key Terms

carryback sale	**net profit**
Individual Tax Analysis (INTAX)	**taxable income**

The batching and taxing of gains

Income tax knowledge by real estate agents is an engaging and personal tool for assisting clients with their decision to sell a property they do not want to own. Specifically, an agent's tax knowledge passed on to clients becomes business *goodwill*, an indicia of the agent's brand. In turn, the earning power of goodwill generates further employment by members of the public, i.e., superior listings, larger dollar transactions and expanded clientele.

Counseling a client on the tax aspects of a sale, purchase, or reinvestment in the early stage of an agency relationship typically excites an ongoing tax discussion. Tax consequences are of constant concern to all participants in real estate transactions – a material fact grooming their decisions.

Of course, the objective of a discussion on taxes is to achieve the most favorable tax result available to the client without altering the financial underpinnings and risks deemed acceptable in a sale (or purchase). While material, tax consequences is the least important in the hierarchy of fundamentals when making decisions in a real estate transaction.

The earlier in the client relationship an agent begins the tax discussion, the likelier the client will consult with other competent professionals about their agent's tax-related discussions. The agent's discussion becomes the focal point influencing the client's conversations with other advisors, professional or otherwise. A client's early consultation with others allows the client to follow up on their agent's advice, such as a **carryback sale** or the purchase of replacement property in a §1031 reinvestment plan, or as here, the magnitude of unrecaptured and capital gains taxes.

carryback sale
Financing provided by a seller of real estate by extending credit to a buyer for the deferred payment of a portion of the sales price, typically repaid monthly with accrued interest — also known as an installment sale.

Encouraging a client to discuss the transaction with other advisors available to the client – or the client authorizing the agent to do so – results in increased coordination between the client and agent.

When a client involves other professional advisors, the agent's duty of care owed a client is not relinquished to their other advisors. The agent's duty is to present their client with information about a transaction the agent believes may impact the client, information the client needs to consider when making decisions. The agent's counseling might well be contrary to advice given to the client by others, such as the client's attorney or accountant, which then needs to be resolved.[1]

Although an agent's opinion is not conclusive, it is relevant and important. Further, agents negotiating a transaction need to maintain influence over a client's decisions so the client's goals known to the agent are attained. Changing market conditions and the innuendos and nuances of real estate negotiations are best known and managed by agents. Agents are regularly involved in real estate transactions, clients not so much. Agents are likely more often involved in transactions than other advisors of a client's other. Also, agents giving advise routinely develop professional relationships with individuals from other professions who will remember the agent long after the transaction is closed.

Finally, an agent's failure to coordinate activity in a transaction with the client's other advisors can prove detrimental for the agent. An agent who persuades a client to rely on their advice to the exclusion of contrary (and correct) advice of other professionals is liable for any losses suffered by the client due to the agent's unsound advice. It is best to let the client sort out all the advice they receive (including the agent's) and make their own decision regarding whose advice to follow.[2]

Disclosures benefit the agent

As most agents and sellers know, the sale of every parcel of real estate, except dealer property, produces a profit (or loss as the flip side of that coin) for a seller when the price exceeds the seller's cost basis in the property. And agents know a sale at a price above the cost basis produces a tax liability. [See Chapter 3]

1 **Brown** v. **Critchfield** (1980) 100 CA3d 858

2 **In re Jogert, Inc.** (1991) 950 F2d 1498

However, an agent handling a one-to-four unit residential property is not obligated to mention tax consequences or disclose any part of their tax knowledge to their buyers or sellers of this class of properties. The exculpatory provisions in the state mandated agency disclosure law eliminate any duty to affirmatively disclose the tax aspects in one-to-four unit transactions. This permissive non-disclosure is part of the dumb-agent rules for one-to-four unit sales dear to large SFR brokerage operations. [See **RPI** Form 305]

However, an agent with knowledge of the tax aspects of real estate transactions does not leave their buyer or seller to their own devices, nor need they, not even on one-to-four residential units. Consider that an agent's interests are best served when they assist their client by:

- giving tax advice on the transaction to the best of their knowledge with the understanding tax-related information is confidential;
- disclosing the basis for their opinion as the advice given;
- encouraging (or requiring) the client to consult other advisors about the tax advice given; and
- conditioning the transaction on the client's right to cancel the purchase agreement by including a further-approval contingency provision regarding clearance of the transaction's tax consequences.

The individual Tax Analysis (INTAX)

Before entering into a tax discussion with your seller about a proposed sale, you need to think through the preparation of an **Individual Tax Analysis (INTAX)** form for review with the seller. By using it, you break down the profit taken on a sale into the two types of gains, called *batching*. Without first batching the gains, you are unable to develop an accurate estimate of the seller's tax liability generated by closing a sale you negotiated. [See Form 351 accompanying this chapter]

Individual Tax Analysis (INTAX)
An estimate of a seller's tax liability incurred due to unrecaptured and capital gains realized on a proposed sale of a property.

During a review of the profit tax liability estimated on the *INTAX* form, you need to discuss variations for the client to consider on a sale to *exclude or exempt* profit from taxes or to *defer* profit reporting and taxes on the proposed sale.

Thus, the seller who initially sought only to "cash out" their ownership of real estate they no longer want, might consider a §1031 reinvestment plan and acquire a replacement property — with your assistance. Alternatively, the seller might see good reason to structure a sale as a carryback transaction. Thus, the seller retains the earning power of their profits, untaxed, until years later when the deferred profit from the sale is reported and taxed.

taxable income
The amount of an individual's income subject to tax, determined as adjusted gross income (income and profits less allowed losses from all income categories) minus deductions.

The top half of the INTAX form is a review of the seller's **taxable income** and profit or loss. You need the client's estimate of their taxable income before you can estimate the profit tax on a sale. Further, the client's estimated ordinary income is needed to determine how much of the client's taxable income remains to be taxed at the lower unrecaptured and capital gains rates.

The profit review first takes place at the listing stage, and again when a purchase agreement offer or counteroffer is submitted and reviewed. Your

Form 351

Individual Tax Analysis (INTAX)

INDIVIDUAL TAX ANALYSIS (INTAX)

Prepared by: Agent ______________________ **Phone** ______________________

Broker ______________________ **Email** ______________________

NOTE: This form is used by an agent when negotiating a sale or partial §1031 transaction for a client, to prepare an estimate for review and provide advice on any income tax liability generated by the proposed transaction.

Date: ______________, 20_____

Client: ______________________

Prepared by: ______________________

	Items	Standard Income Tax (SIT)	Alternative Minimum Tax (AMT)
1.	**ADJUSTED GROSS INCOME (AGI):**		
1.1	Salary/professional fees/wages	(+) $______	(+) $______
1.2	Trade or business income/loss	(+/-) $______	(+/-) $______
1.3	Sale of business property profit/loss	(+/-) $______	(+/-) $______
1.4	Rental operating income and profit	(+) $______	(+) $______
1.5	Business related rental operating loss	(-) $______	(-) $______
1.6	Loss spillover of rental sales	(-) $______	(-) $______
1.7	Investment category income and profits	(+) $______	(+) $______
1.8	Investment category capital losses (up to $3,000)	(-) $______	(-) $______
1.9	Retirement, pension and annuity plans	(-) $______	(-) $______
1.10	**ADJUSTED GROSS INCOME**	$ 0	$ 0
2.	**REAL ESTATE RELATED DEDUCTIONS:**		
2.1	First/second home interest ($750,000 loan cap)	(-) $______	(-) $______
2.2	$25,000 rental loss deduction	(-) $ 0	(-) $ NONE
2.3	**TOTAL REAL ESTATE RELATED DEDUCTIONS**	(-) $ 0	(-) $ 0
3.	**OTHER DEDUCTIONS AND EXEMPTIONS:**		
3.1	Medical and dental	(-) $______	(-) $ NONE
3.2	Other deductions (charitable contributions, etc.)	(-) $______	(-) $ NONE
3.3	Personal deduction	(-) $______	NONE
3.4	AMT exemption		(-) $______
3.5	**TOTAL OTHER DEDUCTIONS AND EXEMPTIONS**	(-) $ 0	(-) $ 0
4.	**TAXABLE INCOME** (line 1.10 minus lines 2.3 and 3.5)	**$** 0	**$** 0
5.	**TAX BATCHING:**		
5.1	Net profits and short term losses (line 4 minus income in line 1.10 not a gain)	(+/-) $______	$______
5.2	Ordinary income (line 4 minus line 5.1 but not less than zero)	$ 0	$ 0
	(a) Tax: Use SIT and AMT tax bracket rates	$______	$______
5.3	Unrecaptured depreciation gain	$______	
	(b) Tax: Use further SIT and AMT tax rates up to 25%	$______	$______
5.4	Long-term capital gain (line 5.1 minus line 5.3)	$______	
	(c) Tax: Use threshold tax rates when line 4 is >$87,500	$______	$______
	(2021 thresholds for couples: line 4 > $87,500 use 15%; >$496,600 use 20%)		
6.	**INCOME TAX:** The total of lines a, b, and c (Tax amount due is the larger of the SIT or AMT at line 6)	**$** 0	**$** 0

Additional taxes are due for state income taxes and possible NIIT.

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tax discussion with the seller on each occasion may be limited to the amount of profit on the sale, the batching of the gains, and any tax liability exposure due on those gains. Also, a seller who is a *high-income earner* is more likely to respond favorably to a tax discussion than a low-income earner.

Two formats for setting tax liability

The INTAX worksheet contains separate columns for calculating the amount of profit taxes: one for the *standard income tax (SIT)* and the other for the *alternative minimum income tax (AMT)*.

AMT rates can increase the seller's tax liability on income from their business, professional, and investment sources. However, the distinction has no impact on the profit tax rates on the sale of a capital or business asset. The tax rate for *gains* (profit) on a sale remains the same for SIT and AMT no matter the amount of ordinary income and itemized deductions of a high-income earner.

Thus, a tax discussion with a seller of investment or business-use property is limited to the types of gains contained in the profit on the sale, and the tax due on those gains, not the SIT or AMT tax consequences. [See Form 351 §§5.3 and 5.4]

In contrast, you do not use the INTAX form to assist a buyer of real estate on their selection of property based on the tax consequences of a purchase. The *Annual Property Operating Data (APOD)* sheet provides the depreciation schedule covering the only tax benefit available to a buyer during the buyer's ownership and operation of their property. [See **RPI** Form 223]

Further, the increase or decrease in the buyer's annual taxes brought on by the purchase of a property is calculated on a **Comparative Analysis Projection (CAP)** worksheet, not the INTAX form which is designed solely for sales. [See **RPI** Form 353 §5.3]

When a seller acquires like-kind replacement property in a §1031 reinvestment plan, they avoid profit taxes on some or all the profit realized on the property sold. In §1031 situations, an agent need only prepare a Profit and Basis Recap Sheet to calculate the profit tax the client avoids. [See **RPI** Form 354; see Chapter 30]

Occasionally, the seller's §1031 reinvestment plan might qualify them for a partial §1031 exemption. Their withdrawal of cash, receipt of a carryback note, or a reduced amount of mortgage debt on the reinvestment causes part of the profit they realize to be taxed. Items withdrawn before acquiring all replacement property cannot be offset and the profit allocated to them is taxed. Here, the INTAX form section for batching taxable profit includes profit taxed in the partial §1031 transaction.[3]

Capital gain tax rate set by taxable income thresholds

When the amount of the net sale price of business-use or investment real estate is greater than the price the seller paid for the property and improvements, the seller takes a capital gain as part of their profits. Capital gains are broken down into either *short-term capital gains* when held less than one year and treated as ordinary income, or *long-term capital gains* when held for more than one year.

From a different analysis of profits, the **net profit** on a sale is the difference between the net sales price (gross price less transactional costs) and the seller's remaining cost basis in the property sold (price minus basis equals profit).

Net profit is taxed, but at different rates from ordinary income, unless exempt, excluded, deferred, or reduced by offsets for losses and deductions.

net profit
Gains on the sale of business-use and capital assets calculated as the sales price minus transactional costs minus the remaining cost basis.

3 Internal Revenue Code §1031(b)

Critically, net profit consists of two types of gain — *unrecaptured gain* and *capital gain* — each with different sets of tax rates and priorities for computing taxes on taxable income, specifically:

- *unrecaptured gain*, represented by the accumulated amount of *depreciation deductions* taken on the property sold, is taxed up to the maximum rate of 25%;[4] and
- *long-term capital gain*, is the net profit remaining in the sales price of a capital asset held for more than 12 months, minus the remaining cost basis and unrecaptured gain, and to the extent it is taxed is taxed at a single rate of either 0%, 15% or 20% set by two thresholds applied to the seller's taxable income.[5] [See Form 351 §5.4]

Further, when the resale price is less than the price paid to acquire the property and make improvements (no capital gain is realized), the unrecaptured gain taxed is limited to the net resale price minus the cost basis.

For example, a couple selling a rental property paid $300,000 for the property. Their depreciation deductions total $100,000. The property is sold for $450,000, a profit of $250,000 over their remaining cost basis of $200,000. Critically, the couple's taxable income for the year 2021 is between the $80,800 and $501,600 *taxable income* thresholds triggering the taxing of all capital gains in the couple's taxable income at the rate of 15%. [See Form 351 §4]

The couple's profit of $250,000 is broken down — *batched* — into:

- unrecaptured gain, consisting of $100,000 in reported depreciation deductions, taxed at remaining ordinary income tax rates up to a ceiling 25% rate for a maximum tax liability of $25,000 [See Form 351 §5.3]; and
- long-term capital gain, limited to the remaining $150,000 of taxable income, and based on taxable income thresholds taxed at the 15% rate for a maximum tax liability of $22,500.

The taxable income thresholds which set the single rate used to tax all capital gains are adjusted each year for inflation.[6]

In the order of descending rates to reduce subsidies

Here is presented a fuller picture of the effect on taxable income by including in these examples the seller's ordinary income and personal deductions which limit the amount of capital gains to be taxed.

Typically the capital gain amount on a sale is greater than the portion of the seller's taxable income allocated to capital gains and taxed. This result of taxes on only a portion of the capital gains is due to the limitation on taxes for the amount of the taxable income and priority treatment given to taxing ordinary income and unrecaptured gains. When capital gain amounts are greater than the amount of taxable income remaining after taxing ordinary income and unrecaptured gains, the capital gain rate simply applies only to the remainder of the taxable income.

4 IRC §1(h)(1)(E); see Form 351 §5.3
5 IRC §1(h)(1)(C)-(D)
6 IRC §1(j)(5)(B)

Also, when capital gains are reported personal deductions end up reducing the amount of capital gains remaining to be taxed, but do not reduce ordinary income or unrecaptured gains which are taxed at higher rates (up to 37% and 25%) than capital gains (15% or 20%). Ordinary income in the AGI is the first batch of *taxable income* to be accounted for and taxed. When sales generate capital gains, any taxable income remaining untaxed after ordinary income and unrecaptured gains are accounted for is taxed at the capital gains rate. Capital gains exceeding the taxable income amount are ignored and go untaxed due to offsets to the AGI for deductions to produce the taxable income.

Other types of profit exist in taxable income which are batched and taxed after accounting for ordinary income but before taxing unrecaptured gains. Profit on the sale of coins and art is called a *collectibles gain*. Collectibles are taxed up to a maximum rate of 28%, unless sold in a §1031 reinvestment plan as exempt. Profit on the sale of small business stock, called a §1202 gain, is also taxed up to a maximum rate of 28%.[7]

Netting gains and taxing priorities

Recall that the total amount of all income, profits and allowable losses from each income category is called adjusted gross income (AGI). Subtracting personal and rental loss deductions from AGI produces the seller's taxable income.[8]

To determine the tax liability of the seller, taxable income is broken down into two major components for sellers of real estate:

- net profit (unrecaptured and capital gains) [See Form 351 §5.1]; and
- ordinary income. [See Form 351 §5.2]

To accomplish this breakdown of the taxable income, the net profits – gains – within each income category are added together to produce the AGI.

Further, ordinary income in the AGI is taxed at whichever produces the greater amount of taxes:

- SIT rates ranging from 10% to a ceiling of 37%, or
- AMT rates of 26% and 28%.

Batching gains for taxable income

To calculate the income tax on net profits from a sale, profits are broken down and batched into unrecaptured gain and capital gain. Then after ordinary income in the taxable income amount is taxed at rate brackets up to 37%, profits are taxed by their type of gain in the order of descending rates, until no amount of taxable income remains to be taxed:

- first, any collectibles gain and business stock gain is, taxed at a 28% rate;
- next, any unrecaptured gain — depreciation taken, is, taxed at a maximum rate of 25%; and

---

7 IRC §§1(h)(4), 1(h)(5), 1(h)(7)

8 IRC §§63(b), 63(d)

- last, any taxable income remaining untaxed is long-term capital gain taxed at either the 15% or 20% capital gain rate as set by thresholds applied to the taxable income. [See IRS Form 1041, Schedule D Part IV]

Earnings on the sale of dealer property, also called inventory, are reported as business income, not profit on the sale of assets. Recall that dealer property is held primarily for sale to customers of a business, not for productive use in a business or investment.[9]

The principal residence profit exclusion

Profit remaining on the sale of a principal residence after taking the profit exclusion is reported as a short- or long-term gain (held, respectively, less or more than one year). [See Chapter 3]

For example, a homeowner and spouse paid $250,000 for their principal residence which they are now offering for sale at a net sales price of $900,000. The homeowners did not take any depreciation deductions on the residence as a home office or as a rental, in whole or in part. Thus, their cost basis remains unchanged as the price they originally paid for the residence and additional improvements.

On the sale, they will take a profit of $650,000 since a principal residence is classified as a capital asset. They qualify for a combined exclusion from profit tax of $500,000. Thus, they have a reportable profit of $150,000 – a portfolio income category profit which in combined into their AGI, and after deductions, is part of the homeowner's taxable income.

Further, the $150,000 in profit remaining (after taking their principal residence profit exclusion) will be reported as a long-term capital gain and taxed as remaining taxable income at the 15% rate after all other income is taxed. Their maximum tax liability on the sale of the residence is $22,500. [See Form 351 §5.4]

Conversely, a seller may not use a loss on the sale of the principal residence to offset investment or business category income or profits — it is an unsubsidized personal loss.

Carryback sale profit reporting

Profit allocated to any note carried back by a seller is reported each year as payment is received. The profit allocated to the principal in the installment payments is also batched and reported in the year received. The profit allocated to the down payment and principal installments is taxed at the relevant rates.[10]

For example, real estate used to provide warehouse space for a seller's distribution business is sold for the net sales price of $1,000,000. Terms include a $100,000 down payment, the buyer to assume or refinance a $400,000 mortgage and execute a $500,000 carryback note for the balance of the price.

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9 IRC §1231(b)
10 IRC §453

The seller has taken depreciation deductions of $150,000, leaving an adjusted cost basis of $500,000 at the time of sale. Thus, the profit on the sale is $500,000 (price minus basis equals profit).

As a result, the installment sale's *contract ratio* of profit-to-equity ($500,000/$600,000) for the allocation of profit to principal is 83.3%. Accordingly, the down payment of $100,000 is 83.3% profit ($83,333) and the carryback note of $500,000 is 83.3% profit ($416,666), both amounts making up the total profit on the sale. [See Chapter 15]

Further, by batching, $150,000 of the profits is unrecaptured gain (depreciation), to be taxed before calculating the tax for any long-term gain remaining in the taxable income. Thus, profit taxes are only paid when cash is received from the down payment, and from installments of principal.

The entire profit of $83,333 in the down payment is reported as unrecaptured gain and taxed up to the 25% ceiling rate. The remainder of the unrecaptured gain is reported on 83.3% of the principal payments and taxed when received on the carryback note, ending the year the unrecaptured gain is fully reported. All remaining profit (83.3% of the note's principal balance) is taxed at the long-term capital gain rate as principal is received on the note. [See Form 351 §§5.3 and 5.4]

The alternative minimum tax on other than profits

For high-income earners, ordinary income tax needs to be calculated twice, once under SIT rates and again under AMT rates.

This is not so for profits, as the rate on profits remain are the same for both SIT and AMT reporting.

Whichever SIT or AMT calculation sets the highest tax liability, that amount is the tax paid on the ordinary income portion of the taxable income.[11] [See Form 351 §§5.2(a) and 6]

The rates on ordinary AMT income (taxable income less profits) for all taxpayers, except for married individuals filing separately, are (for 2021):

- 26% on amounts up to $199,900; and
- 28% on amounts over $199,900.[12]

When reporting AMT, *depreciation* taken on a property is reported as unrecaptured gain taxed at remaining ordinary rate brackets up to a ceiling of 25%, the same as SIT treatment of unrecaptured gain. Likewise, the long-term capital gain rates and taxable income thresholds apply to both SIT and AMT reporting.[13]

The net investment income tax (NIIT)

A NIIT tax of 3.8% is also imposed on the lesser of an owner's:

- net investment income; or

11 IRC §55(a)
12 IRC §55(b)(1)(A)
13 IRC §55(b)(3)

- AGI amounts greater than the $250,000 NIIT threshold amount for joint filers ($200,000 for single filers).[14]

Net investment income (NII) for real estate investors is income, profits, and losses from:

- operations and sales of rental property; and
- interest income on savings and trust deed notes, earnings on land held for profit and rents received on management-free net-leased property.

The 3.8% surtax when imposed on AGI applies only to amounts of AGI exceeding the NIIT threshold of $250,000 for joint filers ($200,000 for single filers).

An owner's AGI derived solely from salary or wages is not subject to the 3.8% tax – zero NII exist. For example, when the owner has an AGI greater than the NIIT threshold amount, but $0 in net investment income, the lesser of the two amounts ($0) results in a $0 net investment income tax.

14 IRC §1411(a)(1)

Chapter 12 Summary

An agent's tax knowledge passed on to clients becomes business goodwill. This goodwill reflects positively on the agent's brand and generates further employments. Encouraging a client to discuss the transaction with other advisors available to the client – or the client authorizing the agent to do so – results in increased coordination between the client and the agent.

The sale of every parcel of real estate, except dealer property, produces a profit (or loss as the flip side of that coin) for a seller when the price exceeds the seller's cost basis in the property.

By using an Individual Tax Analysis (INTAX) form for review with the seller, the agent breaks down the profit taken on a sale into the two types of gains, called batching. The agent is unable to develop an accurate estimate of the seller's tax liability generated closing a sale the agent negotiated without first batching the gains.

The net profit on a sale is the difference between the net sales price (gross price less transactional costs) and the seller's remaining cost basis in the property sold (price minus basis equals profit). Net profit consists of two types of gain – unrecaptured gain and capital gain – each with different sets of tax rates and priorities for computing taxes on taxable income.

Chapter 12 Key Terms

Chapter 13

The tax rates in application

Learning Objectives

After reading this chapter, you will be able to:

- distinguish between unrecaptured gain and long-term capital gain a couple takes as their profit on the sale of real estate;
- advise clients on the rates applying to unrecaptured gains and the taxable income thresholds setting the single tax rate for their long-term capital gains; and
- counsel clients about arrangements which reduce the financial consequences of income tax liabilities on their transactions.

Key Terms

all-inclusive trust deed note (AITD)

net investment income tax (NIIT)

net sales proceeds

seller's net sheet

Tax rates put to your seller's best use

Property owners considering the sale of a property are often averse to selling for fear of an unknown – **tax consequences**, a profit tax liability incurred in the year of the sale. To neutralize this fear, an agent representing a seller analyzes and advises on the approximate amount of profit taxes they will incur on the sale as part of the real estate services they render.

To discuss the *tax aspects* of a sale with anyone, real estate licensees need sufficient expertise to understand and determine the likely profit tax consequences of the transaction they are negotiating. Also, licensees have good reason to develop their working knowledge about tax ramifications to best manage the client's contracting and financial aspects of a sale, whether acting on behalf of a client or as a principal. The basis for this tax advisory approach with clients is that taxes are an inherent part of every real estate sales transaction, may inform the client's decisions, and that tax aspects as accounting is taught as part of a real estate education for licensees.

On acquiring profit tax knowledge, many agents advertise they specialize in advising investor clients on alternative structuring for generic cash-out sales transactions. Based on their advice, sellers are enabled to consider prudent steps they might take to avoid or defer profit tax, including:

- acquiring replacement property in a §1031 reinvestment transaction;
- carrying paper in a §453 deferred installment sale;
- timing the closing so gain is taxed at a lesser rate; or
- qualifying for the $250,000 per person principal residence profit exclusion or 2020 Prop 19 replacement home assessment.

Recall that an agent uses the INTAX form to calculate the seller's anticipated federal tax liability on a sale. California's state income tax liability on the sale is additional, around one-third the amount of the federal tax liability.

When an owner sells a primary residence, each owner-occupant is entitled to take up to $250,000 in capital gains profit on the sale tax-free due to the *principal residence profit exclusion*. [See Chapter 3]

The mid-income earner sells property

Consider an agent managing their employment under a listing agreement with the owner of an income-producing property at a sales price of $900,000. The owner of the property acquired the property for $500,000 as shown in a property profile title report.

During discussions, the owner voices concern about any profit tax liability a sale of the property might create since their depreciated cost basis in the property is $270,000. On a review of documents in the property profile, the owner comments on their recent refinancing of the property with a $400,000 mortgage originated to obtain cash to fund needs unrelated to the property.

Noting the mortgage balance is greater than the remaining cost basis, the agent suggests the owner might consider avoiding taxes on any profit as *exempt* by acquiring a replacement property in a §1031 *reinvestment plan*. However, the owner only wants to liquidate their properties - they need the sales proceeds for purposes other than real estate ownership.

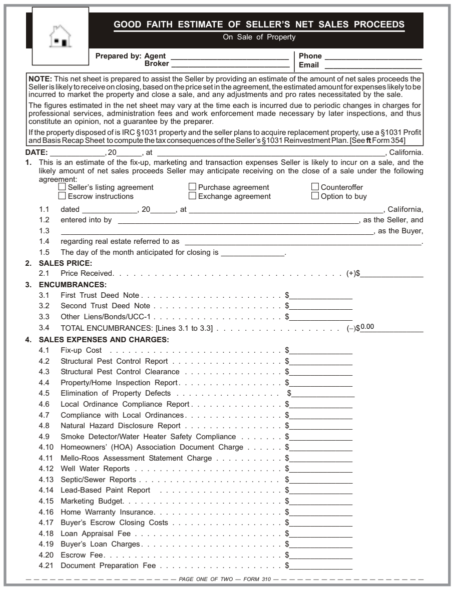
Further, the agent mentions the owner's ability to defer profit taxes in an installment sale until principal is paid on the note received in a *carryback sale*. Here too, the owner only wants cash.

On inquiry by the agent, the owner is aware profit taxes will reduce the amount of cash sales proceeds but does not know by how much. The agent offers to assist in a profit tax analysis and the owner agrees as the amount of after-tax cash on the sale is a concern.

Figure 1

Form 310

Good Faith Estimate of Seller's Net Sales Proceeds



GOOD FAITH ESTIMATE OF SELLER'S NET SALES PROCEEDS
On Sale of Property

Prepared by: Agent ____________ Phone ____________
Broker ____________ Email ____________

NOTE: This net sheet is prepared to assist the Seller by providing an estimate of the amount of net sales proceeds the Seller is likely to receive on closing, based on the price set in the agreement, the estimated amount for expenses likely to be incurred to market the property and close a sale, and any adjustments and pro rates necessitated by the sale.

The figures estimated in the net sheet may vary at the time each is incurred due to periodic changes in charges for professional services, administration fees and work enforcement made necessary by later inspections, and thus constitute an opinion, not a guarantee by the preparer.

If the property disposed of is IRC §1031 property and the seller plans to acquire replacement property, use a §1031 Profit and Basis Recap Sheet to compute the tax consequences of the Seller's §1031 Reinvestment Plan. [See **ft** Form 354]

DATE: ____________, 20______, at ____________, California.

1. This is an estimate of the fix-up, marketing and transaction expenses Seller is likely to incur on a sale, and the likely amount of net sales proceeds Seller may anticipate receiving on the close of a sale under the following agreement:
☐ Seller's listing agreement ☐ Purchase agreement ☐ Counteroffer
☐ Escrow instructions ☐ Exchange agreement ☐ Option to buy

1.1 dated ____________, 20______, at ____________, California,
1.2 entered into by ____________, as the Seller, and
1.3 ____________, as the Buyer,
1.4 regarding real estate referred to as ____________.
1.5 The day of the month anticipated for closing is ____________.

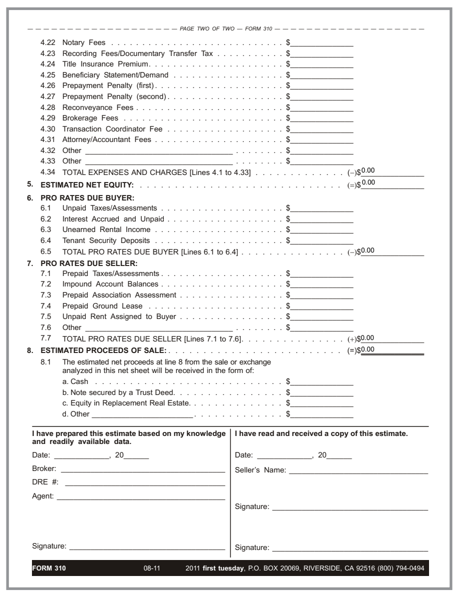
2. SALES PRICE:
2.1 Price Received . . . . . (+)$________

3. ENCUMBRANCES:
3.1 First Trust Deed Note . . . . . $________
3.2 Second Trust Deed Note . . . . . $________
3.3 Other Liens/Bonds/UCC-1 . . . . . $________
3.4 TOTAL ENCUMBRANCES: [Lines 3.1 to 3.3] . . . . . (–)$0.00

4. SALES EXPENSES AND CHARGES:
4.1 Fix-up Cost . . . . . $________
4.2 Structural Pest Control Report . . . . . $________
4.3 Structural Pest Control Clearance . . . . . $________
4.4 Property/Home Inspection Report . . . . . $________
4.5 Elimination of Property Defects . . . . . $________
4.6 Local Ordinance Compliance Report . . . . . $________
4.7 Compliance with Local Ordinances . . . . . $________
4.8 Natural Hazard Disclosure Report . . . . . $________
4.9 Smoke Detector/Water Heater Safety Compliance . . . . . $________
4.10 Homeowners' (HOA) Association Document Charge . . . . . $________
4.11 Mello-Roos Assessment Statement Charge . . . . . $________
4.12 Well Water Reports . . . . . $________
4.13 Septic/Sewer Reports . . . . . $________
4.14 Lead-Based Paint Report . . . . . $________
4.15 Marketing Budget . . . . . $________
4.16 Home Warranty Insurance . . . . . $________
4.17 Buyer's Escrow Closing Costs . . . . . $________
4.18 Loan Appraisal Fee . . . . . $________
4.19 Buyer's Loan Charges . . . . . $________
4.20 Escrow Fee . . . . . $________
4.21 Document Preparation Fee . . . . . $________

PAGE ONE OF TWO — FORM 310

For a full-size, fillable copy of this or any other form in this book that may be legally used in your professional practice, go to realtypublications.com/forms



PAGE TWO OF TWO — FORM 310

4.22 Notary Fees . . . . . $________
4.23 Recording Fees/Documentary Transfer Tax . . . . . $________
4.24 Title Insurance Premium . . . . . $________
4.25 Beneficiary Statement/Demand . . . . . $________
4.26 Prepayment Penalty (first) . . . . . $________
4.27 Prepayment Penalty (second) . . . . . $________
4.28 Reconveyance Fees . . . . . $________
4.29 Brokerage Fees . . . . . $________
4.30 Transaction Coordinator Fee . . . . . $________
4.31 Attorney/Accountant Fees . . . . . $________
4.32 Other ____________ . . . . . $________
4.33 Other ____________ . . . . . $________
4.34 TOTAL EXPENSES AND CHARGES [Lines 4.1 to 4.33] . . . . . (–)$0.00

5. ESTIMATED NET EQUITY: . . . . . (=)$0.00

6. PRO RATES DUE BUYER:
6.1 Unpaid Taxes/Assessments . . . . . $________
6.2 Interest Accrued and Unpaid . . . . . $________
6.3 Unearned Rental Income . . . . . $________
6.4 Tenant Security Deposits . . . . . $________
6.5 TOTAL PRO RATES DUE BUYER [Lines 6.1 to 6.4] . . . . . (–)$0.00

7. PRO RATES DUE SELLER:
7.1 Prepaid Taxes/Assessments . . . . . $________
7.2 Impound Account Balances . . . . . $________
7.3 Prepaid Association Assessment . . . . . $________
7.4 Prepaid Ground Lease . . . . . $________
7.5 Unpaid Rent Assigned to Buyer . . . . . $________
7.6 Other ____________ . . . . . $________
7.7 TOTAL PRO RATES DUE SELLER [Lines 7.1 to 7.6] . . . . . (+)$0.00

8. ESTIMATED PROCEEDS OF SALE: . . . . . (=)$0.00
8.1 The estimated net proceeds at line 8 from the sale or exchange analyzed in this net sheet will be received in the form of:
a. Cash . . . . . $________
b. Note secured by a Trust Deed . . . . . $________
c. Equity in Replacement Real Estate . . . . . $________
d. Other ____________ . . . . . $________

I have prepared this estimate based on my knowledge and readily available data.	**I have read and received a copy of this estimate.**
Date: ____________, 20______	Date: ____________, 20______
Broker: ____________	Seller's Name: ____________
DRE #: ____________	
Agent: ____________	Signature: ____________
Signature: ____________	Signature: ____________

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Initially, the agent prepares a **seller's net sheet** for review with the owner based on a cash-out sale of the property at the listed price. Using the net sheet the agent determines the amount of **net sales proceeds** the owner can anticipate receiving at the listed price — before payment of taxes on profits taken on the sale. [See Figure 1]

Starting with the listing price of $900,000, the agent deducts the $400,000 mortgage financing and estimated closing costs of $70,000. The estimated *net sales price* is $830,000 – $900,000 gross sales price minus $70,000 closing costs. On review of the net sheet with the seller, the agent advises the owner to anticipate receiving approximately $430,000 in *net sales proceeds* on the close of escrow — in the form of cash.

seller's net sheet
A document prepared and used by a seller's agent to itemize expenditures and charges incurred on a sale of a property, disclosing the financial consequences of a sales price set in a listing agreement or a buyer's offer to purchase.

net sales proceeds
The amount of a seller's receipts on closing a sale of their property after deducting all costs of the sale and mortgage assumptions/payoffs from the gross price, but before payment of taxes on any profit on the sale.

The gathering of tax figures known to the client

Further, the agent now requests personal tax information which the owner provides, including:

- the owner's *ordinary income* of $65,000;
- accumulated depreciation deductions of $230,000 taken during ownership of the listed property;
- the couple's remaining cost basis of $270,000 on the listed property; and
- the couple files a *joint return* taking the standard deduction of $25,100 (for 2021).

With tax information about the owner and the property, the agent calculates the couple's taxable profit on the sale (remember, price minus basis equals profit):

- $830,000 net sales price; minus
- $270,000 remaining cost basis; equals
- $560,000 in reportable profit – *gains*.

However, the agent notes the profit of $560,000 on the sale is significantly larger than the net sales proceeds of $430,000. This inversion is the result of the *mortgage-over-basis* financing of their ownership.

When the owner refinanced the property with a mortgage encumbrance to withdraw equity in cash (the ATM effect), they incurred no tax consequence for the cash back they received as they are tax-free dollars. In contrast, profit taken on a sale may or may not generate a tax liability depending on whether the profit is exempt or its reporting deferred.

On the close of a sale, the mortgage is either satisfied using funds received from the buyer or remains of record, assumed by the buyer. However, a portion of the mortgage principal represents profit taken on the sale and is reported and taxed (when not exempt or deferred). This tax result is partially due to *debt relief* in a mortgage-over-basis situation on a cash-out sale.

Next, the agent fills out an INTAX form using the information provided by the couple. The couple's estimated *taxable income* is $600,000. [See Figure 2 §4 accompanying this chapter]

The taxable income consists of:

- the owner's joint ordinary income of $65,000; [See Figure 2 §1.1]
- their total profits taken during the year of $560,000 profit - this income property sale; [See Figure 2 §1.4]
- totaling their Adjusted Gross Income (AGI) of $625,000 [See Figure 2 §1.10] from which
- their $25,100 (for 2021) standard personal deduction is subtracted; and [See Figure 2 §3.3, which is rounded]
- totaling taxable income of $600,000. [See Figure 2 §4]

Note that taxable income is less than the combined ordinary income and profits on the sale which comprise the adjusted gross income (AGI). Further, that ordinary income is taxed first leaving the remainder of taxable income as gains taxed at lower rates. [See Figure 2 §5.1]

Taxing the profits, batch by batch, in taxable income

Calculating the approximate amount of taxes is straightforward using the Tax Batching section 5 in figure 2. Initially, from the taxable income of $600,000 you subtract all the couple's ordinary income in the AGI, here being $65,000 of professional income. The result is the amount of reported profit in their taxable income. Since the couple's net profit at line 5.1 is less than their total profits in the AGI at line 1.4, the profits taxed in section 5 will be less than the profits taken during the year. [See Figure 2 §5.1]

The $65,000 reportable ordinary income is the first batch of taxable income to be taxed. The types of income and gains are taxed with priority based on the highest tax rate batches taxed first before the next lowest, and so on. [See Figure 2 §5.2]

Observe: The $65,000 in ordinary income exceeds the 10% ordinary income tax bracket ceiling ($19,900 in 2021 for married couples filing jointly), but not the 12% ordinary income tax bracket ceiling amount ($81,050 in 2021). Thus, two tax brackets in tandem set the amount of tax on ordinary income. The tax due on the ordinary income is $7,400 ($2,000 + .12($65,000 -$19,900)). [See Figure 2 §5.2(a)]

The remaining taxable income is taxed at rates on gains for the profit taken on the sale.

Before proceeding with the profit tax analysis, you separate the profit of $560,000 on the proposed sale into its component gains as their priority for taxing and the tax rates for each are different. Here, the gains which are the profit, in the order of priority they are taxed, include:

- *unrecaptured gain* on real estate ($230,000), the result of depreciation deductions taken by the couple [See Figure 2 §5.3]; and
- long-term capital gains on the sale ($330,000), the portion of the net sales price exceeding the price the couple paid for the property. [See Figure 2 §5.4]

4.	**TAXABLE INCOME** (line 1.10 minus lines 2.3 and 3.5)....**$**	600,000	**$**
5.	**TAX BATCHING:**		
5.1	Net profits and short term losses ....(+/-) $	535,000	$
	(line 4 minus income in line 1.10 not a gain)		
5.2	Ordinary income		
	(line 4 minus line 5.1 but not less than zero)...........$	65,000	$
	(a) Tax: Use SIT and AMT tax bracket rates ....$	7,400	$
5.3	Unrecaptured depreciation gain ....$	230,000	
	(b) Tax: Use further SIT and AMT tax rates up to 25% ...$	53,060	$
5.4	Long-term capital gain (line 5.1 minus line 5.3).............$	305,000	
	(c) Tax: Use threshold tax rates when line 4 is >$87,500 $	61,000	$
	(2021 thresholds for couples: line 4 > $87,500 use 15%; >$496,600 use 20%)		
6.	**INCOME TAX:** The total of lines a, b, and c.................**$**	121,460	**$**
	(Tax amount due is the larger of the SIT or AMT at line 6)		
	Additional taxes are due for state income taxes and possible NIIT.		

Figure 2

Excerpt from Form 351

Individual Tax Analysis (INTAX)

Because the couple's ordinary income ($65,000) is $15,250 less than the $80,250 ceiling for the 12% tax bracket, $15,250 of the $230,000 unrecaptured gain on the sale is taxed at the 12% rate ($1,830 in tax). The ordinary tax rate bracket is used since its tax rate is lower than the ceiling rate of 25% for unrecaptured gain.

The $214,750 balance of the unrecaptured depreciation gain ($230,000 minus $15,250) is then taxed on the next $91,700 at the 22% tax bracket ($21,700 additional tax). This leaves $123,050 in unrecaptured gain to be taxed at the 24% ordinary income bracket rate ($29,530 additional tax). Thus, the total tax on the unrecaptured depreciation gain portion of the taxable income is $53,060 ($1,830 + $21,700 + $29,530). [See Figure 2 §5.3(b)]

The couple's taxable income now remaining to be taxed is $305,000 (the taxable profits of $535,000 at line 5.1 minus $230,000 at line 5.3). The remaining taxable income being long-term capital gain is taxed at a single rate set based on the amount of taxable income reported.

Note: While the reportable amount of capital gain on the sale was $330,000, the *taxable income* remaining to be taxed at the capital gains rate is $305,000, $25,000 less than the capital gains on the sale – the result of personal deductions from AGI to set the taxable income.

To select the one tax rate applied to the couple's capital gain portion of the remaining taxable income, the agent applies threshold figures to their taxable income (line 4).

For couples filing jointly in 2021, one of the following rates applies to all their capital gains:

1. When the couple's taxable income is below $80,800 ($40,400 for individual filers) the tax rate is 0% for capital gains – no tax on it, but this zero rate does not apply to this couple's capital gain;
2. When the couple's taxable income amount is between $80,800 and $501,600 ($40,400 and $445,850 for individual filers) the tax rate on all capital gains is set at 15% - but this 15% rate does not apply to the couple's capital gain;
3. When the couple's taxable income is over $501,600 ($445,850 for individual filers) the tax rate on all capital gains is set at 20%.[1]

Thus, the couple's long-term capital gain rate for taxing the $305,000 remainder of the taxable income is 20%. Their taxable income of $501,600 (for 2021) exceeds the 20% threshold for couples filing jointly. Here, the capital gain tax on the remainder of the taxable income is $61,000. [See Figure 2 §5.4(c)]

net investment income tax (NIIT)
A surtax on income from investment assets such as income, profits and losses from the operations and sales of rental property, interest income, stocks, bonds, and land held for profit on resale.

Separately and in addition to the figures in the INTAX form, the couple's $605,000 profits exceed the $250,000 threshold for the 3.8% **net investment income tax (NIIT)** by $355,000. This overage is subject to NIIT liability.

1 [Internal Revenue Code §1(j)(A)-(B)

When the total profit on the sale of investment properties is greater than the NIIT threshold, the excess here of $355,000 is subject to an additional NIIT tax of 3.8%, a further tax of $13,490 ($355,000 x 0.038). [See Chapter 12]

Thus, the couple's total tax on the sale of the property is $127,550 ($53,060 unrecaptured gain tax + $61,000 long-term capital gain tax + $13,490 NIIT). [See Figure 2 §§5.3(b); 5.4(c)]

Remember, the couple further owes approximately a third of these amounts as additional tax of around $40,000 due the State of California on the sales profit and other income.

After-tax net proceeds

Based on the agent's estimation of the net sales proceeds (seller's net sheet) and profit tax liability (INTAX form) at the listed price, the total amount of after-tax net proceeds the couple can anticipate from the sale is approximately $302,450 (net sales proceeds of $430,000 minus profit taxes of $127,550).

Thus, the payment of profit taxes to the IRS consumes approximately 40% of the net sales proceeds on account of the mortgage-over-basis situation. Critically, the profit tax due the IRS of $127,550 equals 23% of the $560,000 profit on the sale (state taxes being around an additional 8% of profit).

Since the couple is liquidating some of their estate to obtain cash, the agent suggests ways the couple can reduce their taxes, including:

- considering the sale of different property with a lower loan-to-value (LTV) ratio and a higher basis-to-value ratio to generate more after-tax sales proceeds; or
- carrying paper in the form of an **all-inclusive trust deed (AITD)** after a substantial cash down payment to minimize risk of loss and maximize tax benefits available by reporting as a carryback sale to defer and reduce taxes in the year of sale. [See Chapter 15]

all-inclusive trust deed note (AITD)
A note entered into by a buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment. This amount includes mortgage debts remaining of record which the seller remains responsible for paying. Also called a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

Chapter 13 Summary

When selling a property, an agent alleviates their seller's fear of unknown tax consequences and profit tax liability by analyzing and giving advice on the estimated amount of taxes generated by their sale.

Licensees need to be sufficiently knowledgeable about tax ramifications to best manage the contracting and financial aspects of a sale, whether acting as a principal or on behalf of a client. Taxes are inherent in most real estate education as they do affect ownership. Many agents advertise specializing in advising investor clients on alternative structuring for generic cash-out sales transactions. Based on their advice, sellers are able to consider which steps they might take to avoid or defer profit tax.

An agent prepares an individual tax analysis (INTAX) form, to calculate the seller's anticipated federal tax liability on a sale. An agent prepares a seller's net sheet to determine the amount of net sales proceeds the owner can anticipate receiving on a sale at the listed price – before payment of taxes on profits taken on the sale.

Chapter 13 Key Terms

Chapter 14

Inflation, appreciation, and taxes

Learning Objectives

After reading this chapter, you will be able to:

- identify price inflation and appreciation as separate factors contributing to tax revenues through upward property price movement;
- explain capital gain taxes as taking a percent of the value increase a property experiences on resale over the price the seller paid to acquire the property; and
- understand a rental property's earning power and value as driven by inflation and appreciation.

Key Terms

asset price inflation

consumer price inflation

Consumer Price Index (CPI)

real profit

real rate

Uncle Sam creates his share — mostly

Consider an investor who decides to sell an improved parcel of real estate they bought 21 years ago for $440,000. The investor's broker locates a buyer willing to pay $1,000,000 for the property. The seller's net sales price will be $900,000 ($1,000,000 minus $100,000 in transactional expenses).

During their ownership of the property, the investor took $140,000 in depreciation deductions. Consequently, the investor's adjusted basis in the property is $300,000 ($440,000 original cost basis minus $140,000 depreciation).

The investor does not plan to reinvest the net sales proceeds by acquiring replacement property in a §1031 reinvestment plan.

The investor's agent reviewing a seller's net sheet with the investor informs the investor their net profit on the sale will be $600,000 ($900,000 net sales price minus $300,000 adjusted cost basis). The investor's profit comprises:

- $140,000 in *unrecaptured gains* due to depreciation deductions, taxed at ordinary income rates limited to a ceiling of 25%; and
- $460,000 in *long-term capital gains* due to an increase in the property's dollar value, taxed at capital gains bracket rates of 0%, 15% and 20%.

The broker's analysis of the sales tax consequences does not consider the monetary inflation that has taken place in the past 21 years and is reflected in the property's price increase — and thus the profit.

When consumer inflation of the dollar is taken into consideration, the purchasing power of the investor's property value and net operating income has remained, in *real terms*, unchanged over the 21-year period of ownership.

A basket of goods and services

Changes in the general price level are measured and indexed as a figure by the *Bureau of Labor Statistics*. The Bureau reports the figures periodically for several metropolitan regions as the **Consumer Price Index (CPI)**. The *CPI* measures and tracks the rate of consumer inflation. CPI is simply an index of fluctuations in the general price of a huge selection of consumable products — a "basket of goods and services."

Consumer Price Index (CPI)
An index of fluctuations in the general price of a wide selection of consumable items consisting of goods and services to measure and track the rate of consumer inflation.

The CPI is published nationally and regionally; however, the most relevant index is regional. There are three regional indexes for California: Los Angeles-Long Beach, San Francisco-Oakland and San Diego. Regional indices reflect local economic pressures affecting retail pricing.

The CPI doubled during the investor's 21-year holding period. Thus, a dollar held on the date they bought the property has only about half its purchasing power today. Put another way, over 21 years it takes twice as many dollars to purchase the same amount of land, labor, and materials to produce the property the investor is now selling.

The demographic and cultural conditions which affect the property's value may not have changed — but the dollar has.

The investor believes it is unfair to pay tax on their receipt of inflated dollars from a sale — especially since the dollar's value has decreased due to the monetary policy of the very government doing the taxing.

The investor claims the taxes need to be based on *real economic gain* — the nominal sales price today less the *inflation-adjusted* cost basis — to bring the two figures into conformity with the worth of the dollar today. The adjustment eliminates the effects of federally induced monetary inflation over the period since the investor's acquisition of the property.

The property is located in Riverside County, so the investor calculates their **real profit** (adjusted for inflation) by using the same CPI figures for Los Angeles the investor uses to adjust the rents they charge tenants. The calculation is:

- 212.9 (Current CPI)
- 106.45 (Original CPI at time of purchase 21 years ago)
- X $440,000 (Original purchase price)
- = $880,000 (Original purchase price in today's dollars)

Thus, $440,000 of the current net sales price is created solely by price inflation. Due to a lack of local demographic changes other than wages running parallel with inflation, the appreciation factor has added nothing to the nominal dollar value of the property while consumer inflation alone has altered its dollar value.

On closing, the investor reports the profit on the sale — using inflation-adjusted figures — as $300,000 ($900,000 resale price minus $600,000, the remaining cost basis of $300,000 adjusted for inflation).

The IRS disagrees and claims the profit is $600,000 ($900,000 resale minus the nominal $300,000 remaining cost basis).

Does the investor owe capital gain taxes on the $440,000 portion of the net sales proceeds which consists solely of inflated dollars?

Yes! Taxes are based on *nominal profit*, calculated as the actual dollars of capital invested in the property subtracted from the net sales price of actual dollars received on the sale of the property. The **real profit** (after inflation adjustments) received by the investor on the original investment is of no concern to the government. However, the *real profit* is of concern to a prudent investor and their broker when determining the time to sell during an economic business cycle.[1]

real profit
The price received on the sale of property less the owner's capital investment in the property as adjusted for consumer inflation over the period of ownership.

consumer price inflation
An increase in the general price level of all goods and services consumed in the economy. Contrast with asset price inflation.

Fluctuation in the price level of goods and services

Inflation is the rise in general price levels of everything people buy. Inflation consists of two categories:

- **consumer price inflation**; and
- **asset price inflation**.

Although the two categories of inflation are intertwined with the dollar (and California real estate is a *US dollar denominated asset*), their differences are significant.

Consumer price inflation is an increase in the general price level of all consumable goods and services in the economy. Simply, the rate of consumer price inflation is set by the rise in price of everything we buy to consume.

While the category of consumable goods includes *rent movement* in housing, it does not include the price movement of the underlying asset —

asset price inflation
A rise in the value of assets, such as stocks, bonds, and real estate. Contrast with consumer price inflation.

1 **Hellerman** v. **Commissioner** (1981) 77 TC 1361

the housing itself. Home improvements are not consumed, only used, while remaining intact. Land and improvements are directly correlated to *savings* — a store of wealth in the ownership of a home. A property's resale value is not associated with day-to-day expenditures for consumable goods or services while the rental value of the property is.

The *Consumer Price Index (CPI)* does not measure *asset inflation*. Asset prices behave quite differently and independently from factors driving consumer price movement. Assets are investments, with pricing based on the capitalization rate applied to the likelihood of a return on the investment. These are an investor's expectations, not a consumer's. For investors, inflation relates to the future price of the investment; for consumers, inflation is today's changes in the price of goods and the wages they earn to buy them.

Inflation and the taxes sellers pay on sales

The government's need to raise revenue through a system for taxation of income and profits that does not respond well to inflation. When inflation occurs and investors take profits, they need to pay taxes on any profit created by the inflated dollars the investor accepts at the time of sale.

Thus, investors pay taxes on the nominal dollar amount of inflation-generated profit. Profit taxes are not calculated on the actual economic value received which reflects the **real profit**.

There are two reasons the tax system largely ignores inflation.

First, the U.S. dollar's primary function is to act as a uniform medium of exchange, or the dollar's "legal value." The dollar is the unit of exchange the U.S. has established to pay all public and private debts, including the payment of taxes.[2]

As a medium of exchange, *inflated dollars* affect everybody, everywhere who sets prices for goods in US dollars. Not only do we receive inflated dollars for services, but we pay for services with inflated dollars. Therefore, an investor who sells property and receives inflated dollars as their price pays taxes with inflated dollars (from net sales proceeds). The adverse impact of inflated values is diminished since the investor pays their taxes with inflated dollars.

Also, during the time the investor holds the property, rents typically increase to cover the landlord's inflated cost of operations and earnings on increased property value. Greater amounts of rent for the same property can only be successfully demanded when wages and salaries increase.

In a loopback, consumer inflation is met by consumers demanding higher wages and salaries, usually at or above the rate of consumer inflation, the COLA pay raise. Recall that rent amounts paid for housing are part of the calculation setting the rate of consumer inflation. Inflated rents in turn set the value of the rental property (based on the current capitalization rate for like investments which always includes an inflation premium added to the base **real rate** of return).

real rate
The nominal interest rate minus the rate of inflation.

2 **Norman** v. **Baltimore & O. R. Co.** (1935) 294 US 240

Second, when profit is calculated, the amount includes actual dollars received on a sale. Profit does not factor in the effect of inflation on the quantity and quality of consumables, i.e., goods and services.

For a capital gains profit to exist in a real estate transaction, more dollars are received on a sale than dollars paid to acquire and improve the property. In this sense, the capital gains tax takes a portion of only the increase in actual dollars received. Yet, when the inherent value of the real estate declines due to physical deterioration or obsolescence, the property's value in current dollars may fail to keep up with consumer inflation. In terms of *real value*, the property's dollar value has fallen when the dollar amount of inflation since acquisition is backed out of the property's current market value.

For example, an investor bought a property 20 years ago for $440,000. What if the current resale price for the property is $500,000 — an 11% nominal increase in dollars?

Here, the investor has a capital gain of $60,000 – the 11% increase in value.

However, under the *real profit* analysis, our investor has an inflation-adjusted loss of $180,000 ($500,000 resale minus $580,000, the investor's inflation-adjusted price on acquisition).

Editor's note — For the property to maintain its original purchasing power of $440,000, the investor would have to net $880,000 on resale — after the payment of their capital gain profit tax.

Can the investor report a loss on the sale?

No! The profit is again measured in actual dollars received, even though the real estate's price (and its basis) has not kept pace with inflation.[3]

This applies to both state and federal taxes. California definitions of income and profit are the same as federal definitions.[4]

Losses due to inflation and cost basis reduction through depreciation deductions are subject to the same rules — the use of actual dollars paid and received, without any adjustment for inflation.

Cutting its share

The government awards itself a share of an investor's real estate value, payable on any resale of the property at a price greater than the investor's remaining cost basis — in the form of capital gain taxes.

To understand how "government equity sharing" works, it is important to recognize the economic fact that, everything else remaining constant (like cap rates, which don't), improved real estate tends to follow inflation trends over time as rents tend to rise at the rate of inflation (as do salaries to pay the rent). Thus, the earning power of improved, income-producing real estate typically remains constant. Rents simply increase to meet (and create) inflation. Increased demographics within the local population is a factor

3 **Spurgeon** v. **Franchise Tax Board** (1984) 160 CA3d 524
4 **Calhoun** v. **Franchise Tax Board** (1978) 20 C3d 881

creating property appreciation, not asset inflation. Over time, appreciation of the property's location by the population adds to a property's value. By definition, appreciation drives the increase in a property's value *beyond* the rate of annual inflation.

When real estate values and the CPI increase at the same pace over time, the real economic value of the real estate remains constant. Due to this phenomenon, real estate is deemed a "hedge" against inflation, albeit a hedge that is taxed if the property is disposed of in a cash-out sale.

Were profits not driven by inflation, the government would not receive as much tax revenue as it now does.

For example, consider an investor who bought real estate for $500,000 20 years ago.

Today, the property's value is $1,000,000. However, due to intervening consumer price inflation, the property is worth the same as it was 20 years ago in *real* terms.

When the investor sells the property for $1,000,000, they will have a $500,000 profit on property that has only maintained its original worth in dollar purchasing power. The profit taken due to price increase is classified as net long-term capital gain, currently taxed at 15% and 20%.

Thus, the government cuts itself a 7.5% to 10% share in the total current dollar value of the property due solely to a reduction in the value of the dollar (not to mention the transactional costs of a sale running in the range of 5% to 10% of a property's gross price).

The investor is economically worse off selling the property than retaining it. This makes it difficult for agents to encourage owners to sell, unless the owner acquires like-kind replacement real estate in a §1031 exchange to exempt all profit from taxes.

Economic consequences

Investors need to keep a close eye on long-term inflation trends and business cycle price fluctuations (from boom to bust) and maximize annual rent increases and thus property value, and on a sale, profits. It is said the three most important words in real estate are "location," "timing" and "price."

The *timing* of any sale of a property up for consideration to be sold needs to be influenced by an increase in its value through asset price inflation, which exceeds the percentage change in the CPI since acquisition. When the value increase exceeds the increase in the CPI figures, which usually occurs during a business cycle's boom but not a recession, the investor will experience a *real* economic profit on the sale.

When an investor sells real estate that has not kept pace with inflation at the time of sale, they will have lost *real money*, but they will still be taxed on their inflation-created profit. The investor will be poorer going forward for failure to sell at the right time — at the peak of the upward phase of a business cycle.

LOS ANGELES'S "MANSION TAX"

On the sale of high-priced properties sold in the City of Los Angeles, a "Homelessness and Housing Solutions" tax was voted into law in 2022.

Commonly known as the ***mansion tax****, the tax is added to the base tax rate of 0.45% the city charges on the sale or other transfer of all types of property.*

As of April 1, 2023, the **property transfer tax rates** *in the City of LA are:*

- *unchanged at 0.45% for properties with a fair market value (FMV)* ***less than $5 million*** *at the time of transfer;*
- *4.45% for properties valued* ***at least $5 million but less than $10 million*** *when transferred; and*
- *5.95% for properties valued at* ***$10 million or more*** *when transferred. [Los Angeles Municipal Code Chapter II, Article 1.9 §21.9.2(a)]*

These thresholds are adjusted annually by the City's Director of Finance. [LA Mun C Chapter II, Article 1.9 §21.9.2(c)]

These tax rates on sales apply to all types of real estate in the City of LA, including sales of ***residential****,* ***commercial*** *and* ***vacant parcels****.*

Some types of residential purchases are ***exempt****, including property purchased by:*

- *tax-exempt institutions;*
- *non-profit entities or community land trusts with a history of low-income housing development and/or low-income housing property management experience; and*
- *non-profit entities or community land trusts without a history of low-income housing development or management — but which record an* ***affordability covenant*** *at the time of purchase. [LA Mun C Chapter II, Article 1.9 21.9.14]*

Further exempt are ***501(c)(3) entities*** *initially designated as such by the Internal Revenue Service (IRS) at least ten years prior to the transaction with total assets valued less than $1 billion. [LA Mun C Chapter II, Article 1.9 §21.9.15]*

For example, a commercial property which sold for $10 million in March 2023 was subject to a property transfer tax of $45,000. Now, a property which sells for the same price will be taxed a 13-fold figure of $595,000.

Chapter 14 Summary

Inflation is the rise in general price levels of everything people buy. Inflation consists of two categories: consumer price inflation and asset price inflation. Consumer price inflation is an increase in the general price level of all goods and services consumed in the economy, while asset price inflation is the rise in the value of assets, such as stocks, bonds and real estate.

Simply, the rate of consumer price inflation is set by the rise in price of everything we buy to consume. Asset prices behave quite differently and independently from factors driving consumer price movement. Assets are investments, with pricing based on the capitalization rate applied to the likelihood of a return on the investment.

For investors, inflation relates to the future price of the investment; for consumers, inflation is today's changes in the price of goods and the wages they earn to buy them.

Chapter 14 Key Terms

Chapter 15

Short payoff on negative equity property

Learning Objectives

After reading this chapter, you will be able to:

- understand that a discounted payoff on a short sale produces income from debt relief; and
- discuss the tax reporting with sellers for their discharge of indebtedness income on a short sale.

Key Terms

deficiency judgment
discharge-of-indebtedness
nonrecourse debt
recourse debt
short sale

The short-sale discount: income, profit, or loss?

Consider a homeowner who purchases their residence for the price of $450,000 with a down payment of $25,000. The residence was purchased at the peak of a real estate pricing boom.

The homeowner's cost basis in the residence consists of the $450,000 price paid, plus transactional/mortgage costs incurred to acquire the property and any value-adding improvements made to the property. When the owner resells the property, their cost basis will be subtracted from the net sales price. The difference between the cost basis and net sales price is the profit or loss the owner takes whether they dispose of the property by a conventional sale, short sale, foreclosure sale or a deed-in-lieu of foreclosure.

Due to the cyclical decline in real estate values following a speculator-driven peak in prices, the owner's residence is now worth $250,000. Also, while the monthly mortgage payments on the FRM have remained the same, the owner's combined household income has declined. Nearly all of the homeowner's disposable income and savings are now consumed by mortgage payments.

The mortgage balance is $400,000, far greater than the current market value of the property — a *negative equity property*.

The owner lists the residence for sale with a broker. The listing notes that the closing of a sale is to be conditioned on the mortgage holder's acceptance of the seller's net sales proceeds as the payoff amount and in full satisfaction of the mortgage, called a *short-sale contingency provision*.[1] [See Form 274 accompanying this chapter; see **RPI** Form 150-1]

The seller's agent understands the fair market value (FMV) of the residence is below the outstanding debt encumbering it. Further, they need to negotiate with the mortgage holder for a discount on a payoff demand, called a *short pay*. When the mortgage holder agrees to accept a discounted payoff in full satisfaction of the mortgage, the transaction is processed by escrow as a **short sale**.[2]

short sale
A sale of mortgaged property by the owner when at closing the mortgage holder accepts the owner's net sales proceeds in full satisfaction of a greater amount of mortgage debt.

*Editor's note — Equity purchase (EP) investors who will not occupy a property-in-foreclosure they purchase in a short sale need to use an equity purchase agreement with a short sale provision. [See **RPI** Form 156-1]*

When reporting the sale of their principal residence to the IRS and the California Franchise Tax Board (FTB), the income tax issue confronting the seller is whether to report the amount of the discount as:

- a reduction in cost basis, which produces either a reduced capital loss or an increase in home profit; or
- discharge-of-indebtedness income, taxable at ordinary income tax rates unless excluded.

For the sale of all properties other than a principal residence, and for all mortgages other than a purchase-assist, or the refinance of a purchase-assist debt on a principal residence, the debt discharged — the discount — is subject to ordinary income tax rates unless the mortgage has **nonrecourse status**.

nonrecourse debt
A mortgage debt recoverable on default solely through the value of the security interest held by the lender in the mortgaged property. Contrast with recourse debt.

Through December 31, 2020, unless extended again, the discharge-of-indebtedness income from the sale of a qualified principal residence in California is *excluded* from the seller's gross income — and by extension, their taxable income — up to $500,000 when it is a nonrecourse mortgage. In comparison, under federal law the qualified principal residence exclusion does not set a limit.[3]

1 **Holmes** v. **Summer** (2010) 188 CA4th 1510
2 Calif. Civil Code § 2943
3 Internal Revenue Code §108(a)(1)(E), Calif. Revenue and Taxation Code §17144.5

Form 274

Shortsale Addendum

SHORTSALE ADDENDUM
Loan Discount Approval

Prepared by: Agent ______________________ **Phone** ______________________
Broker ______________________ **Email** ______________________

DATE: ____________, 20_____, at ________________________________, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:
☐ Purchase Agreement ☐ Counteroffer
☐ Escrow Instructions ☐ ______________________
1.1 ☐ of same date, or dated ____________, 20_____, at ______________________, California,
1.2 entered into by ________________________________, as the Buyer, and
1.3 ________________________________, as the Seller,
1.4 regarding real estate referred to as ________________________________
________________________________.

AGREEMENT:
In addition to the terms of the above referenced agreement, Buyer and Seller agree to the following:

2. Close of escrow under this agreement is conditioned on Seller obtaining payoff demands at a discount from the lienholders of record in full satisfaction of all amounts owed them.
2.1 The discounts are to be amounts which collectively allow Seller to fully perform on this agreement and escrow instructions without the need for escrow to call for funds from Seller to close escrow.
2.2 Seller on opening escrow to promptly request payoff demands from the lienholders, directly or through escrow, and diligently assist each lienholder in their analysis of their discount and processing of their payoff demand by providing them with information and documentation on themselves and this transaction.

3. After ____________, 20_____, this agreement may be terminated by either Buyer or Seller should Seller be unable to obtain written payoff demands, or consent from the lienholders, to accept Seller's proceeds from this transaction which remain after disbursement of all costs incurred by Seller in the full performance of this agreement and escrow instructions. [See **ft** Form 183]

4. Seller may accept backup offers contingent on the cancellation of this agreement.
4.1 If backup offers are received, they will be submitted to the lienholders for payoff demands which may be accepted by the lienholders in lieu of a payoff demand on escrow complying with this agreement.
4.2 Should lienholders submit a written payoff demand in a backup offer acceptable to Seller, Seller may terminate this agreement. [See **ft** Form 183]

5. The Seller understands a discount by a lienholder in full satisfaction of the debt owed will likely have consequences on the Seller's creditworthiness and income tax reporting, and other unforseen difficulties, including,
5.1 The delinquencies on payments due the lienholders and the discount allowing for payment of a lesser amount then owed may be reported by the lienholder to credit reporting agencies and adversely affect the Seller in the future.
5.2 The amount of the interest on the discount on the principal will be reported by the lienholder to the IRS as a 1099 Form receipt of income, and depending on the recourse or nonrecourse nature of the debt discounted, or whether secured by the Seller's principal residence, will be reported by the Seller as discharge of indebtedness income, part of the price realized on the sale or a reduction in cost basis.
5.3 ☐ Seller may terminate this agreement within five days of acceptance, based on Seller's reasonable disapproval or the disapproval of tax or legal advisors to the Seller, of the consequences of this discount on Seller's credit or tax reporting, or on liability issues arising due to the discount. [See **ft** Form 183]

I agree to the terms stated above.	**I agree to the terms stated above.**
Date: ____________, 20_____	Date: ____________, 20_____
Buyer: ______________________	Seller: ______________________
Signature: ______________________	Signature: ______________________
Buyer: ______________________	Seller: ______________________
Signature: ______________________	Signature: ______________________

FORM 274 10-11

The short sale and the resulting short pay as a discount

A *short sale* is the sale of a property by the owner that:

- generates net sales proceeds for the seller in an amount less than the total amount(s) owed on the mortgage(s) encumbering the property; and
- the mortgage holder by prior agreement accepts the net sales proceeds as full satisfaction of the mortgage debt.

When the broker is unable to negotiate a discount with the mortgage holder in these negative equity ownership situations, one of the owner's alternatives is to stop making payments. An owner by no longer making payments is exercising the *put option* they hold under the trust deed securing the mortgage debt. Thus, the negative equity owner forces the holder of a nonrecourse mortgage to take the property by a foreclosure sale and terminate both the ownership and the mortgage debt. The put option is a contract right inherent in all trust deed mortgages in California due to the effect of antideficiency laws.

When the mortgage holder does not agree to a short sale compromise before their foreclosure sale, the seller's default has forced the mortgage to complete the foreclose sale.

Ironically, most mortgage holders require the seller to default on payments for at least three months (so they pay the penalty of a ding to their FICO score) before the mortgage holder will consider a discounted payoff to accommodate a short sale.

The discount reduces the homeowner's cost basis

discharge-of-indebtedness
Reportable income resulting for an owner from a mortgage holder's discount on a payoff of a mortgage debt. Also called a short pay.

Again, consider the seller-in-foreclosure who owes $400,000 on the purchase-assist trust deed mortgage encumbering their residence. The property's FMV is $250,000. The original purchase price, and thus the seller's cost basis, is $450,000 (plus closing costs).

The seller sees an advertisement which implies any discount taken by the mortgage holder on the sale or foreclosure of the property, called **discharge-of-indebtedness** income, is taxed at ordinary rates — meaning the seller would owe taxes on the loss of their home.

The ad claims the homeowner will avoid the tax liability resulting from income generated by the discount on a short sale when title to the property is transferred to the person offering the service, calling themselves a "coordinator."

The coordinator offers to take title to the property in foreclosure, and either:

- complete or arrange a short sale of the property themselves; or
- allow the mortgage holder to foreclose, eliminating the coordinator's ownership interest in title for nonpayment of installments.

Does the advertisement correctly represent the homeowner's tax reporting and tax liability exposure from a short sale?

No! The short sale of an owner-occupied one-to-four unit residential property encumbered by a purchase-assist mortgage or improvement mortgage – nonrecourse mortgages – does not trigger IRS reporting of ordinary income by the seller for the discounted portion of the mortgage.

The discount on purchase-assist and home improvement mortgages, in this case $150,000, is deducted from the seller's cost basis ($450,000) to establish an adjusted cost basis of $300,000. Thus, the sale produces a capital loss of $50,000 — the price realized ($250,000) minus the owner's adjusted cost basis ($300,000). Since the property was the owner's principal residence, the owner's capital loss is a personal loss and may not be written off to reduce taxable income. [IRC §108(h)(1)]

Form 406

Deed-in-Lieu of Foreclosure

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

DEED-IN-LIEU OF FORECLOSURE

NOTE: This form is used by a mortgage holder when the owner of a mortgaged property defaults and faces loss of the property by foreclosure, to transfer ownership of the property to the lender in exchange for the lender cancelling the trust deed note.

DATE: ______________, 20______, at ____, California.

1. I/We, ____,
hereby quitclaim to ____
1.1 all of my rights, title and interest in the real property situated in ______________________County, California, referred to as ____
____

2. This deed is an absolute conveyance in consideration for ______________________________
____ and
2.1 the cancellation and release of all rights and obligations arising from the document
2.2 entitled ____, dated ______________,
2.3 entered into by ______________________________________, as the ______________, and
2.4 ____, as the ______________.

3. Grantor declares that this conveyance was freely and fairly made upon the consideration listed above, and no agreements exist, oral or written, except as contained in this deed, with respect to the described property.

☐ See attached Signature Page Addendum. [**RPI** Form 251]

Date: ______________, 20______ ____
(Print name) *(Signature)*

Date: ______________, 20______ ____
(Print name) *(Signature)*

A notary public or other officer completing this certificate verifies only the identity of the individual who signed the document to which this certificate is attached, and not the truthfulness, accuracy, or validity of that document.

STATE OF CALIFORNIA
COUNTY OF ____
On ______________________ before me, ____
(Name and title of officer)
personally appeared ____,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

(This area for official notarial seal)

Signature: ____
(Signature of notary public)

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recourse debt
A mortgage debt which exposes a borrower to personal liability when a judicial foreclosure sale of the secured property does not fully satisfy the debt. Contrast with nonrecourse debt.

Recourse mortgage discounts taxed as income

Recourse mortgage discounts are reported to the IRS as gross income. Thus, the owner is not entitled to apply capital gain tax rate to the amount of the discount. Any discharge-of-indebtedness is income, not profit. Instead, the entire discount is taxed at ordinary income rates — even when a short sale occurs.

A **nonrecourse debt** discounted on a short sale does not create an extra tax liability for the seller when reporting to the IRS. However, the net sales price is set at the greater amount of the principal on the nonrecourse mortgage, without concern for the discount or the property's FMV. [Code of Federal Regulations §1.1001-2(a)(4)(i)]

Consider a property encumbered by a $400,000 mortgage. When the mortgage is a recourse debt and the value of the property securing the debt is less than the debt, the owner is exposed to a deficiency judgment on a judicial foreclosure, but not when the completed foreclosure sale is by a trustee.

The real estate is now worth only $250,000, and the owner's cost basis in the real estate is $450,000.

The owner sells the real estate in a short sale. The net amount the buyer pays for the real estate is $250,000. The mortgage holder accepts the net proceeds from the sale as a short payoff in full satisfaction of the recourse debt. The remaining unpaid balance of $150,000, the discount, is forgiven by cancellation of the note. As a result, the mortgage holder does not judicially foreclose as is required to pursue a **deficiency judgment** against the owner/borrower. Here, mortgage holders report the discount to the IRS as income to the property owner.

deficiency judgment
A money award obtained by the holder of a recourse mortgage debt to recover money losses experienced when the value of the mortgaged property is less than the mortgage debt at the time of their judicial foreclosure sale.

The owner's tax consequences on a recourse mortgage debt include:

- a capital loss of $200,000 ($250,000 price received from the buyer minus the owner's cost basis of $450,000); and
- a discharge-of-indebtedness income of $150,000 ($400,000 mortgage amount minus the $250,000 price realized and paid to the mortgage holder), reported as ordinary income.

A discount on the payoff of a *recourse* mortgage (refinancing) encumbering a principal residence results in taxable discharge-of-indebtedness income. Ironically, a capital loss produced by the principal residence on a short sale is a personal loss and may not offset income produced by a short pay in the same sale of the same principal residence.[4]

Discount reporting for investor-owners

For an investor, debt discharged by a discount of a mortgage paid off on a short sale of property other than the investor's principal residence is a recourse mortgage producing discharge-of-indebtedness income, unless the investor:

- assumed a nonrecourse mortgage;
- executed a carryback note secured solely by the property acquired by the investor; or
- executed a note with an exculpatory clause releasing the investor from any personal liability.

When the payoff discount is on a nonrecourse antideficiency mortgage, the amount of debt discharged by the discount is added to the net sales price the seller received for their for the negative equity property (and turned over to the mortgage holder). Tax-wise, the *price realized* and reported by the seller is the total principal amount due to the mortgage holder before the discount. Further, any profit taken on the price realized (the mortgage amount) is taxed at capital gains rates, not ordinary rates.[5]

4 **Vukasovich** v. **Commissioner of Internal Revenue** (9th Cir. 1986) 790 F2d 1409; IRC §165(c)

5 Rev. Reg. §1.1001-2(a)(2)

Foreclosure avoids the discount

When faced with discharge-of-indebtedness income on a recourse mortgage, a negative-equity property owner might decide to exercise their put option by defaulting on payments thus forcing the mortgage holder to foreclose and acquire the property. Mortgage holders nearly always foreclose by trustee's sale. When they do not and elect to foreclose judicially, the owner is confronted with recourse liability exposure by way of a deficiency judgment amount.

Further, mortgage holders at a trustee's sale usually bid on the property in the amount of all monies owed them, regardless of the property's present market value. Thus, they have been fully satisfied by their bid without a discount or uncollectible amount remaining due (but uncollectible) from the owner — which means no discharge-of-indebtedness income.

Chapter 15 Summary

A short sale is a sale of encumbered property when at closing the mortgage holder accepts the seller's net sales proceeds in full satisfaction of a greater amount of mortgage debt. A short sale is the sale of a property that: generates net proceeds for the seller in an amount less than the total amount(s) owed on the mortgage(s) encumbering the property and fully satisfies the mortgage(s) on receipt of the net proceeds from the sale.

When a homeowner sells a one-to-four unit residential property encumbered by a first trust deed in a short sale, the discount is discharged and the mortgage holder barred from collecting any deficiency.

For the sale of all properties other than a principal residence, and for all mortgages other than a purchase-assist or refinance of the purchase-assist debt on a principal residence, the debt discharged — the discount — is subject to ordinary income tax rates unless the mortgage has nonrecourse status.

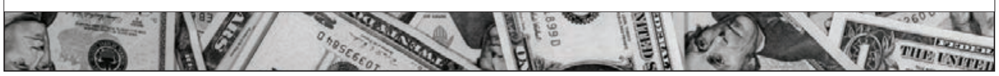
Nonrecourse debt is a mortgage debt recoverable on default solely through the value of the security interest held by the lender in the mortgaged property.

Chapter 15 Key Terms

deficiency judgment	**pg. 128**
discharge-of-indebtedness	**pg. 126**
nonrecourse debt	**pg. 124**
recourse debt	**pg. 127**
short sale	**pg. 124**

Chapter 16

Option money tax consequences



Learning Objectives

After reading this chapter, you will be able to:

- understand the nature of option money paid for an option to buy property as an alternative to a buyer's good faith deposit with a purchase agreement offer; and
- advise on the tax aspects of option money for an option to buy any type of property.

Key Terms

capital gain **option to buy**

When exercised, expired or assigned

Consider a buyer who submits a purchase agreement offer to acquire rental income property that initially appears suitable. The offer is accompanied by a $10,000 good-faith deposit payable to escrow. Further-approval contingency provisions in the purchase agreement condition the closing on the buyer's completion of a due diligence investigation and approval of the property's:

- income and expenses;
- physical condition; and
- title condition. [See **RPI** Form 159 §11]

Due primarily to the contingencies in the buyer's offer, the listing agent recommends the seller counter with an offer to grant a four-month **option to buy** for $10,000. [See **RPI** Form 160]

Granting an *option to buy*, also referred to as a *call option*, presents the seller with some advantages.

option to buy
A unilateral agreement entered into by a property owner granting a prospective buyer the right to buy property by exercising the option within a specified time period or on an event, at a determinable price and terms for payment. [See **RPI** Form 161]

Option money is the buyer's payment of consideration for the seller granting an irrevocable option to buy. The buyer buys an option, not the property as occurs under a purchase agreement.

To distinguish, option money paid by the buyer is not a good faith deposit toward payment of the purchase price. Thus, when a buyer holds an option and fails to acquire the property, the seller retains the option money as earned income. On a buyer's failure to purchase by exercising the option, the seller's retention of option money does not expose the seller, as under a purchase agreement, to a claim of wrongful forfeiture for failure to release a good faith deposit to the buyer.

Options, by their nature, do not contain contingency provisions. With an option, the buyer is forced to decide whether to exercise the option and buy the property on the price and terms for payment stated. The buyer exercises their option when they complete their due diligence investigation and decide to buy the property – before the option expires.

In our example, the seller on considering their agent's advice, makes a counteroffer to grant an option to buy, which the buyer accepts. [See **RPI** Form 160]

Within the first month of the option period, three months before it expires, the buyer decides not to exercise the option based on their due diligence investigation.

The buyer tells their agent they have a high-income year and will write off the loss this year, the tax year in which they purchased and paid for the option. Further, the option expires next year, not the year the option was granted.

The agent advises the buyer there is no reportable tax consequence for a buyer until the tax year in which the option:

- is exercised;
- expires; or
- is assigned to a substitute buyer.

Is the agent's advice about the buyer's timing of tax reporting for option money correct?

Yes! The option money has no tax consequence to the buyer (or the seller) when the option is granted.

In further counseling, the agent discusses the resale of the option by assignment to another buyer as the 'right to buy' may have value to other buyers. Also, when a substitute buyer is found, any loss is reported in the year of the assignment.

The buyer authorizes their agent to locate a substitute buyer and negotiate the sale and assignment of the option rights based on disclosure of the buyer's due diligence findings. (Note: The agent's fee is a provision in the option to buy, just as it is in a purchase agreement.)

The agent locates a substitute buyer for the option. The agent's buyer is reimbursed for the costs incurred in the due diligence investigation as total consideration for an assignment of the option. The sale of the option is completed before the end of the current tax year. The buyer is not reimbursed for the option money payment. Thus, the buyer realizes a capital loss on assignment of their option rights.

The buyer properly reports the loss in the year of the assignment, which offsets an equal amount of income from taxation as sought by the buyer of the option.

Option money as a cost of acquisition

The tax treatment of option money paid by buyers and received by sellers depends initially on the character of the real estate involved, which may be:

- a capital asset held for investment as either a passive or portfolio income category property;
- a business-use asset held in connection with a trade or business;
- a personal residence which is a capital asset; or
- dealer property held as inventory for sale in a trade or business.[1]

Thus, whether the client is the buyer or seller, the tax treatment of option money depends on their use or intended use of the property.

Buyer's option money treatment when exercised or expired

A *capital asset* is property purchased primarily for investment comprising passive or portfolio income category assets.[2]

Recall that real estate used to house and operate the taxpayer's business, including hotels, inns, motels, and business-use property, is a *trade or business asset*. However, business category assets are treated the same as capital assets but only after they have been held for more than one year.

An option to buy a capital asset or a business asset is a separate property right, itself treated as a capital asset. Likewise, option money paid is reported in the income category for the property as determined by the buyers intended use of the property.

When a buyer exercises an option and acquires a capital or business-use asset, the buyer adds the amount of option money paid to their cost basis for the property acquired. Option money is part of the buyer's transactional costs incurred to acquire the real estate. It is not an expense since it was not incurred in the operations or ongoing ownership of the optioned property.[3]

1 Internal Revenue Code §1234(a)(1)
2 IRC §1221
3 Revenue Regulations §1.1234-1(a); **Realty Sales Co.** v. **Commissioner of Internal Revenue** (1928) 10 BTA 1217

In contrast, consider a buyer who holds an option to buy a capital asset as an investment, such as an industrial or residential income property, and allows the option to expire *unexercised.* Here, the buyer reports the amount of option money they paid as a *capital loss*.

Depending on the length of the option period (less or more than one year), the loss is classified as either a short- or long-term capital loss. The capital loss is reported in the income category for the type of property optioned. In this example the option money is reported in the passive income category as a loss on a rental property investment.

Seller's option money treatment as income or gain

A seller granting an option in exchange for option money does not report the option money when it is received.

However, when the buyer closes escrow and acquires the property by exercise of the option, the seller then accounts for their prior receipt of the option money. The amount of the option money is added to the net proceeds from the sale under the option, becoming part of the price received for the property. The option money either increases the seller's profit or decreases their loss on the sale.

Consider a seller who grants an option to buy property held as dealer property. On the buyer's exercise of the option, the seller adds the amount of the option money to the price received for the optioned property. Thus, the accounting either increases ordinary income or reduces ordinary loss on the sale of their dealer property.[4]

Conversely, consider a *seller* who grants an option to buy. The buyer does not exercise the option. It expires and the seller retains ownership of the property. Here, the seller reports the option money as ordinary income generated by the property optioned in the year the option expires. For a seller, option money on expiration of an option is always ordinary income, like rent, regardless of the category of the optioned real estate.[5]

Assignment of an option from buyer to substitute buyer

A buyer acquires an option to buy with the intent to immediately sell and *assign* it on locating a substitute buyer. In lieu of an assignment, the buyer might exercise the option, take title, and concurrently resell the real estate via a double escrow situation to the substitute buyer.

Buyers who are flippers often employ the contractual arrangements of options, sandwiching themselves between the owner who is selling and the ultimate buyer who will pay the agreed price. The flipper receives a fee for the assignment of the options, or a higher price on a double escrow – either way it is ordinary income in their business.

When an option is assigned to a substitute buyer, any profit or loss on the sale of the purchase option is reported within the same income category as the real estate which is the subject of the option. In this flipper example, the

4 Rev. Regs. §1.1234-1(d)

5 Rev. Regs. §1.1234-1(b)

option money is reported as trade or business category income. The property optioned is not a capital asset or a business-use asset. It is inventory for resale in the business of flipping properties. No long-haul investment intent there.

Now consider a buyer who purchases an option for $10,000 to buy an income property for their own account. The buyer later sells the option for $25,000 having himself located a more suitable property to acquire. The assignment of the option produces a reportable $15,000 **capital gain** in the passive income category on the sale of the option, a capital asset.

capital gain
Profits from the sale of a capital or business-use asset at a price exceeding the cost of acquisition and further improvements. Contrast with unrecaptured gain.

Had the option been sold for $7,500, the buyer would report a capital loss of $2,500 in the passive income category. The property optioned was treated by the buyer as a capital asset — an investment property, not inventory which produces ordinary income or loss, as with a flipper.

Principal residences

Consider a buyer who negotiates an option to buy a home for use as their residence. The buyer pays the owner option money for granting the option. On exercise of the option, the buyer adds the amount of the option money to the price they paid for the property, their cost basis.

Likewise, the seller, on closing the sale, adds the option money to their net sales proceeds to determine their profit or loss, regardless of the seller's use of the property.

In contrast, had the homebuyer failed to exercise the option to purchase a property intended for use as their principal residence, it would expire. Here, the buyer may not write off the option money as a capital loss, even though the home sought as a principal residence is a capital asset. Yes, the homebuyer has a capital loss, but the loss is personal and thus disallowed. Had the buyer intended to purchase the residence as an income property investment, the buyer writes off the option money as a capital loss in the passive income category.[6]

In a reversal of fortunes, a homebuyer holds an option to buy property they intend to use as their principal residence. They sell and assign the option for more than they paid, taking a profit. Since a principal residence is a capital asset, the profit is reported as a *capital gain* and taxed – in the portfolio income category as the capital asset was not a rental property.

Dealer property

Recall that dealer property – inventory – includes real estate bought and held primarily with the intent to resell it to customers in the normal course of an owner's trade or business.

The owner's sale of dealer property produces ordinary income or loss for their trade or business. Dealer property is not a capital or business-use asset and thus generates business income, not profits on sale.

6 IRC §165(c)

A buyer exercising an option and acquiring property for any intended use, including its resale to business customers, will always add the option money to the cost basis for the property as a cost of acquisition. For a business operator, it is not an expense of doing business, but a cost of acquiring inventory.[7]

On expiration of a buyer's unexercised option to acquire property to be held as dealer property, such as land to subdivide, develop and resell as lots or units, or an SFR/condo to be flipped, the buyer accounts for the option money as an ordinary trade or business loss in the year the option expires.

7 Rev. Regs. §1.1234-1(c)

Chapter 16 Summary

Capital assets are assets of a permanent nature which produce operating income or sales profits, such as land, buildings, machinery, equipment and IT software.

The portion of profits from the sale of a capital asset at a price exceeding the cost of acquisition and further improvement is known as capital gain.

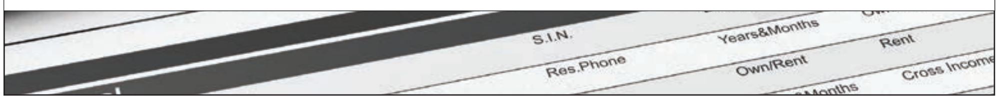
Option money paid by the buyer is not a good faith deposit toward payment of the purchase price. Rather, option money is the buyer's payment of consideration to the seller for granting an irrevocable option to buy. Option money received by a property owner becomes income, profit or loss depending on the character of the real estate as held by the owner.

When a buyer exercises an option to buy a capital or business-use asset, the buyer adds the amount of option money paid to their cost basis for the property acquired. Option money is part of the buyer's transactional costs for acquiring real estate. Tax treatment of option money depends on their use or intended use of the property.

Chapter 16 Key Terms

Chapter 17

Seller financing shifts profit taxes to other years



Learning Objectives

After reading this chapter, you will be able to:

- explain how a seller's profit reporting and taxation is deferred to later years by a carryback sale;
- apply the installment sale profit-to-proceeds ratio to set the profit reported on a carryback sale; and
- advise a carryback seller on mortgage debt relief avoidance to increase the portion of profits for deferred taxation.

Key Terms

balloon payment

straight note

pledge

Untaxed profits increase after-sale earnings

Consider a seller who lists their rental property for sale by employing a real estate agent. The listing price for the property is $1,500,000 and it is unencumbered by mortgage debt. The seller's *cost basis* in the property is $100,000 — the land value when purchased — as the price allocated to improvements is fully depreciated.

The agent understands the seller wants to convert their net proceeds on the sale of the property into a relatively management-free, interest-bearing investment. The seller is an experienced investor not inclined to turn their real estate over to a managing trustee or exchange it for an unsecured annuity.

To meet this objective, the agent suggests the seller consider carrying back an interest-bearing installment note to provide purchase-assist financing for a creditworthy buyer who makes a substantial down payment. For the seller, the property's current net operating income (NOI) is replaced by receipt of monthly principal and interest payments on a carryback note. As security for the carryback note, the property's location and physical condition assure it will retain its rental value for years.

After a period of marketing the property under a listing agreement, a buyer submits a full-price offer consisting of:

- a 20% down payment; and
- a carryback mortgage in favor of the seller for the remaining 80% of the purchase price.

Terms of the carryback sale

The buyer agrees to tender a $300,000 down payment in cash and sign and deliver (i.e., *execute*) a **promissory note** for the balance of the price, payable on terms suitable for the buyer and seller, secured by a trust deed on the property.

The terms of the carryback note include:

- $1,200,000 in principal;
- a 7% fixed interest rate;
- monthly payments of $7,983.63 on a 30-year amortization schedule; and
- a 10-year due date with a **balloon payment** of $1,037,732.25.

balloon payment
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final payment. [See **RPI** Form 418-3 and 419]

Editor's note – The balloon payment discussed in this example envisions a carryback note and trust deed to finance a buyer's business or investment acquisition. In contrast, the inclusion of a balloon payment on a consumer carryback mortgage (buyer occupant of a one-to-four unit residential property) is subject to restrictions set by Regulation Z (Reg Z) when the seller carries back more than five consumer mortgages in a calendar year.

The agent prepares an estimate of the seller's net proceeds from the sale of the property and reviews it with the seller. After payment of around $100,000 in closing costs, the net sales price is approximately $1,400,000. Taking the seller's cost basis of $100,000 into account, the seller's agent quickly figures the profit of unrecaptured gain and capital gain on the sale is approximately $1,300,000. [See **RPI** Form 310]

Further, the agent now considers the amount of taxes the seller incurs on a $1,300,000 profit in a carryback sale.

Tax bite deferred by installments

The seller reports the transaction as a carryback sale — also called an *installment sale* — on their income tax return for the year escrow closes on the sale.

The installment sale treatment for the carryback note *defers* reporting and taxes on the portion of the profit allocated to the carryback note. To determine the amount of profit allocated to principal in the note, you first calculate the profit on the sale. Then calculate the *profit-to-proceeds ratio* unique to the carryback transaction. In turn, the ratio establishes the percentage of the dollar amounts on closing of net cash proceeds and principal on the carryback note that is profit. [Internal Revenue Code §453(c)]

Recall that the amount of the seller's profit *realized* on a sale is the sum of the *net sales price* minus the seller's remaining cost basis in the property, represented by the formula:

net price - basis = profit

Also recall that profit realized on a sale is reported and taxed — *recognized* — in the year of sale, unless the profit is:

- *excluded*, as occurs when the sale of property qualifies for the $250,000 principal residence profit exclusion per individual homeowner;
- *exempt*, as occurs when the net sales proceeds from the sale of business of investment property are used to acquire like-kind replacement property in a §1031 reinvestment plan, or to replace property taken by eminent domain; or
- *deferred*, as occurs in an installment sale for the profit allocated to a note carried back on the sale.

Critical to understanding the treatment of profit is awareness of the different situation-titles given to *taking* a profit on a sale versus *taxing* that profit, specifically:

- profit is *realized* when the seller closes the sale of a capital or business-use asset and takes a profit on the sales price; and
- profit is *recognized* when it is subject to taxation in the year of the sale unless the profit is excluded or exempt from taxes, or its recognition for taxation deferred to another tax year.

Again, the sale of dealer property, such as vacant lots or homes held out for sale by a developer or flipper, generates ordinary income, not profit.[1]

Setting and applying the profit-to-proceeds ratio

To report the profit realized on an installment sale, first calculate the *contract ratio* for the transaction — called the *profit-to-proceeds ratio*. The ratio sets the percentage of profit in the dollar amounts of net proceeds from the sale – the cash and carryback note received by the seller.

The percentage figure is applied to set the dollar amount of the cash and principal in the carryback note which represents profit taken on the sale.

In our introductory example, the net sales proceeds are calculated as the sales price ($1,500,000), minus any *mortgage debt relief* ($0), minus closing costs ($100,000).

Here, the profit-to-proceeds ratio for the sale is based on profit of $1,300,000 realized on the sale and the $1,400,000 in net sales proceeds, a ratio of 93% as profit.

1 IRC §1231(b)(1)(A-B)

For reporting, 93% of the cash portion of the net sales proceeds ($200,000) received on closing is *recognized* as profit ($186,000) taxed in the year of the sale. Further, the 93% ratio is applied to each payment of principal as it is received on the carryback note. The ratio determine the amount of the principal recognized – reported – as profit taxed in the year principal amounts are received.

The $14,000 of the cash proceeds from the down payment that is not profit represents the seller's recovery of a portion of their remaining cost basis in the property. It is a return of invested capital from the sales price, not profit or income earned on capital invested.

During the year following the year of sale, the 12 installments of $7,983.63 the seller receives on the carryback note includes $12,189.71 in principal plus $83,613.85 in interest. The seller reports all interest received (i.e., unearned income) as portfolio category income.

The profit-to-proceeds ratio

Carryback notes are portfolio category investments no matter how obtained. Like stocks, bonds, and savings accounts they are management-free. While the property sold for a profit was an asset with income and profits reported in the passive income category, interest income is earned on principal in the note, not the real estate sold which now is security for a mortgage held by the seller as a creditor.

Continuing on previous example, the carryback seller's taxable profit in the year following the year of sale is $11,336.43 — the result of $12,189.71 in principal payments the seller receives multiplied by the profit-to-proceeds ratio of 93%.

The 7% of the principal remaining in each principal payment ($853.28) is not taxed. Again, it represents a partial return of the seller's unrecovered cost basis — original invested capital.

Ten years after closing, the seller receives the *balloon payment*. Again, the final principal payment of $1,037,732.25 is multiplied by the profit-to-proceeds ratio of 93% to determine the profit recognized and taxed. The result is $965,090.99 in profit, reported by the carryback seller and taxed on receipt of the balloon payment.

The seller acquired the improved property as a *capital asset* and annually reported depreciation deductions, reducing the cost basis below the price paid for the property. Recall that depreciation taken is taxed as recaptured gain on a sale of the property. The profit taken by the seller and allocated pro rata to the net proceeds of an installment sale consists of both unrecaptured gain and long-term capital gain - profits.

Critically, as profits are received, they are first treated and taxed as unrecaptured gains until no further unrecaptured gains remains. All profits then remaining are capital gains.

The seller's goals for an installment sale

On a carryback sale of a capital or business-use asset, the seller achieves two financial objectives:

- the *highest sales price* possible, achieved by extending credit to the buyer in the form of purchase-assist financing; and
- the *maximum annual income* going forward, by earning interest on the untaxed principal in the carryback note.

Now consider a seller who carries back a **straight note** calling for a single payment of principal in a year after the year of sale. Here, the sale is reported as an installment sale. To qualify, at least one installment is scheduled for payment in a year after the year of the sale.[2]

straight note
An instrument evidencing a debt on which the entire amount of principal together with accrued interest is paid in a single lump sum when the principal is due. [See **RPI** Form 423]

Conversely, a *straight note* due in the year of the sale but on a default is paid in the following year, does not qualify the transaction for installment sale reporting. Thus, the seller incurs a tax liability on the profit allocated to the note in the year of sale without first receiving the principal due on the note.

Further, the seller may structure payments on the carryback mortgage so they receive all or most of their principal lumped in a designated later year (or in any year when the carryback note is due and payable on demand). This is advantageous when the seller anticipates taking a substantial loss in the future.

Combining the separate profit and loss events allows the seller to offset reportable profit allocated to the principal in their carryback mortgage on incurring the loss. Buyers with cash reserves or who acquire a line of credit for the payoff may be willing to accommodate these arrangements.

Mortgage-over-basis, profit, and taxes

Consider a seller who lists their rental property for sale. The seller recently refinanced the property, encumbering it with a $480,000 mortgage.

The seller is willing to accept the following terms for the sale of the property:

- a purchase price of $800,000;
- a 20% down payment of $160,000;
- an assumption of the existing $480,000 mortgage by a buyer (or a new purchase-assist mortgage); and
- a carryback mortgage for the balance of the seller's proceeds of $160,000.

The agent inquiries the seller about the remaining cost basis in the property which is $50,000. Improvements to the property are fully depreciated as the seller purchased the property decades ago.

After deducting all transactional costs, the net sales price is approximately $720,000.

2 IRC §453(b)(1)

The net sales price, comprising mortgage debt and net sales proceeds, represents a return of the remaining $50,000 of originally invested capital and a $670,000 profit on the sale. The profit represents the sum of:

- accumulated depreciation deductions – taxed as unrecaptured gain at ordinary income rates up to a 25% ceiling; and
- the increase in the property's dollar value over the price paid to acquire it – taxed as long-term gain at 15% and 20% capital gains tax bracket rates.

Federal taxes and state taxes require the seller to pay up to 28% of the net sales proceeds from the sale (unless exempt or excluded).

The agent advises the seller that an assumption or refinancing of their existing mortgage by the buyer on a carryback sale produces an adverse tax consequence the seller needs to consider avoiding.

Existing mortgage debt versus profit

The calculation of profit on a sale is unaffected by the existence of *mortgage debt*. Debt encumbering a property plays no role in calculating the profit on a sale — debt is associated with proceeds from the property's equity (price minus debt equals proceeds), but not profit.

However, the assumption or refinancing of an existing debt by a buyer in a carryback sale does play a significant financial role. Only net sales proceeds, which do not include existing mortgage debt, and profits are considered by the profit-to-proceeds ratio when setting the percentage of profit allocated to the cash and carryback note in an installment sale. Thus, mortgage debt affects the amount of profit reported in the year of sale in an installment sale.

As a goal, the seller in an installment sale seeks to structure the net sales proceeds to produce the lowest possible profit-to-proceeds ratio on the transaction, all other sales considerations being acceptable having priority. The lowest ratio occurs when the *net sales price* and the *net sales proceeds* are the same – when no mortgage exists.

Maximum tax deferral benefits

Again, the seller receives the maximum benefits of installment sales tax deferral when no debt relief occurs. To entirely avoid debt relief on the sale of a property encumbered by mortgage debt, the seller needs to remain responsible for payment of the mortgage installments after closing the sale. An alternative for the seller is to pay off or reduce the mortgage debt with their separate funds prior to the close of escrow.

With an existing mortgage at time of closing, debt relief is avoided in an installment sale situation by use of either a carryback *all-inclusive trust deed (AITD)* note or land sales contract. With an AITD carryback note, the buyer does not assume responsibility for or refinance the seller's existing mortgage on the property. The buyer makes a down payment and executes an all-inclusive trust deed and note, together their dollar amounts comprise the purchase price. [See **RPI** Form 167 and 168]

With an AITD, the principal amount of the carryback note is the balance of the *purchase price* remaining to be paid after deducting the buyer's down payment.

However, the profit on the sale does not vary, regardless of how the price is financed or structured for payment. Thus, the smaller the amount of the carryback seller's net sales proceeds in proportion to the sales price, the higher the percentage of profit allocated to those net sales proceeds. Eventually, the profit is 100% or more of the net sales proceeds, all due to the profit-to-proceeds ratio driven up by greater amounts of mortgage debt.

The profit-to-proceeds distortion of 100% or more profit than the amount of the net sales proceeds occurs when the amount of the mortgage debt assumed or financed by the buyer exceeds the seller's remaining cost basis. As a result, the amount of the seller's profit is greater in amount than the seller's net sales proceeds, a situation called *mortgage-over-basis*.

Thus, all cash and principal in the carryback note received on closing the transaction is profit. Further, the profit-to-proceeds ratio tops out the note as 100% profit. The remaining unallocated profit spills over and is reported and taxed in the year of the sale due to debt relief.[3]

Existing mortgage assumption by the buyer

In our mortgage assumption example, 100% of the net proceeds from the down payment and the entire principal in the seller's $160,000 carryback note is profit, taxable when principal is received by the seller. Again, the tax is deferred only on the portion of the $670,000 profit allocated to the principal in the carryback note ($160,000).

However, $510,000 in profit remains that is not allocated to the carryback note ($670,000 - $160,000). It is taxed in the year of sale. Thus, the profit taxes of up to the 25% ceiling rate on the unrecaptured gain and at brackets of 15%-20% on the capital gain are payable to the IRS in the year of sale – around $105,000 (plus state taxes).

However, the seller's cash sales proceeds are only $80,000, the $160,000 down payment minus the $80,000 in closing costs.

When the carryback seller allows a buyer to assume or refinance the existing mortgage in a mortgage-over-basis situation, the immediate financial result is disastrous. In this instance, taxes greatly exceed the seller's cash proceeds on closing. The seller's only relief on an assumption/refinance and carryback sale comes from any losses incurred in their businesses or investments when the losses are allowed to offset these profits and reduce the profit tax liability.

However, a more favorable approach exists for the seller to consider.

The prudent seller on the advice of their agent considers structuring any carryback mortgage on the sale of encumbered property as an AITD mortgage. Again, the AITD note amount is for the *balance of the purchase price* after deducting only the down payment, the mortgage remaining the seller's

3 Revenue Regulations §15a.453-1(b)(2)

obligation under the AITD. Unlike a standard carryback note when the buyer assumes or refinances the existing mortgage, the AITD principal amount is not calculated based on the seller's equity minus the down payment.

With an AITD, the amounts of the net cash from the down payment and the carryback AITD note equal the *net sales price*. Here, the AITD principal is a substantial 80% portion of the sales price. The resulting profit-to-proceeds ratio is the lowest percentage figure available for setting the amount of profit allocated to the cash proceeds and the carryback mortgage. Thus, the seller ameliorates the profit tax consequences in the year of sale due to the mortgage-over-basis financing.

The profit realized on the sale is $670,000 while the net sales proceeds are $720,000 – the net cash and the AITD carryback. This results in a profit-to-proceeds ratio of 93%, the lowest percentage possible on the transaction, the tax objective in installment sales.

In the year of sale, the seller nets $80,000 in cash sales proceeds. 93% is profit ($74,400) realized on the sale. All other profit realized is allocated to the principal amount of the all-inclusive note, the equivalent of 93% profit in the AITD note principal. Thus, the profit allocated to the cash proceeds received on closing is recognized and taxed. The profits allocated to the AITD note while realized on the sale are not taxed until they are recognized – deferred to later years when principal is received by payments on the AITD note.

The $74,400 profit allocated to the cash proceeds represents unrecaptured gain. It is taxed before capital gains and at rates up to 25% — here around $18,600. The use of the AITD avoids the $105,000 in taxes the seller otherwise incurs in the year of sale had the buyer assumed or refinanced the seller's existing mortgage.

Structuring the carryback sale as an AITD allows the seller to receive *after-tax sales proceeds* of $61,400 from the $80,000 net down payment.

Engineering future tax reporting

An AITD carryback seller may incur a loss in future years and want to use it to offset a portion of the profit allocated to the AITD. This may be accomplished in any year following the sale by future negotiations with the buyer to modify the AITD. The seller then arranges for a substantial portion of the installment profit to be recognized and reported in that year by:

- *shifting responsibility* for payment of the wrapped mortgage to the buyer by their assuming or refinancing it which then reduces the principal balance due on the AITD note (and AITD payment amounts); or
- *pledging* the all-inclusive note as collateral for a loan of an amount greater than their losses. [See **RPI** Form 242]

Recall, the percentage of profit in the principal of the AITD note is set by the profit-to-proceeds ratio. It is applied to the principal payments received on the AITD note to determine the profit to be reported. The principal reduction on the AITD note due to mortgage debt relief is equal to the amount of the mortgage assumed or refinanced by the buyer, or the amount the carryback seller borrows on a pledge of the note.

Thus, on incurring debt relief by converting the AITD note into a regular note, the carryback seller engineers the time for reporting a substantial amount of the profit on their carryback. As a result, the seller avoids tax on the profit due to the offsetting losses from business or rental category operations and sales in the year the AITD note is modified.

Pledging carrybacks

A seller who **pledges** — *hypothecates* — their carryback note as collateral for borrowed money from a lender triggers recognition and thus taxation of profit allocated to the carryback note.

pledge
To provide an asset, such as an existing carryback note, as collateral or security for repayment of a borrowing. Also known as hypothecation. [See **RPI** Form 242]

The borrowing and pledging may also be timed to occur in a tax year when a loss on a business or rental activity has occurred, thus offsetting the loss.

Critically, when a seller pledges a carryback note, the amount of loan proceeds received is considered equivalent to receipt of principal on the note. Thus, profit allocated to principal equal to the loan amount is recognized – reported and taxed in the year of the pledge.[4]

Essentially, the percentage determined by the profit-to-proceeds ratio sets the amount of the loan proceeds – or debt relief – recognized as profit reported and taxed on the carryback note in the year of the pledge.[5]

Prepayment avoidance preserves tax benefits of a carryback

The principal received by a seller in full satisfaction of a carryback note includes profit. The profit is recognized and taxed in the year of the *payoff*.

To ensure a seller retains the tax advantages of a carryback sale until the year the balloon payment becomes due, the seller's agent suggests their client include a prepayment penalty clause in the carryback note.

Statutory limits exist for prepayment penalties on carryback mortgages secured by owner-occupied, one-to-four unit residential properties. Additionally, all consumer carryback mortgages with a prepayment penalty are required to meet *qualified mortgage (QM)* parameters under federal *ability-to-repay (ATR)* rules.[6]

For business and investment property carryback financing, an enforceable prepayment penalty clause in the carryback note is structured to compensate the seller for the entire amount of the profit tax they anticipate they will incur due to the prepayment of principal on the note.

The prepayment penalty needs to be *reasonably related* to the actual amount of profit taxes likely to be incurred on a buyer's early payoff, including:

- *profit taxes*, based on current or reasonably anticipated rates; and

4 IRC §453A(d)(1)
5 IRC §453A(d)(2)
6 Calif. Civil Code §2954.9

- *maintaining a portfolio yield* during the lag time between early payoff and the reinvestment of funds.

Election out

A carryback seller may elect out of installment sale reporting by voluntarily reporting the profit as taxable in the year of the sale.[7]

Reporting all the profit on a carryback sale as taxable in the year escrow closes may be advantageous to a seller who has an equivalent offsetting loss during the year of sale.

Possible offsetting losses include:

- *trade* or *business loss*es on a real estate brokerage, speculator fix-and-flip programs or a developer's business;
- *rental operating loss*es offset by the profit on a carryback sale of a rental property;
- *rental operating losses* which reduce the seller's adjusted gross income (AGI) when they qualify as in a *real estate-related business*;
- *capital losses* on the sale of a rental or passive business investment; or
- *capital losses* carried forward or from the sale of investment/portfolio category assets (stocks and bonds) when the installment sale involves an investment/portfolio category property.

California Franchise Tax Board carryback rules

Unlike the federal withholding scheme, California requires the buyer, through escrow, to withhold 3.33% of the sales price from the seller's proceeds on property sales, unless the transaction is excluded from withholding.

Excluded transactions include sales by:

- all California-based entities; and
- any individual who certifies that the transaction qualifies for an exclusion from withholding for the Franchise Tax Board (FTB).

For individual sellers entering into a carryback sale of their property, the transaction is either:

- *qualified* to avoid withholding by the individual seller certifying they are excluded; or
- *not qualified* and subject to the mandatory withholding of the entire 3.33% of the price from the down payment, unless the buyer agrees to withhold the 3.33% from each installment of principal paid on the price and forward to the FTB. [See Franchise Tax Board Form 593-I]

The seller's transaction is *excluded* from FTB withholding on both the down payment and the dollar amount of a carryback note when:

- the property is the seller's *principal residence*;

7 IRC§453(d)(1)

- the seller declares the sale is a *§1031 transaction* (with the carryback note payable to the buyer's trustee for ultimate assignment as consideration for the purchase of a replacement property);
- the property is *sold at a loss*; or
- the property is sold for a price of *$100,000 or less*.

When the buyer refuses to withhold and forward 3.33% of the principal in each periodic payment to the FTB or permit arrangements for a payment service to do so, the carryback note may call for installments of interest-only payments to avoid amortization of the principal and withholding.

Thus, only the final/balloon payment contains a payment of principal. In this fashion, the buyer's agreement to withhold principal is limited to the final payoff, which is handled through an escrow for payoff and reconveyance of the carryback trust deed.

Miscellaneous installment rules

A carryback note needs to qualify for installment sale reporting at the time the sales escrow closes.

Consider a carryback note with a due date in the year of the sale, signed and delivered to the seller on close of escrow. Here, the seller may not later restructure the carryback transaction *after* escrow closes in an attempt to qualify the sale as an installment sale by extending the due date on the carryback note to beyond the year of the sale.[8]

However, the seller may later modify the terms of a carryback note they have reported as an installment sale by:

- extending its due date to further defer profit taxes;
- subordinating the carryback mortgage to a new mortgage; or
- accepting substitute security from the buyer.

Installment sale reporting is not available for builders, developers and speculators who sell their dealer property on a credit sale. Their earnings from the sale of inventory are classified as trade or business income, not profits taken on the sale of a capital asset or property used to house and conduct an ongoing trade or business operation.[9]

However, the exclusion of dealer property from installment sale reporting of income does not apply to the carryback sale of farms, vacant residential lots, and short-term timeshares when classified as dealer property.[10]

8 Rev. Regs. §15a.453-1(b)(1)
9 IRC §§453(b)(2)(A), (l)
10 IRC §453(l)(2)

Chapter 17 Summary

A balloon payment is as any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final payment.

Installment sale treatment defers profit reporting on the portion of the profit taken on a sale and allocated to the carryback principal until the seller receives principal installments on the carryback mortgage. For a seller of real estate, profit is the portion of the net sales price remaining after deducting the seller's remaining cost basis in the property.

When reporting the profit realized on a sale, the profit is first allocated pro rata to the net cash proceeds and the principal of the carryback note received from the sale.

To allocate the profit between the cash and carryback components of the net sales proceeds, a percentage figure called the contract ratio or profit-to-proceeds ratio is calculated as: the percent the amount of profit on the sale represents of the net sale proceeds the seller receives on closing (cash and a carryback note).

Chapter 17 Key Terms

Chapter 18

Profit on modification of a trust deed note

Learning Objectives

After reading this chapter, you will be able to:

- distinguish the tax treatment of notes held by a carryback seller from those held by a trust deed lender; and
- identify when the modification of a note is treated as a disposition, triggering the reporting and taxing of profit.

Key Term

disposition

No taxation on modification of a carryback note

Consider a seller who carries back a note and trust deed in an installment sale to facilitate the buyer's need for medium-term financing to pay part of the purchase price, sometimes called a "bridge loan."

The note contains a five-year due date calling for a balloon payment at the end of the fifth year after the close of escrow.

The net sales price received for the property is greater than the seller's remaining cost basis in the property. Thus, a profit is realized on the sale. Taxwise, a portion of the seller's profit on the sale is:

- a percentage of the principal amount of the carryback note (and the net cash proceeds) under the profit-to-equity ratio (IRS contract ratio); and
- reported and taxed in the year the owner receives principal payments on the carryback note.[1] [See Chapter 17]

1 Internal Revenue Code §453(c)

As the due date approaches for payoff of the note, the seller wants to *further defer* reporting the profit. When the balloon payment of principal is paid, the profit in the principal is taxed. The carryback seller enters negotiations with the buyer to extend the due date, modifying the terms of the note. [See **RPI** Form 425 accompanying this chapter]

To induce the buyer to agree to the modification, the seller offers to lower the interest rate (but not lower than the applicable federal rate for imputing interest) and reduce monthly payments to interest only.

The seller and buyer memorialize their agreement in a note modification agreement. [See **RPI** Form 426]

With the due date for payment of principal extended, may the seller further defer the reporting of profit allocated to the principal in the carryback note to a later year?

Yes! Initially, a carryback seller automatically defers reporting and payment of taxes on the part of their profit allocated to the principal amount of the carryback note. Sellers may elect out and pay profit taxes in the year of the sale.[2]

During ownership of the note, the carryback seller may extend the due date and alter the interest rate and payment schedule on their note without triggering taxes on the profit due to the modification. Modifying a carryback note does not bring about the reporting or taxation of:

- profits in principal balance of the carryback note; or
- income on any increase in the note's current market value due to the modification.[3]

While the payment of taxes on the profit apportioned to the note principal continues to be deferred, any increase in the current value of the note due to the modification is exempt from reporting until received as increased principal or interest paid on the note.[4]

disposition
The act of transferring or otherwise giving up an asset, such as property or a trust deed note, which triggers the reporting and taxing of profit.

In contrast, modification of a note held by an institutional mortgage holder or trust deed dealer/investor triggers a recharacterization of the modification as a **disposition** of the note. Thus, reporting and taxing of income results from a modification of a money mortgage, but not on a carryback note held by a seller.[5]

The installment sale exemption

Institutional and private trust deed lenders, and subdividers or builders who carry back a mortgage on the sale of parcels in their projects, are classified for taxation as *dealers in notes*. Taxwise, trust deed notes held by dealers are categorized as either:

- *portfolio assets*, when held by a mortgage lender or trust deed investor for income (or profit on a resale); or

2 IRC §1001(d)
3 Revenue Ruling 68-419
4 Rev. Rul. 82-122
5 IRC §1001(b)-(c)

- *trade or business inventory*, when held by a developer or subdivider from a sale of inventory.

The modification of a note held for investment by a trust deed investor or mortgage holder or carried back on the sale of a builder's business inventory, is a reportable *disposition* of the note and taxed. The existing note is treated as exchanged for a new one or sold for cash.

On a modification of a mortgage, the dealer is charged with constructive receipt of the principal in the note — whether the modified note represents the receipt of cash, a new note or a "rollover" obligation represented by the modified note.

In contrast, a carryback seller of property used in the operation of their trade or business (not held as inventory), or of rental or investment category property, is exempt from profit reporting on modification of the carryback note.

The sale or exchange of a carryback note is considered a disposition of the note and any remaining profit allotted to the note principal is taxed. Also, a carryback note *collaterally assigned* to provide security for a loan causes the carryback seller to report and pay taxes on profit in the note principal equal to the amount of the loan proceeds.

On a subdivider's modification of a note carried back on the sale of improved dealer property, the income on the sale assigned to the carryback note or any value increase in the note due to the modification is income and not reported under installment sale rules. Exceptions exist for the sale of unimproved lots, short-term time shares, and farms.[6]

Modifying the carryback

A seller holding a note they carried back on the sale of a capital asset is allowed to:

- modify payment schedules;[7]
- alter the interest rate;[8]
- accept substitute security;[9]
- bifurcate the note into separate obligations when the secured property is subdivided;[10] and
- accept new or additional obligors, such as an assuming buyer of the secured real estate, whether or not the existing owner is released of liability.[11]

However, consider the resale of real estate encumbered by a carryback note held by a prior seller. To help facilitate the owner's resale of the property, the prior seller agrees to cancel their note and reconvey the trust deed in exchange for the resale buyer executing a new note and trust deed in their favor on entirely different terms for payment of the remaining principal.

6 IRC §453(l)
7 Rev. Rul. 68-419
8 Rev. Rul. 82-122
9 Rev. Rul. 55-5
10 Rev. Rul. 74-157
11 Rev. Rul. 82-122

Form 425

Modification of the Promissory Note

MODIFICATION OF THE PROMISSORY NOTE

Prepared by: Agent ____________________ **Phone** ____________________
Broker ____________________ **Email** ____________________

NOTE: This form is used by a holder of a mortgage, their servicing agent or broker when a modification of the debt has been negotiated, to evidence the modification of the original note and state the change in terms of the note.

DATE: ____________, 20____, at ______________________________, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This is a modification of a promissory note
 1.1 executed by ______________________________, as the Payor,
 1.2 in which ______________________________, as the Payee,
 1.3 dated ______________, at ______________________________, California,
 1.4 in the original amount of $____________.

2. The promissory note is secured by a deed of trust of the same date
 2.1 executed by ______________________________, as the Trustor,
 2.2 in which ______________________________ is the Beneficiary,
 2.3 recorded on ______________, as Instrument No. ______________,
 in the records of ______________________ County, California.

3. regarding real estate referred to as ______________________________
______________________________.

AGREEMENT:

4. The above mentioned promissory note is modified as follows: ______________________________
____

I agree to the terms stated above. ☐ See attached Signature Page Addendum. [**RPI** Form 251] Date: ____________, 20____ Payee's Name: ____________________ Signature: ____________________ Signature: ____________________	**I agree to the terms stated above.** ☐ See attached Signature Page Addendum. [**RPI** Form 251] Date: ____________, 20____ Payor's Name: ____________________ Signature: ____________________ Signature: ____________________

Here, the carryback seller disposed of their original carryback note in exchange for an entirely new and different note and trust deed from a different person. Only the amount of principal and security for its repayment remain the same.

As a disposition of the note, the carryback seller reports and pays taxes on profit allocated to the remaining carryback principal.[12]

Instead of canceling and reconveying the original note and trust deed, the carryback seller needed to retain the original note and trust deed and enter into an *assumption and modification agreement* to set the terms of

12 **Burrell Groves, Inc.** v. **Commissioner** (1955) 223 F2d 526

the carryback note with the new buyer. Here, the carryback seller achieves the same economic result without a disposition of the note and premature taxation of their profits.

Modification rules for trust deed dealers

Consider an investor who purchases a carryback note secured by a second trust deed on the property sold. The note has a face amount of $250,000 with 10% interest and monthly payments of $3,276, fully amortizing over a ten-year period.

The note now has a principal balance of $199,000 with seven years remaining until paid in full. The investor pays $180,000 to purchase the note, producing a yield rate of 13.4% interest on the investor's funds.

Later, the value of the secured property declines, reducing the note's market value to $120,000. The investor wants to sell the note and take their loss. The principal owed is a *nonrecourse debt* collectible only from the remaining value of the property. The loss will be reported and used to offset income from other sources.

The investor seeks a stable — though reduced — stream of income on disposition of the now risky and devalued note. The investor knows a more aggressive trust deed buyer who holds a well-secured note valued at $120,000. They exchange notes by assignment.

The investor writes off their loss on the exchange of the notes against income from other notes. They claim their exchange of the devalued note for another note, secured by different real estate and executed by a different borrower, is a disposition of the carryback note as though it had been sold for cash, triggering profit/loss reporting.

The IRS claims the exchange of the trust deed note for a similarly valued trust deed note is not a material alteration of the investor's rights under the carryback note they disposed of. The IRS views the transaction as merely an acceptance of an *economic substitute* other than cash for the original note, the same as modifying the note by accepting substitute security and new obligors.

Is the trust deed investor allowed to report their lost value on the exchange of the notes?

Yes! The exchange of notes secured by different properties with different borrowers is a *material alteration* of the debt evidenced by the note and trust deed the investor assigned. Thus, the exchange is a disposition of a note triggering profit/loss reporting.[13]

IRS dealer paper regulations

IRS regulations control whether modifications to dealer-held trust deed notes trigger profit reporting.[14]

13 **Cottage Savings Association** v. **Commissioner of Internal Revenue** (1991) 499 US 554

14 Revenue Regulations. §1.1001-3(b)

The modification of a dealer note triggers profit reporting when:

- the fixed interest yield is altered by more than 1/4th of 1% per annum or 5% of the note rate, whichever is greater;
- payments are deferred or payment amounts altered such that payment of principal is deferred;
- the due date is extended for more than five years or 1/2 of the original term of the note, whichever is less;
- a buyer assumes a recourse note and the original borrower is released from liability, called a novation;
- the security pledged on a nonrecourse note is materially altered;
- substitute security is given on a nonrecourse note;
- a fixed rate note is changed to a variable rate or contingent interest note (e.g., a shared appreciation mortgage), or vice versa, unless the change has been agreed to in the original note; or
- a note is otherwise altered from a recourse to a nonrecourse obligation, or vice versa.[15]

Disposition and profit reporting not triggered

Insignificant modifications of dealer paper that do not trigger disposition and profit reporting include:

- altering the interest yield 1/4th of one percent or less per annum;
- altering payment terms in a way that does not defer payments on principal and does not increase the interest yield (i.e., changing to quarterly payments from monthly payments, provided the quarterly payments are the same as three monthly payments);
- a due date extension that does not exceed five years or 1/2 the term of the note, whichever is less;
- prepayment of any portion of the note, or imposition of a penalty on the prepayment;
- assumption of a nonrecourse note;
- addition of a co-obligor;
- improvements to the secured property;
- a substitution of security for a recourse note; or
- subordination of the trust deed securing the note.[16]

15 Rev. Regs. §1.1001-3(e)
16 Rev. Regs. §1.1001-3(f)

Chapter 18 Summary

Disposition is the act of transferring or otherwise giving up an asset such as property or a trust deed note which triggers the reporting and taxing of any profit.

When a note originated or acquired by an institutional mortgage holder or trust deed dealer/investor is later modified, the modification is recharacterized as a disposition of the note.

The modification of a note held for investment by a trust deed dealer or mortgage holder or a note carried back on the sale of a builder's business inventory is a reportable disposition of the note. On a modification, a mortgage holder is treated as having constructively received the proceeds of the original note — whether it is the receipt of cash, a new note or a "rollover" obligation represented by the modified note.

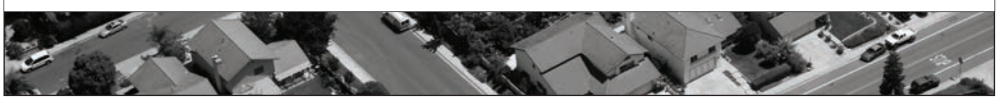
Unlike a modification, when a seller sells or exchanges a carryback note, it is considered a disposition of the note and tax is due on remaining untaxed profit allocated to the note. Any benefit received when a carryback note is collaterally assigned as security for a loan triggers reporting of an amount of profit equal to the amount of the loan proceeds.

Chapter 18 Key Term

disposition .... **pg. 150**

Chapter 19

Lease-option sale triggers profit reporting — it's a carryback



Learning Objectives

After reading this chapter, you will be able to:

- identify when a lease-option agreement masks a reportable carryback sale; and
- advise clients on the tax implications of a lease-option sale.

Key Terms

Applicable Federal Rate (AFR)

common interest development (CID)

equitable ownership

homeowners' association (HOA)

land sales contract

recharacterization

Ownership deductions for the buyer

During the recovery phase of a real estate sales cycle, while mortgage financing is tight and tenants need incentive to become an owner, sellers for various reasons use lease-option forms designed as intended for leasing to document a carryback sale.

The tax reporting advantages available to sellers granting an option to buy include:

- larger sales profits through a premium sales price;
- tax-deferred profit or income from option monies;
- no interest stated as accruing on the amount owed on the price;
- rental income in lieu of interest;

- rental operating expense deductions; and
- depreciation and mortgage interest deductions.

A *lease-option agreement* used to sell property typically couples the normally separate documents used for a tenant to lease real estate and the landlord to grant the tenant an option to buy the leased property. However, the combining of these documents, with slight modification, creates a hybrid form real estate transaction intended to "mask" a sale more conventionally entered into as a purchase agreement and escrow conveying title or, occasionally, a land sales contract. [See **RPI** Form 163]

Granted concurrently with the transfer of a leasehold interest in the real estate, the conventional features of an option to buy real estate include:

- the price to be paid, almost always stated as the property's market value on the date of exercise, rarely a fixed dollar amount as in a purchase;
- the right to possession and use of the property by the tenant for the lease term, a tenant's primary financial objective;
- no payment of option money, the consideration for the grant of the option always being the lease agreement entered into by the tenant which incorporates the option; and
- No financial compulsion to exercise the option, such as periodic dollar credits applied toward the price from either rent or ongoing option money payments.

He who wears a mask

Coupling the lease and option to buy in a lease-option sale masks from local government agencies and the public what is actually a sale. The combination, together with provisions adjusting the economic function of a lease agreement to fit a purchase, commingles the separate financial aspects of each, a hybridization producing a reportable sale of the property.

The legal function of the hybrid lease-option sale documentation is that of a note and *security device* – a trust deed. The resulting agreements collectively contain evidence of both the principal amount remaining due on a fixed purchase price and the creditor status of the seller retaining title as security until fully paid. Thus, the hybrid documentation for a lease-option sale is just another form of seller carryback financing.

land sales contract
A security device used for the sale of real estate when the seller retains title to the property as security until all or a prescribed part of the purchase price has been paid.

In application, a purported lease-option sale is either:

- a **land sales contract** under California law (when the term for payments exceeds one year);
- a two-party mortgage or wraparound mortgage for a term less than one year; or
- a trust deed or all-inclusive trust deed (AITD) when the documentation contains a power-of-sale provision.

When a "lease-option" agreement calls for part or all of the periodic payments (rent) to apply to the purchase price and a conveyance of title to occur more than one year after entering into the agreement, the agreement is a *land sales contract*. Thus, the title given the documentation does not conform to the economic function of the agreed-to financial arrangements.[1]

The title of "lease-option" is an incorrect recharacterization of the transaction. The owner credits the buyer with a buildup of equity in the property produced by the agreed-to principal reductions on the price received in each monthly payment. This economic function is more akin to a buyer owning property subject to a mortgage securing a debt owed to the seller, called **equitable ownership** since the seller retains vested title.

equitable ownership
Held by a person who purchases a property and has possession but has not yet received legal ownership with title vested in their name, such as occurs under an unexecuted purchase agreement, land sales contract or lease-option sales agreement.

Buyers might intentionally structure a sale as a lease-option on the mistaken belief the arrangement for the seller to retain title avoids reassessment for local property tax purposes. However, lease-option documentation used to mask a sale results in the same property tax consequences as a grant deed conveyance, recorded or not. The lease-option sales transaction is characterized as a *change of ownership* triggering reassessment. When the lease-option documents are recorded to perfect the buyer's interest in the property, the assessor's office reassess the property on review.[2]

Seller's erroneous tax expectations

The lease-option sale format does not state the rate of return the seller receives on the principal remaining unpaid on the price. No provision exists stating either an annual percentage yield or an interest rate the buyer is paying on the balance owed to the seller. However, the annual yield – interest rate – is easy to calculate under lease-option sale figures.

Typically, the periodic payments received by the seller are labeled "rent." Unlike rent, however, some or all of the payments are credited toward the purchase price — a *reduction of principal* labeled as both rent and payment on the purchase price, an irreconcilable conflict in terminology. [See **RPI** Form 163 §17.3]

In spite of the credit on the price, the seller intends to report all payments on the lease as rental income, not as *interest and principal* (which includes a return of capital and profit) as reported on a carryback sale.

Alternatively, the monthly payment is broken into two separate amounts: one for rent and the other for option money. The provision for monthly option money payments is structured to extend the option an additional month on receipt of the option money.

The seller defers reporting of the option money payments until the option is exercised or expires. Thus, the rent income is reduced and the profit on exercise of the option increased, a shift of interest income earnings into gains from profit. The result is a lower tax rate and reduced taxes.

homeowners' association (HOA)
An organization made up of owners of units within a common interest development (CID) which manages and operates the project through enforcement of conditions, covenants, and restrictions (CC&Rs).

The payment of rent in gross leases implicitly includes ownership expenses disbursed by the seller for property taxes, insurance premiums and **homeowners' association (HOA)** assessment when the property is located

1 **McCollough** v. **Home Ins. Co. of New York** (1909) 155 C 659

2 State Board of Equalization Letter to Assessor No. 80/147

common interest development (CID)
Condominium projects, cooperatives, or single-family residences in a planned unit development. [See **RPI** Form 135]

in a **common interest development (CID)**. The rent remaining after the seller's payment of expenses is offset by interest paid on the existing loan and depreciation deductions allowed on residential rental property and reported by the seller.

However, the typical lease-option agreement shifts all care and maintenance of the property to the buyer, a net lease set of conditions. Thus, the risks of ownership are the burden of the buyer, as is the risk of loss when the property value drops below the option price.

The lease-option in application

Consider a seller who relocates to another community and is unable to sell their vacate residence at an asking price of $385,000.

The residence is encumbered by a loan with a balance of $275,000. The monthly loan payment is $2,000, plus property taxes and insurance premium impounds. However, the market rental value of the residence is just $1,500. The seller needs to sell the property and get out from under its *negative cash flow*, which is a debilitating drain on earnings.

The seller refuses to deed out their property and carry back a note and trust deed based on the understanding they are not to help finance a sale unless the buyer has at least a 10% cash down payment net to the seller.

However, to attain the desired sales price, the seller needs to offer buyers some incentives, though they still have no cash downpayment.

A creditworthy but cash-poor prospective buyer with a high paying job is located. The buyer qualifies to make monthly payments of $3,000, which is double the current market rental value, but sufficient to cover the seller's carrying costs of the property.

The buyer suggests a lease with an option to purchase the property. However, the buyer wants all monthly rent and option money payments to apply to the fixed purchase price. Mathematically, this will build up a deferred down payment (and equity in the property) as the buyer makes monthly payments.

Ultimately, the buyer and the seller agree to lease-option terms calling for a $3,000 monthly payment — $1,500 allocated to rent due under the lease and $1,500 as option money for monthly extension of lease and the option.

The agreement also calls for a $6,000 advance payment at the time of occupancy — $3,000 prepaid for the first and last months' rent and $3,000 as option money. The lease and option have a two-year term, at the end of which the buyer may exercise their option by paying the balance due on the price, decreased by credit for all payments of rent and option money.

The lease terminates if the buyer does not pay either the monthly rent or the option money. Any default in monthly payments triggers a forfeiture provision that either converts all payments to rent or declares a loss of the right to credit payments to the price.

Tax-wise, the seller expects to report the lease-option transaction as:

- $36,000 in rental income over the two-year term of the lease — $19,500 the first year and $16,500 the second;
- $37,500 in option money received over the term of the lease, to be reported only in the year the option is exercised or expires, as profit or income, respectively;
- $311,500 in gross sales price remaining to be paid through a sales escrow in the form of cash and loan assumption or new financing, which price equals the portion of the lease-option remaining unpaid when the option is exercised at the end of the term (the balloon payment);
- $8,500 in annual depreciation deductions based on a cost basis for the property of $310,000 (75% depreciable on a 27.5-year schedule);
- $30,000 in annual mortgage interest deductions against rental income; and
- a $250,000 principal residence profit exclusion for each seller on exercise of the option.

The seller's anticipated tax reporting includes an annual gross rental income of $18,000 offset by insurance and property tax expenses along with interest and depreciation deductions taken as owner of the property, netting a rental operating loss of about $46,000 over the two-year term of the lease.

Two years of depreciation deductions will reduce their cost basis in the property to $293,000.

The seller will report $349,000 on the sale, the amount of the price due on the exercise of the option plus the option money they have received ($311,500 plus $37,500). Escrow will not reference the lease-option, and no purchase agreement other than the escrow instructions will be prepared.

Thus, the seller figures their profit on the sale will be $56,000.

All payments will be reported as profit and excluded from income since it is profit on the sale of property that qualifies as a principal residence of the seller.[3]

IRS recharacterization

On an audit, the Internal Revenue Service (IRS) looks beyond the form used by a seller and a buyer in a lease-option transaction, ferreting out its underlying economic function and legal substance.

The IRS looks into a number of factors to determine whether a purported lease-option is really a sale, including:

- whether the buyer has built up an equity in the property without regard to forfeiture provisions [See **RPI** Form 163 §17.3];
- who bears the risk of loss for property damage and reduced property value [See Form 163 §§11, 12];
- who pays property taxes [See Form 163 §5(c)];

3 IRC §121

- the relationship of payments to market value rent; and
- the price paid on the option's exercise compared to the property's value when the option is exercised.

When the IRS finds a lease-option is actually a sale, the seller's tax reporting will be disallowed and recalculated as a carryback sale, triggering:

Applicable Federal Rate (AFR)
Rates set by the Internal Revenue Service and used by carryback sellers to impute and report minimum interest income when the note rate on their carryback debt is a lesser rate.

- the recharacterization of rent as interest income;
- the imputing and reporting of interest at the agreement's **Applicable Federal Rate (AFR)**, reported as investment/portfolio category income;
- a reduction of the sales price due to re-allocation based on imputed interest;
- option money reported as interest income at the *AFR*, with any remainder credited to the price;
- profit reporting of principal payments applied to the price, based on the carryback sale contract/profit-to-proceeds ratio;
- disallowance of rental operating losses;
- allowance of a deduction from interest income for interest paid on the underlying loan;
- disallowance of depreciation deductions; and
- allowance of the $250,000 profit exclusion on sale of the principal residence when the two-of-five year ownership-occupancy rule is met. [See Chapter 3]

recharacterization
The depiction of a lease-option agreement as the economic equivalent of a sale and financing arrangement rather than by the function of a landlord/tenant transaction.

The **recharacterization** of the lease-option as a sale is based on the seller's transfer of *equitable ownership* to the buyer by the terms of the lease-option agreement functioning as a carryback note and trust deed. An equity buildup in the property results from the credit of some or all of each payment to the price paid for the property.[4]

When a buyer in possession of property is building equity over a period exceeding one year, their lease-option is a land sales contract in everything but name. It is not a trust deed as no provision for a trustee's foreclosure on default is written into the lease-option documents. The option money realistically is a payment on the price as it reduces the amount owed, and the rent is interest and principal (and possibly impounds for property taxes and insurance premiums) under what is a disguised mortgage.[5]

Editor's note — No legislation exists that recharacterizes a bogus lease-option as a masked land sales contract. However, rules relating to equivalent lease-back and option arrangements involving equity purchasers are codified.[6]

When a lease-option agreement masks what is a land sales contract, the tenant becomes a buyer with equitable ownership of the property — because they are in possession of the property, have agreed to responsible for all

4 **Petersen** v. **Hartell** (1985) 40 C3d 102; see Form 163 §17.3
5 **Oesterreich** v. **Commissioner** (1955) 226 F2d 798
6 Calif. Civil Code §1695.12

property repairs and maintenance and make payments that apply to a fixed purchase price. None of the terms of a sale or carryback note are missing or cannot be calculated.[7]

The landlord-in-fact as agreed in the lease-option becomes a carryback seller-at-law on a land sales contract. They are a secured creditor with different rights than those of an owner or landlord, even though they retain title – security for payment.[8]

Charge interest or impute it

Tax-wise, the lease-option sale is an *extension of credit* by the seller and subject to carryback sale reporting. Thus, the seller needs to report a minimum amount of interest income at the carryback sale's AFR.

A lease-option sale contract is a form used to document seller financing, as are also:

- a land sales contract;
- a carryback note with or without a trust deed; and
- some unescrowed (unexecuted) purchase agreements with long-term interim occupancy.

Each device for the credit sale of real estate has its own AFR. These seller carryback security devices evidence the debt owed to the seller for the remaining unpaid amount due on the purchase price.

Tax-wise, all payments received by the lease-option seller in excess of impounds for property taxes and insurance, regardless of how they are characterized, apply first to interest at the AFR on the entire amount owed to the seller. Any amount remaining is principal and is applied to the purchase price.

The seller's tax reporting requirements have no effect on the buyer's financial obligations to the seller. However, on entering into a lease-option purchase and taking possession, the buyer has acquired sufficient incidence of ownership as a result of applying payments to the purchase price, maintenance provisions and a set amount for the purchase price that they are treated as the owner for tax purposes.

The seller reports the interest income portion included in each payment based on the AFR as investment/portfolio category income. The principal portion is allocated between basis and profit on the sale based on the seller's profit-to-equity ratio for the installment sale and is subject to the $250,000 residential profit exclusion.

7 **McClellan** v. **Lewis** (1917) 35 CA 64

8 **Los Angeles Investment Co.** v. **Wilson** (1919) 181 C 616

Chapter 19 Summary

For various reasons, sellers use lease-option forms designed as intended for leasing to document a carryback sale. A lease-option agreement typically couples the normally separate documentation used for a tenant to lease real estate and the landlord to grant the tenant an option to buy the leased property.

With slight modification, combining these documents creates a hybrid form real estate transaction intended to "mask" a sale more conventionally entered into as a purchase agreement and escrow conveying titles. The legal function of this hybrid lease-option documentation is that of a note and security device—a trust deed.

The resulting agreements collectively contain evidence of both the principal amount remaining due on the fixed purchase price and the creditor status of the seller retaining title as security until fully paid. However, recorded or not, lease-option documentation used to mask a sale results in the same property tax consequences as a grant deed conveyance.

However, the typical lease-option agreement shifts all care and maintenance of the property to the buyer, a net lease set of conditions. Thus, the risks of ownerships are the burden of the buyer, as is the risk of loss when the property value drops below the option price. On an audit, the Internal Revenue Service (IRS) looks beyond the form used by a seller and a buyer in a lease-option transaction, ferreting out its underlying economic function and legal substance.

Chapter 19 Key Terms

Chapter 20

The foreclosing mortgage holder’s profits and losses

Learning Objectives

After reading this chapter, you will be able to:

- advise on the strategies mortgage holders use to avoid reporting income or profit on the acquisition of property at a trustee’s sale;
- discuss the IRS’s presumption that a mortgage holder’s successful credit bid at a trustee’s sale is equal to the fair market value (FMV) of a property; and
- distinguish the tax treatment of a seller’s foreclosure on a carryback mortgage from that of a mortgage lender.

Key Terms

bid-equals-value presumption
fair market value (FMV)
deed-in-lieu of foreclosure

Planning the tax-free, note-for-property exchange

Consider a property owner who defaults on a mortgage with a remaining balance of $500,000. The mortgage holder calls the note due and commences a trustee’s foreclosure to enforce collection of the amounts due under the mortgage note and trust deed.

At the trustee’s sale, the mortgage holder submits an opening *credit bid* of $400,000. No other bidders appear. The mortgage holder as the high bidder acquires title to the property **in exchange for** partial satisfaction of the debt owed. Based on the amount of bid and the debt owed, the mortgage holder suffers a loss of $100,000.

On analysis, note that the maximum amount of any mortgage holder's credit bid equals the total debt owed to the mortgage holder under the note and trust deed, including:

- the principal remaining due on the note;
- any cash advances made under the trust deed;
- foreclosure costs and attorney fees for any litigation;
- interest accrued and unpaid;
- late charges; and
- prepayment penalties.

fair market value (FMV)
The price a reasonable, unpressured buyer and seller would agree to for property on the open market, both possessing symmetric knowledge of material facts.

Contrary to the amount of the credit bid, the **fair market value (FMV)** of the property received in exchange for satisfaction of debt was $550,000 on the date of the trustee's sale. Thus, a $150,000 profit is realized on the exchange.

May the mortgage holder write off the unpaid, uncollectible balance remaining on the note as a *loss* on their mortgage investment based on the amount of their underbid and acquisition of the property?

Yes, with a flipside. Here, the remaining debt owed on the note has become uncollectible. Anti-deficiency laws bar the mortgage holder from collecting the $100,000 balance remaining unpaid on the note. The lender foreclosed by completing a trustee's sale, not a judicial sale of the property.[1]

Here, at the option of the mortgage holder, the $100,000 underbid loss taken at the foreclosure sale is fully deductible.

Not exempt from taxation

Financially, however, the mortgage holder received a profit on the exchange at the trustee's sale. This profit too is taxed if not offset by losses. The exchange transaction of a foreclosure and acquisition of real estate is not exempt from taxation.

The economic function of a foreclosure sale in an exchange by the mortgage holder:

- satisfaction of all or a portion of the mortgage debt as consideration given in exchange for
- acquiring ownership of real estate which was security for the debt.

In our example, the exchange of principal remaining due on the note, even a portion of that principal, for ownership of the secured property is a taxable transaction.[2]

Thus, the mortgage holder receives a profit on their credit bid acquisition of the property. The FMV of the property ($550,000) was the value received in exchange for satisfaction of a $400,000 portion of the mortgage debt.

1 Calif. Code of Civil Procedure §580d
2 Internal Revenue Code §1001(c)

As a result, the foreclosing mortgage holder realizes a $150,000 profit on the note-for-property exchange transaction, taxable in the year of the foreclosure transaction.

The mortgage holder concurrently suffered a $100,000 loss on the note due to the underbid and bar against collection and enjoyed a $150,000 profit on their exchange — a net profit of $50,000 on the entire exchange-by-foreclosure transaction.[3]

Now the flipside. The mortgage holder may avoid reporting the profit taken due to the greater value received in the foreclosed property by applying the Internal Revenue Service (IRS) **bid-equals-value presumption**.

Mortgage holder forecloses and buys – a forced purchase

A mortgage holder acts as a *creditor* at a foreclosure sale by limiting its bid to include only the amount of the remaining principal, advances and costs. Classified as a creditor, the IRS presumes the amount of the credit bid is equal to the property's FMV. Thus, the mortgage holder receives no reportable income in the form of interest and penalties added to the bid. Importantly, the profit on the greater value in the property acquired at the foreclosure sale is not reported — the result of the *bid-equals-value presumption*.[4]

bid-equals-value presumption
The IRS's presumption a mortgage holder's successful bid at a foreclosure sale, limited in amount to the remaining principal, costs and advances, is equal to the FMV of the interest acquired in the property leaving no reportable income in the exchange.

The mortgage holder properly opens bidding at or below the amount of the remaining principal balance plus advances and foreclosure costs. And when cash bidders overbid, it is prudent for the mortgage holder to consider increasing their credit bid, limited to the amount that covers the accrued interest, earned late charges and any prepayment penalty due and unpaid.

A mortgage holder will rarely bid an amount in excess of the total amount owed on the debt unless competitive bidding drives up the bid amount and the mortgage holder is willing to *add cash* in an exchange to become the owner of the property.

"Bidding in" is buying property

Consider a mortgage holder who forecloses on a mortgage with an outstanding balance of $400,000. The mortgage holder's successful bid at the trustee's sale is $350,000, but the property's FMV is only $320,000.

The mortgage holder takes a $50,000 loss on their mortgage. Further, the mortgage holder has an additional $30,000 reportable loss. They received only $320,000 in FMV on their exchange of the portion of the mortgage debt they canceled for property ownership at the foreclosure sale. Thus, the mortgage holder's total losses amount to $80,000.[5]

To substantiate the loss on the exchange, the mortgage holder presents evidence to the IRS, such as an opinion of value or appraisal, demonstrating the property's FMV is below their successful bid.

3 **Helvering** v. **Midland Mut. Life Ins. Co.** (1937) 300 US 216
4 Revenue Regulations §1.166-6(b)(2)
5 **Nichols** v. **Commissioner** (6th Cir. 1944) 141 F2d 870

IRS presumptions and appraisals

The bid-equals-value presumption for reporting the exchange is rebuttal by the IRS. Thus, the IRS may independently establish the property's value at the time of the trustee's sale when a loss is reported by the mortgage holder. When the IRS demonstrates through appraisals that the property's FMV was higher than the bid price at the foreclosure sale, the mortgage holder either reduces the reported loss or reports income for the difference between the property's FMV and the mortgage holder's basis in the mortgage.

For example, consider a mortgage holder who forecloses by trustee's sale on several mortgages. Losses are declared based on the difference between their underbidding and their cost basis in the mortgages.

Reporting their losses triggers an audit. The IRS appraises the properties to determine their values at the time of the foreclosure sales. The IRS discovers the FMV of the properties was much higher than the bid prices and disallows the losses and assesses taxes on the profits.

The mortgage holder claims:

- the bid prices set the FMV of the properties under state law, as all the trustee's sales were publicly advertised auctions properly conducted under California foreclosure law;[6]
- a trustee's foreclosure sale bars any deficiency judgment and collection of remaining debt in California;[7] and
- the IRS presumes the underbid price at a properly conducted trustee's sale to be the FMV.

Is the IRS bound by the California limitations on foreclosures or any other borrower defenses?

No! The state anti-deficiency laws are designed with the purposes of protecting borrowers after foreclosure, not mortgage holders. Federal tax law, on the other hand, is designed to measure a mortgage holder's income, profits or losses on a foreclosure since a foreclosure sale concluding with the lender taking title to the property is a taxable exchange.[8]

deed-in-lieu of foreclosure
A grant deed from the owner of mortgaged real estate conveying it to the mortgage holder in exchange for cancelling the mortgage debt and avoiding foreclosure.

Here, the IRS may independently appraise the property to calculate the mortgage holder's profit on the note-for-property exchange that occurred. When establishing a higher value for the property than the price bid, the IRS *rebuts* their own bid-to-value presumption. Moral: do not do loss reporting that will trigger an audit if you are foreclosing at a profit.

Deed-in-lieu of foreclosure as an exchange

By taking a **deed-in-lieu of foreclosure**, a mortgage holder acquires the property immediately, rather than waiting for a foreclosure sale to be noticed and processed. Thus, they reduce one risk of further loss.

When the value of a property conveyed to the mortgage lender by a *deed-in-lieu* is greater than the remaining balance, costs and advances, the mortgage

6 Calif. Civil Code §§2924 et seq.

7 CCP §580d

8 **Community Bank** v. **Commissioner** (9th Cir. 1987) 819 F2d 940

holder will have interest income, and possibly profit, to report. Unpaid interest when received constitutes a creditor's income, while *excess value* in the real estate acquired (as the seller exchanging a mortgage) produces profit.

On the other hand, when the property's value is less than the unpaid mortgage balance, the mortgage holder has a reportable loss on the cancellation of mortgage debt in exchange for ownership of the property.

For a deed-in-lieu to be insurable by a title company, the deed needs to state the conveyance is freely and fairly made as granted in *full satisfaction* of the debt. [See **RPI** Form 406]

Some title companies further require an estoppel affidavit or additional statement in the deed that confirms the mortgage holder's consideration for the deed equals the value of the interest conveyed in the property. However, the mortgage holder needs to avoid reporting a loss when they accept a full satisfaction declaration in a deed-in-lieu.

Foreclosure guidelines

A prudent foreclosing mortgage holder appraises the property before the foreclosure sale to:

- ascertain whether the property's FMV exceeds the debt owed; and
- plan a bidding strategy to avoid reportable income or profit on the foreclosure.

Ordinarily, mortgage holders do not want to acquire secured property at a foreclosure sale. However, a foreclosing mortgage holder making a full credit bid is usually the successful bidder at a trustee's sale (the owner-in-foreclosure had no equity to sell). Typically, trustee's sales are not competitive bidding events, except during transitions after a recession when the recovery has been acknowledged.

Debt-over-value

When the amount of remaining mortgage debt is greater than the property's FMV, the mortgage holder's opening bid at a foreclosure sale is often set at or below the property's FMV, called an underbid. Thus, the mortgage holder does not create reportable income on acquiring of the property.

Here, the mortgage holder acquiring over-encumbered (underwater) property on an underbid declares:

- no income on the unpaid accrued interest;
- no profit on the note-for-property exchange; and
- a reportable capital loss on the note.

The mortgage holder receives no income or profit on the note-for-property exchange because:

- accrued interest income is not included in the bid; and
- the FMV roughly equals the price set for the underbid.

The loss reported on the note is proper, as the total unpaid principal due on the note exceeded the property's substantiated FMV.

Value-over-debt foreclosure bidding

When the property's FMV exceeds the debt owed (and no waste or insured casualty loss has occurred which are recoverable when a loss results from the trustee's sale bid), the mortgage holder's opening bid will not be greater than the amount of principal and cash advances due under the note and trust deed, including foreclosure costs and attorney fees.

Having acquiring title to the property on a bid equal to the funds invested in principal and cash advances plus the costs of enforcing collection of the debt by foreclosure and preserving the security, the mortgage holder:

- reports no capital loss on the note;
- reports no ordinary income on the interest accrued (since it remains unpaid); and
- delays until resale the reporting of profit taken on acquiring a property of greater value than the amount of the debt canceled.

Mortgage holders need to avoid overreaching to create a short-term loss by deliberately underbidding when the property FMV *measurably exceeds* the bid and they face no competitive bidding.

The IRS bid-equals-value presumption works to the mortgage holder's advantage unless the holder appears to be overreaching with losses. When a foreclosure is profitable a mortgage holder who abuses the presumption by declaring a loss on an underbid runs the risk of triggering an audit resulting in disallowed losses and taxes assessed on the unreported profit taken at the time of the foreclosure sale when acquiring the property.

Carryback seller's foreclosure exemption

Carryback sellers who foreclose on their buyer and bid in the full amount of the debt are exempt from the income and profit tax inflicted on foreclosing mortgage lenders who do the same.

Occasionally, a seller who carries back a note and trust deed is later forced by the buyer's default to foreclose and retake ownership of the property. This recovery objective may be met by negotiating a deed-in-lieu of foreclosure conveyance from the buyer. Like a foreclosing mortgage holder, the foreclosing carryback seller reacquires the property in exchange for cancellation of the note and reconveyance of the trust deed.

Unlike mortgage holders, carryback sellers who reacquire property on a deed in lieu or a full credit bid for all sums owed them, including interest, late charges and prepayment penalties, are exempt from reporting income or profit on the exchange.

Accordingly, the reacquisition of property sold in a carryback sale triggers no reportable income or profit on the foreclosure activity. The value of the seller's security interest in the property may be higher or lower than the entire debt owed the seller with no change in the tax consequence.

Likewise, the carryback seller has no loss when the FMV of the property has decreased below the principal amount of debt remaining unpaid, which is typically the reason for default. They have recovered the property they sold and are whole again as though they never sold – except for current market and pricing conditions. [IRC §1038]

However, the foreclosing carryback seller's reporting of the original installment sale is reconstructed. Any net cash proceeds on the sale or principal in installment payments not taxed (it was a return of capital) are now taxed as income – the seller has ownership of the property back and holds untaxed earnings generated by the property due the installment sale.

Chapter 20 Summary

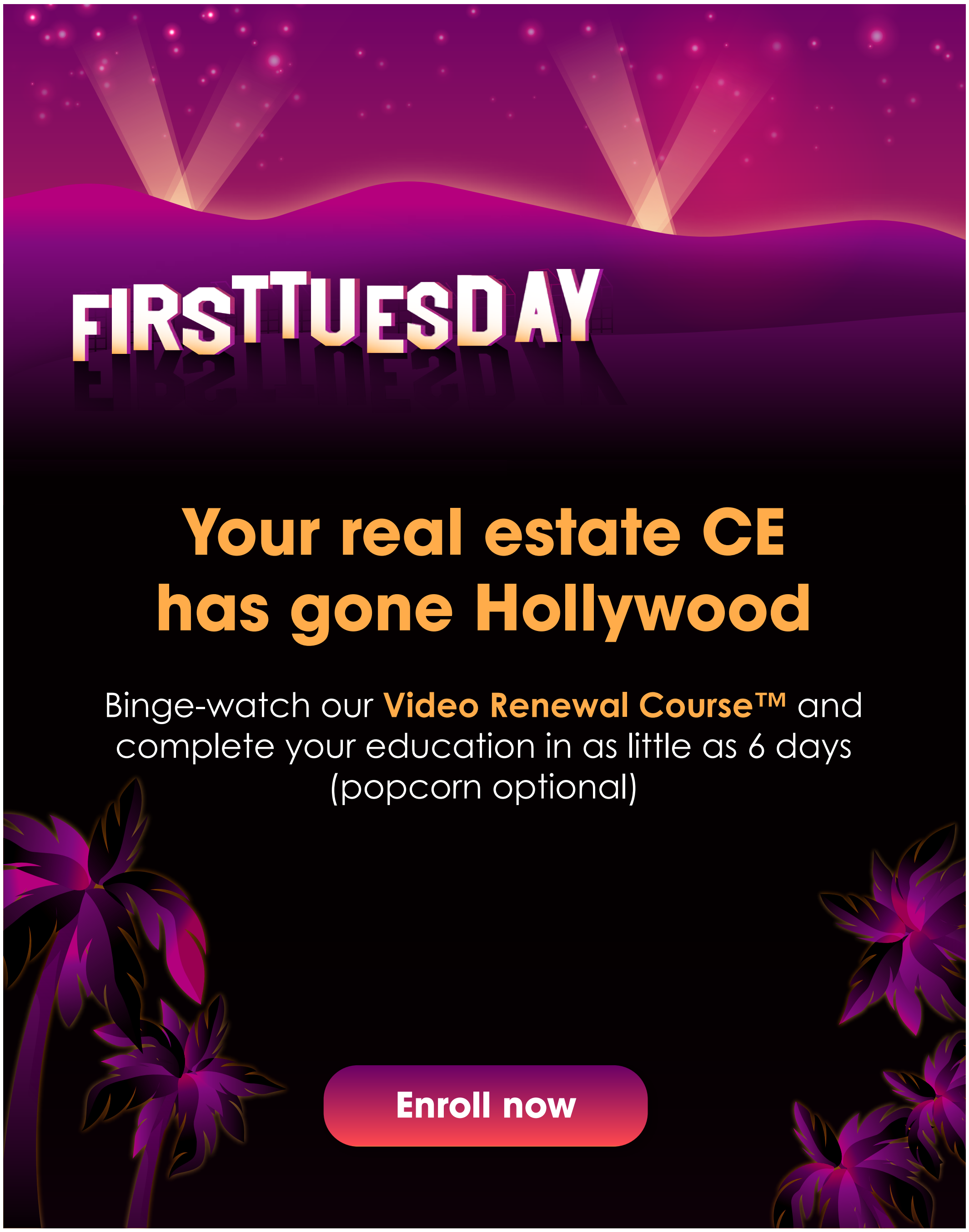
The economic function of a foreclosure sale in an exchange by the mortgage holder is satisfaction of all or a portion of the mortgage debt as consideration given in exchange for acquiring ownership of real estate which was security for the debt.

When a mortgage holder limits its bid to the amount of the remaining principal, advances and costs, the IRS presumes the amount is equal to the property's FMV. A mortgage holder will rarely bid an amount in excess of the total amount owed on the debt unless competitive bidding drives up the bid amount and the mortgage holder is willing to add cash to become the owner of the property.

When the IRS demonstrates through appraisals that the property's FMV was higher than the bid price at the foreclosure sale, the mortgage holder either has to reduce the reported loss or report income as the difference between the property's FMV and the mortgage holder's basis in the mortgage.

By taking a deed-in-lieu of foreclosure, a mortgage holder acquires the property immediately, rather than waiting for a foreclosure sale to be noticed and processed. Thus, they reduce their risk of potential loss.

Chapter 20 Key Terms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Chapter
21

The §1031 reinvestment plan – educating real estate investors

Learning Objectives

After reading this chapter, you will be able to:

- grasp the tax objectives a seller of investment real estate needs to consider to replace property in a §1031 reinvestment plan.

Key Terms

§1031 cooperation provision **nonrecognition of gain**

Determining what an investment property owner wants

A workable §1031 reinvestment environment exists when a property owner wants to sell a property and avoid diminishing their net sales proceeds by paying taxes on the profit they realize on the sale. Here, the owner's listing agent is in a position to:

- negotiate the sale of the owner's property to a buyer who agreed to cooperate with the owner at the time of closing to instruct escrow to transfer funds into a §1031 reinvestment plan; and
- coordinate the owner's use of the net proceeds from the sale of their property to purchase like-kind replacement property.

An agent working with a property owner who wants to sell and is considering the use of the net proceeds from the sale to purchase replacement property, called a §1031 reinvestment plan, needs to prepare a *client profile sheet* in a counseling session with the owner.

The **client profile sheet** documents the owner's needs and expectations for a replacement property the owner is willing to acquire with the net proceeds from a sale, also called §1031 money. With this information, the agent is best prepared to find property suitable for the owner to acquire as a replacement using the equity in the property for sale. [See **RPI** Form 350]

§1031 cooperation provision

When located, the buyer of the owner's property needs to cooperate, allowing transfer of the owner's net proceeds on the sale at the close of escrow into a purchase escrow set up by the owner or to a **§**1031 trustee for holding the funds until the replacement property is located. To bargain for this cooperation, the purchase agreement contains a **§1031 cooperation provision**. [See **RPI** Form 150 sec 11.6]

Buyers typically agree to cooperate in the transfer of the seller's net proceeds of the sale as part of negotiations to set the price and terms of payment. Most buyers, as investors or business owners, appreciate the benefits of avoiding the tax on profit, which the owner plans to do on the sale.

§1031 reinvestment benefits, as planned

The financial benefits available to a real estate owner when entering into a §1031 reinvestment plan on the sale of 1031 property and acquiring replacement property, include:

- the *exemption* from reporting all or a portion of the profit on the sale;
- an increase in *income yield* achievable by replacing the property sold with a more efficient and more productive property, usually one of higher value,;
- an increase in the amount of *depreciation deductions* on acquiring a higher-priced replacement property by assuming (or originating) a greater amount of debt, or adding cash or other property;
- an *inflation and appreciation hedge* by selling at the end of a recession and acquiring a more highly leveraged property to take maximum advantage during the recovery period of an anticipated rapid increase in cyclical rents and property values;
- the voluntary *buyout of a partner* in a co-ownership of property by acquiring multiple replacement properties for an "in-kind" distribution to the partner during the following year to end the partnership;
- a *consolidation of equities* held in several properties (owned by one or each by different owners to form a group acquisition) into a single, more efficient property for ownership and management;
- the acquisition of several lesser-valued replacement properties to *diversify the investment* and reduce the risk of loss inherent in the ownership of one high-value property, or, alternatively, for the purpose of facilitating an *orderly liquidation* of a single, high-value property over a period of years;
- the receipt of *tax-free cash* from sales proceeds by negotiating a carryback note as part of the terms for payment of the price to acquire the replacement property;

§1031 cooperation provision
A condition in purchase agreements advising participants about §1031 reinvestment planning and providing for mutual cooperation prior to closing for the disbursement of net sales proceeds when a participant decides to purchase or sell other property in §1031 reinvestment plan. [See **RPI** form 159 sec 11.6]

- the replacement of a management-intense property under gross leases with a *more manage-free property*;
- the *avoidance of profit taxes* on foreclosure of a property which has little-to-no equity by adding cash or other property in an exchange for replacement property taking on equal or greater debt;
- the *relocation of wealth*, undiminished by taxes, by selling or exchanging the equity in property to acquire property in a different geographic location when the owner relocates;
- the *creation of a job* for the owner who desires to undertake the management or rehabilitation of replacement property;
- the coupling of an assignment of a trust deed *note carried back* in a prior sale of other property with the equity in the property to be sold or exchanged as consideration to acquire a replacement property; and
- the $250,000 *profit exclusion* on the sale of a qualifying principal residence converted to a rental property coupled with the §1031 *profit exemption* on reinvestment of the net sales proceeds remaining after first withdrawing principal from the sale in the amount of profit excluded from taxes as a residence.

The cost basis carried forward

The primary tax advantage for an owner participating in a §1031 reinvestment plan is the ability to "transfer" the cost basis remaining in the property sold to the replacement property purchased. The cost basis is adjusted for contributions or withdrawal of cash and the difference in mortgage balances due to debt relief on the property sold and mortgages on the property acquired.

The carry forward treatment of the cost basis to the replacement property is a result of the **nonrecognition of gain** in a 1031 transaction. Thus, the profit or loss realized on the sale, which amount is not reported, is implicitly carried forward to the replacement property without a taxable consequence. Of course, when the replacement property is disposed of – transferred – in a taxable sale, the profit taken on that sale is taxed. Only on a taxable sale is the amount of profit determined and taxed at rates applicable in the year of sale.

nonrecognition of gain
The exemption from taxes on profits or losses realized on disposition of investment or business-use property when the net equity in the property is replaced by acquiring other investment or business-use property in a continuing ownership of property.

Chapter 21 Summary

When a property owner wants to sell a property to avoid diminishing their net sales proceeds by paying taxes on the profit they realize on the sale, a workable §1031 reinvestment environment exists. An agent working with a property owner who wants to make a §1031 reinvestment plan, uses a client profile sheet to document that owner's needs and expectations for a replacement property.

Once a buyer is located, their cooperation is bargained for in the purchase agreement under a §1031 cooperation provision.

Many financial benefits are available to a real estate owner when entering into a §1031 reinvestment plan on the sale of §1031 property and acquisition of replacement property. The primary tax advantage for an investor participating in a §1031 reinvestment plan is the ability to "transfer" the cost basis remaining in the property sold to the replacement property purchased, adjusted for contributions or withdrawal of cash or mortgage boot.

When the investor's acquisition of the replacement property is delayed until after escrow closes on their sale, the net sales proceeds are rerouted and received by a person other than the investor.

Chapter 21 Key Terms

Chapter 22

Tax aspects advice as a potent aid

Learning Objectives

After reading this chapter, you will be able to:

- turn tax knowledge to your competitive advantage by offering advice to clients on the tax consequences of their real estate transaction you are negotiating;
- develop a higher level of clientele due to your willingness to advise on the tax aspects of transactions which involve your services; and
- understand when a client needs third-party tax counsel, and their transaction documents need a tax-related further-approval contingency provision.

Key Terms

agency duty **Agency Law Disclosure**

Analyzing a transaction's tax aspects

Consider the owner of an income-producing parcel of improved real estate who intends to retain a brokerage office to market the property for sale. The owner interviews a few brokers and sales agents to determine who they will employ.

The owner's primary concern is to hire a broker whose agents are most likely to produce a prospective buyer to purchase the property. Thus, the interviews with agents include an inquiry into:

- the contents of the listing package the agent prepares to market income property;
- the scope of the advertising the agent undertakes to locate prospective buyers and any costs to the seller;

- the agent's accessibility and responsiveness to inquiries into listings the agent publicizes; and
- the professional relationship the agent has with brokers and agents who represent buyers.

One agent interviewed asks about the owner's intended use of the proceeds from the sale. The owner indicates they want to reinvest the funds in developable land, to hold for profit on a later resale to a subdivider or builder. Minimal management is the owner's objective.

On request, the owner provides the agent with data on:

- the price they paid for the income property;
- the principal balance and terms of the mortgage on the property; and
- the depreciated cost basis remaining in the property.

These three key pieces of data are needed for an agent to assist the owner in *tax planning* for a sale.

Initial opinion of tax liability

The agent does some quick math to approximate the amount of profit the owner will take — *realize* — on a sale. The agent immediately determines the owner profits on a sale, they amount owed for profit taxes on *unrecaptured gains* (rates up to 25%) and *long-term capital gains* (rates from zero to15%-20% brackets) which equal a fifth of the net proceeds from a sale (plus 1/3rd more for state taxes).

The agent expands the discussion with the owner into how they can *avoid reporting the profit* and paying taxes on the sale by locating and buying land suitable for the owner to acquire – a §1031 reinvestment plan which starts with the property to be sold.

The agent also informs the owner that listing and purchase agreements entered into for the sale of the income property and the purchase of the like-kind replacement property will contain a *contingency provision* conditioning the closing of the sale on the owner's purchase of other property.

Disclosure of known consequences

To properly relay the extent of the agent's experience, the agent informs the owner they have not personally negotiated a sale that concluded with replacement property in a §1031 *transaction*. However, the agent has taken courses on §1031 transactions and discussed §1031 funding procedures with brokers and escrow officers who have relevant experience.

The agent explains that they are fully able to properly market the property and locate suitable land for the owner's reinvestment, as well as follow up on the steps needed for §1031 tax avoidance if the owner lists the property with the agent's broker.

The owner interviews a second agent concerning the sale of the property. However, on inquiry the agent is reluctant to become involved in a review of the income tax aspects of selling property and asks for no tax information.

The second agent hands the owner a written statement attached to a proposed listing agreement advising the owner that the agent:

- has disclosed the extent of their knowledge of the tax consequences on the sale of real estate;
- is unable to give further tax advice on the rules and procedures involved in a §1031 reinvestment plan; and
- recommends the owner seek the advice of their *accountant or tax attorney* on how to properly avoid the tax on profit from the sale and purchase of real estate.

Did both agents comply with their **agency duty** to make proper disclosures to the owner about their knowledge and willingness to provide tax advice?

agency duty
The fiduciary duty a broker and their agents owe a client to use diligence in attaining the client's real estate objectives. [See **RPI** Form 305]

Yes! Both agents met the *agency duty* undertaken when soliciting employment for services in a commercial transaction since each agent:

- considered the tax consequences of the owner's sales transaction, thus implicitly treating profit taxes as a *material fact*;
- disclosed the extent of their knowledge regarding the possible tax consequences of the sale; and
- advised on any need for another professional to further review and advise on the §1031 tax aspects.

One necessary question remains for agents to sort out: does an agent employed by a seller of real estate owe their seller a duty to consider the need for tax advice as an included service to their seller?

The answer lies in a review of:

- the type of real estate involved; and
- the client's intended use of the sales proceeds.

An affirmative duty to disclose as advise on material facts

Consider a seller's agent who determines that information about the tax aspects of a sale is *material* to a sales transaction under consideration by their client. Tax information when known to the client in any type of sales transaction may alter their handling of the transaction. Due to an awareness of taxable events affecting a client, the agent owes their client a duty to disclose the extent of the agent's knowledge on the transaction's tax aspects.

Further, a concerned seller's agent goes beyond a discussion of tax information and assists their client to structure the sales arrangement so they achieve the tax consequences most consistent with the client's financial and investment objectives.

In conflict with these general rules about disclosures of material facts is a specific rule that in a one-to-four unit residential dwelling transaction a seller's agent has *no duty to disclose* their knowledge of possible tax consequences. Even when the agent understands that the tax consequences when discussed might affect their client's handling of a one-to-four unit sales transaction, the seller's agent has no duty to disclose their tax knowledge, unless transaction-related taxes is the subject of the client's inquiry.[1]

Advice disclosure disclaimer without an explanation

Consider the seller of a one-to-four unit residential property who employs a broker (and in turn the broker's agent) to sell the property by entering into a listing agreement.

The listing agreement form used by the agent's broker contains a boilerplate clause stating a real estate licensee is qualified to advise on real estate. This statement is a general statement consistent with the purpose of state licensing standards. However, further provisions state that when the seller desires legal or tax advice, the seller is to consult an appropriate professional. Nothing is said about the qualifications of the listing broker or their agent to advise on the transaction they are negotiating or whether they know the client need tax advice on the consequences they will experience.

Agency Law Disclosure
Restatement of agency codes and cases summarizing the agency conduct of real estate licensees. It is delivered to all parties in consumer sales and leasing transactions. [See **RPI** Form 305]

The agent also hands the seller a statutorily mandated **Agency Law Disclosure** form that states: "A real estate agent is a person qualified to advise about real estate. When legal or tax advice is desired, consult a competent professional." Here, the **competent professional** consulted may just be the listing broker and agent involved — who on request are obligated to give their best advice.

Neither tax-aspects disclaimer calls for the broker or their agents to provide tax advice, much less obligate the seller as a threshold condition to employ another professional to advise on the tax aspects of their one-to-four unit residential transaction before closing escrow. These tax-aspects disclaimers reek with the implication that taxes in a transaction are material. If not, then no need exists for making the disclaimer of a duty. Left without advice, the client may be unclear on the tax consequences of a transaction, the terms of which their agent negotiated.

The agent markets the property and locates a buyer who enters into a purchase agreement with the seller. The purchase agreement, like the listing agreement, again states the seller is to consult their attorney or accountant for tax advice. The disclaimer, as is their nature, does not require the client to do anything, nor is a contingency provision required for a third-party professional approval before closing.

Prior to closing the sale, the agent also negotiates for the seller to purchase another one-to-four unit residential property, for which the agent prepares a purchase agreement offer that is accepted.

Before escrow closes on either transaction, the seller asks the agent about the number of days they have after the sale closes to purchase the replacement property and avoid paying profit tax on the sale. The seller has never been involved in a §1031 reinvestment plan.

1 Cali f. Civil Code §2079.16

The agent is unsure and orally advises the seller to consult a tax accountant. The seller does not do so. The agent now knows the seller knows and is concerned about tax consequences. Critically, the agent does not include a *contingency provision* for the further approval of the tax consequences in the purchase agreement or escrow instructions to protect the client.

Ultimately, the seller is taxed on the profit from the sale, but not because of the time constraints on the closing of escrow on the purchase of the replacement property. The profit is taxed because the seller failed to avoid receipt of the net sales proceeds. Escrow instructions dictated by the agent using the purchase agreement called for the net sales proceeds to be disbursed directly to the seller. To avoid receipt of the net sales proceeds as required by a §1031 reinvestment plan, the seller needed to direct escrow to either:

- *directly transfer* the sales proceeds from the sales escrow to the purchase escrow; or
- *impound* the sales proceeds with a third-party trustee until the proceeds are needed to fund the purchase escrow for the replacement property.

Tax advice liability exception

After being taxed on the profit from the sale, due to the mishandling of the net sales proceeds used to purchase the replacement property, the seller seeks to recover losses from the agent due to adverse tax consequences incurred on the sale of §1031 property. The seller claims the agent breached their agency duty by failing to disclose the structure of the seller's transfer of net sales proceeds, as arranged by the agent, might (it will) result in *adverse tax consequences* due to the seller's receipt of the reinvestment funds.

The agent claims they have no duty to advise the seller on the tax consequences of the sale since the listing agreement, the *Agency Law Disclosure* and the purchase agreement all clearly stated:

- the agent does not advise on tax matters; and
- the seller is to look to other professionals for tax advice.

Did the seller's agent have a duty to advise the seller on the tax consequences of the sale as known to the agent?

No, but not because of these unworkable disclaimers. On the sale of one-to-four unit residential property, sellers and buyers as consumers are expected as a matter of public policy to obtain tax advice from competent professionals other than the residential real estate brokerage office handling the transaction.

A broker and their agent have no duty to be forthcoming and voluntarily disclose any tax aspects surrounding the sale of a one-to-four unit residential property. This legislated rule applies even when the information on how to avoid the adverse tax consequences is known to the broker or the sales agent. In contrast, on a direct inquiry from the buyer or seller, the agent is duty bound to respond honestly and to the full extent of their knowledge.[2]

2 **Carleton** v. **Tortosa** (1993) 14 CA4th 745

The Agency Law Disclosure addendum attached to listing agreements and purchase agreements restates the law that *eliminates the duty* of a broker and their agents to disclose their knowledge about the tax aspects of a sale when a one-to-four unit residential property is involved.

The irony of mandated disclosures

The tax consequences of sales transactions involving the use of sales proceeds to purchase replacement property are as material to a seller as the structuring of *carryback financing*. Carryback arrangements require an agent to make extensive mandated disclosures regarding documentation and rights of the carryback seller. However, carryback arrangements are less frequently encountered than §1031 reinvestment plans.

Further, the financial damage of profit taxes avoidable in a §1031 transaction often exceeds the risk of loss on an improperly structured carryback note and trust deed transaction. Unlike the agency duty of a broker and their agents in §1031 transactions, the agency duty an agent owes to their carryback seller includes full disclosure of information necessary for the seller to make an informed decision about the *financial suitability* of a carryback sale before the seller enters into the transaction.[3]

Avoid misleading clients by using disclaimers

The boilerplate statement included in some listing agreements and purchase agreements, used by unionized real estate brokers and their agents, incorrectly implies they are not qualified (or worse, not authorized) to give tax advice.

When a broker or agent is not qualified to handle a §1031 transaction, they most likely are at least aware tax advantages are available through a §1031 reinvestment plan. Further, real estate brokers and their agents with tax knowledge are *duty-bound* to advise their client about the material facts in a real estate transaction their client is about to enter — unless a one-to-four unit residential property is involved.

However, a savvy agent *capitalizes* on the tax knowledge they have by advising clients on the tax results of their real estate transactions, regardless of the type of property involved. As always, the agent who advises a client on a transaction's tax consequences as part of their services has a duty to not mislead the client by intentional or negligent misapplication of the tax rules.[4]

To avoid misleading the client- negligence - the agent needs to disclose to the client:

- the full extent of their tax knowledge regarding the transaction;
- how they acquired this knowledge; and
- whether the client needs further advice from other professionals.

Shifting reliance for tax advice given a client

Brokers and agents who provide tax advice are best served by involving the client's other advisors in the final decision, such as their attorney or tax

3 **Timmsen** v. **Forest E. Olson, Inc.** (1970) 6 CA3d 860
4 **Ziswasser** v. **Cole & Cowan, Inc**. (1985) 164 CA3d 417

accountant. Input from others who know the client helps the agent eliminate future claims arising from adverse tax consequences ostensibly due to the client's *reliance* on the agent's silence or erroneous statement of opinion.

The most practical (and effective) method for shifting reliance to the client or others when the agent has discussions with the client about a transaction's tax consequences is to insert a *further-approval contingency provision* in the purchase offer or counteroffer signed by the client.

The contingency provision imposes a duty on the client to initiate the investigation and obtain additional tax advice and a decision about the further approval of the transaction's tax consequences from an attorney or accountant before allowing escrow to close.

An oral or written warning — or general advice to further investigate — is insufficient. Further, advisory statements do not require the client to act like a contingency provision does. Worse, advisories do not explain why the broker or agent providing the advisory statements does or does not believe the client needs to act on one or more of the statements to protect themselves. A further-approval contingency provision avoids all this noise, making the agent's advice an *opinion* to be confirmed by the client before closing. Here, risk mitigation is the goal.[5]

Tax advisor's further approval

In a purchase agreement (or exchange agreement) involving implementation of a §1031 reinvestment plan, a further-approval contingency provision regarding the transaction's tax consequences calls for the client to confirm, prior to closing, that the transaction qualifies for §1031 tax-exempt status, as represented by the agent. When the client is unable to confirm the tax status as represented, they may terminate the transaction by delivery of a notice of cancellation. [See **RPI** Form 171 §5.2j]

Essentially, the client is *not relying* on the agent's opinion when they decide to enter into a purchase or exchange agreement with the intent to close escrow only after *further confirmation* of the tax consequences opined by the agent.

Further, a purchase agreement or exchange agreement containing a written contingency provision also contains an unwritten *implied covenant provision*. Under the implied covenant, before a client may cancel a transaction based on third-party approval, they are required to "act in good faith and with fairness" in their effort to obtain third-party approval, such as submitting data on the transaction for confirmation by an attorney or accountant they retain.

Here, the client's agent usually steps into the chain of events by getting authority from the client to contact the third party and providing the paperwork needed to review the transaction for its §1031 tax-exempt status. On review, the agent makes procedural changes needed to meet the client's objectives and satisfy the concerns of the third party advisor.

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5 **Field** v. **Century 21 Klowden-Forness Realty** (1998) 63 CA4th 18

Since fair dealing and reason are implied in every agreement and applied to the conduct of all parties, a termination of the exchange agreement due to the disapproval of an activity or occurrence subject to a contingency provision must be based on a *justifiable reason*.

On a potential disapproval and possible termination due to reasons expressed by the client or their third party advisor, the agent might be able to cure the defect that gave rise to the reason for disapproval, or demonstrate that the third party's concern is unfounded, i.e., when the third-party advisor's concern is an erroneous conclusion.[6]

An agent who is not knowledgeable about the handling required for a §1031 reinvestment initially avoids a discussion of tax aspects by including the §1031 cooperation provision in the purchase agreement. The provision brings to the seller's attention the availability of activities that go to the tax consequences of the sale and provide for tax handling to be addressed and implemented before closing.

An agent's knowledge of basic tax aspects in transactions

A client's technical questions which go beyond their agent's knowledge or expertise require a forthcoming and meaningful response from the agent, including:

- disclosing the extent of their *knowledge* to the seller and advising the seller to seek further advice from another qualified source;
- involving a more knowledgeable broker, tax attorney or accountant who provides the seller with advice; or
- learning how to handle §1031 reinvestments and giving the advice themselves.

Escrow officers are of great assistance to an agent who has a potential §1031 transaction on their hands. Many escrow officers, transaction agents and persons holding themselves out as qualified intermediaries advertise their expertise in handling §1031 reinvestments.

Ideally, agents handling the sale of like-kind §1031 real estate do, as a matter of basic competency, possess an understanding of several fundamental tax concepts, such as:

- the $250,000 principal residence profit exclusion on a sale [See Chapter 3];
- the separate income and profit categories for different types of real estate ownership [See Chapter 6];
- the §1031 profit reporting exemption;
- the mortgage interest deduction (MID) [See Chapter 1];
- depreciation schedules and cost recovery deductions;
- the $25,000 deduction and real-estate-related business adjustments for rental property losses;
- the tracking of rental income/losses separately for each property;

6 Brown v. Critchfield (1980) 100 CA3d 858

- profit and loss spillover on the sale of a rental property;
- standard and alternative tax bracket rates [See Chapter 1]; and
- carryback sales with deferred profit reporting.

These tax aspects are basic to the sale or ownership of real estate commonly listed and sold by agents. One or more always apply. When they apply they have significant financial impact on sellers and buyers of real estate. Any agent with working knowledge of the tax aspects of real estate may offer a wider range of services — including tax advice — when competing to represent buyers and sellers in their real estate transactions.

Additionally, a seller receiving tax advice concerning a §1031 reinvestment plan who follows the advice always leads to a second fee. It is earned for negotiating the purchase of the replacement property and coordinating the transfer of funds. Add in the goodwill created with the client and you generate referrals of like-type clients.

Chapter 22 Summary

The primary concern of owner of an income-producing parcel of improved real estate who intends to retain a brokerage office to market the property for sale is to hire a broker who is most likely to produce a prospective buyer to purchase the property.

The owner's chosen broker or broker's agent assists the owner in tax planning for a sale. A concerned seller's agent goes beyond disclosure of mere tax information and assists their client in structuring the sales arrangement to achieve the tax consequences most consistent with the client's financial and investment objectives.

The tax consequences of sales transactions involving the use of sales proceeds to purchase replacement property are as material to a seller as the structuring of carryback financing.

Real estate brokers and their agents with tax knowledge are duty-bound to advise their client about the real estate transaction into which their client is about to enter. When a broker or agent is not qualified to handle a §1031 transaction, they most likely are at least aware tax advantages are available through a 1031 reinvestment plan. A savvy broker or agent capitalizes on the tax knowledge they have by advising clients on the tax results of their real estate transactions, regardless of the type of property involved.

Chapter 22 Key Terms


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Chapter 23

A formal exchange of properties

Learning Objectives

After reading this chapter, you will be able to:

- represent an owner of real estate who exchanges their property for another;
- identify the distinctions and similarities between exchanges and cash-out sales of real estate; and
- effectively locate suitable properties for exchange.

Key Terms

equity **exchange**

Structuring a comprehensible transaction

An **exchange** of properties is a multi-property transaction structured as a barter agreement — a swap — entered into by the separate owners of two or more parcels of real estate. By agreement, they transfer to one another the ownership of their properties, conveying them through concurrent closings in consideration for the value of the **equity** in the property they receive from the other.

The *exchange* transaction, often called a *trade,* is in fact two separate sales of properties, owned by different persons, which are purchased by the other person. Exchanges occur most frequently during the recessionary phase of a business cycle. During recessions, property owners frequently are unable or unwilling to part with cash and the supply of properties whose owner need to sell are plentiful.

exchange
A means of trading the equity in a property, owned for the equity in another, treated as a single transaction involving two properties conveyed through tandem escrows. Also called barter.

equity
The value of an owner's capital interest in real estate exceeding the mortgages encumbering it.

Financial adjustments are arranged for the difference in the dollar amount of *equity* in each property based on the values given each in the exchange agreement. The values given do not affect income tax reporting, while the mortgages are part of the tax reporting on the transaction.

Thus, the owners of separate real estate, on entering into a written exchange agreement, agree to sell and convey their property to the other owner who agrees to purchase and acquire it — take it in trade. However, unlike a sale under a purchase agreement, the down payment is not in the form of cash. Rather, the down payment is the *equity* in the property the owner wants to dispose of.

In an exchange of properties, as in the sale of property with a cash down payment, the *balance of the price* remaining unpaid, after deducting the value of the equity used as the down payment, is paid in some form of consideration.

Equity adjustments common to concurrent exchanges

Unlike a sale calling for a cash down payment and assumption of an existing mortgage or new financing, any balance of the price remaining to be paid in an exchange is often deferred, evidenced by a carryback note and trust deed. Exchanges frequently have little to no cash involved beyond transactional costs, a side effect of the times when exchanges are most prevalent.

Adjustments made in a sale to pay the difference between the cash down payment and the mortgage amount, such as a carryback note, are the same for payment of the difference between the equities in an exchange situation, called *balancing of equities*. The *equity adjustment* in an exchange occurs when the equity in one property is larger than the equity in the other property. Here, the owner of the larger equity receives the consideration given for the adjustment, such as a carryback note, other property or just cash.

Also, unlike a cash sale which "frees up" the capital invested in real estate by converting a seller's equity to cash on closing, an exchange continues the owner's investment in real estate, moving wealth in one property to another. In an exchange, the owner disposes of a property they have and no longer want and acquires one they want. Further, whatever other factors may motivate an owner to participate in a §1031 reinvestment plan, the §1031 profit tax exemption is always one of them.

The owner might use their equity to move up into property of greater value for increased leverage to expand their wealth by mortgage amortization and property value appreciation. Or the owner consolidates several properties they own in an exchange for a single, more efficiently operated property.

A contrast in thought and style

The hallmarks of an exchange transaction, in contrast to the common features of a sales transaction, include:

- the *exchange of equities* in real estate in lieu of a cash down payment, though some cash might be involved, casually referred to as *sweetener*;

- no *good-faith deposit* since cash is infrequently used in an exchange of equities. Rather than a cash deposit, the consideration for entering into the exchange agreement is the signature of each owner binding them to perform as promised in the exchange agreement;
- a takeover of *existing financing* with or without a formal assumption of the mortgages, rather than refinancing and incurring expenses that greatly increase the cost of reinvesting in real estate;
- *adjustments* brought about by the difference in the value of the equities exchanged, a balancing that requires the owner with the lesser-valued equity to cover the difference, typically by a note calling for cash installments;
- joint or *tandem escrows*, interconnected for the concurrent conveyance of properties, is similar in effect to the purchase of property for cash when the closing is contingent on the buyer's sale of other property for funds needed to close escrow. This contingency occurs in §1031 reinvestment plans when agreeing to buy a property as the replacement property before selling the property to be disposed of;
- two sets of *broker fees*, one for each property involved in the exchange, rather than the receipt of a single fee as occurs in a cash-out sale of property; and
- one owner simultaneously involved in selling and buying, a coupling of two properties, consisting of the sale of one and purchase of the other.

Commonality with a sale

Common features in an acquisition of real estate, by either a cash purchase or an exchange of properties, include:

- *disclosures* by the owner and their agent of the conditions known to them about the property improvements, title, operation, and natural hazards of the location which adversely affect the property's market value or the buyer's intended use of the property; and
- a *due diligence investigation* by the person acquiring title concerning their future ownership, use and operation of the property.

As in all real estate transactions, a form is used to prepare the offer and commence written negotiations. The objective of a written agreement is to provide a comprehensive checklist of boilerplate provisions the client is to consider in their offer, acceptance, and counteroffer negotiations.

Once the owner's agent locates a suitable like-kind replacement property, owned by a person whose agent indicates is willing to consider an exchange of properties, the agent prepares an exchange agreement. The agent reviews the terms of the exchange agreement with the owner, they both sign it, and the agreement is submitted to the owner of the replacement property for acceptance, counteroffer, or rejection. [See **RPI** Form 171]

As presented in this chapter, an agent only uses the exchange agreement format when an owner's equity in a property is offered as a down payment in exchange for another owner's property. Conversely, for an owner who has already entered into a purchase agreement to sell their property to a cash buyer and now (after tax counseling) wants to include the sale in a §1031 reinvestment plan, their agent prepares and submits a separate purchase agreement offer to buy a replacement property. No exchange agreement is entered into as no exchange exists – just a sale and a purchase of separate properties, coupled solely by a transfer of sales proceeds as part of a §1031 investment plan. [See **RPI** Form 159].

Tax aspects of an exchange transaction

A client considering an exchange of real estate usually intends to complete a §1031 reinvestment plan. With tax avoidance properly in mind, the real estate acquired needs to have *equal or greater debt* and *equal or greater equity* than exists in the property they now own. A tax free *trade-up* environment exists when taking on greater debt and greater equity in a wealth building effort.

Again, when the exchange is a fully qualified *§1031 transaction*, none of the profit realized on the transfer of the property sold or exchanged is *recognized*. Thus, the profit is not taxed.

Profit, when exempt from taxes on the sale of the property, is implicitly transferred to the replacement property. Whatever the profit may eventually become is determined and taxed when the replacement property is disposed of in a taxable sale. The bookkeeping for the replacement property does not have a book entry for profit, only an account for the cost basis carried forward and reallocated between land and improvements for depreciation deductions.

Locating properties for exchange

When searching for replacement properties, the owner's agent first locates suitable properties owned by someone interested in acquiring the client's property.

The most productive environment for locating owners of suitable properties who have an interest in acquiring the client's property exists at marketing sessions attended by licensed brokers and agents, called exchange or investment groups. At these meetings, they "pitch" their listings and advise attendees about the types and locations of property their clients are willing to exchange. With technology like Zoom, the attendance greatly expanded in 2020. Also, loopnet.com is a major player in MLS type distribution of information.

Multiple listing service (MLS) printouts, websites and large brokerage firms with income property sales sections also provide an opportunity for brokers and agents to locate suitable properties. The agent locating properties available for exchange need to contact agents who have listed suitable property to determine whether their client is interested in acquiring property in exchange. If so, they must be willing to acquire the type of property owned by the agent's client.

A prudent agent will not prepare or submit an offer to exchange before getting a reading on the other owner's (or their agent's) willingness to consider an exchange of properties.

To look into the possibility of an exchange and document the inquiry for later follow up, a broker or agent will often prepare a *preliminary proposal form* and deliver it to the other agent to encourage discussions. The proposal form notes the type of properties involved, the amount of equity and debt and arranges for the exchange of information for a discussion between the agents before preparing an exchange agreement. The agent retains a copy of the prepared form in the client file as evidence of the agent's diligence duty to locate property. [See **RPI** Form 170]

The preliminary proposal is not an offer. As a proposal, it does not contain intent-to-contract wording. The clients are not directly involved in the proposal, only the agents who are looking for a possible match. On determining the probability, the other owner will consider entering into an exchange, the agent then prepares an exchange agreement, has it signed and submits it for consideration.

As always, cash buyer are the preferred takers of your client's property. Cash leaves the seller and their agent free to make offers on other property as replacement using cash, without the difficulties of culling for owners to locate one who will take your client's property in exchange.

Equity adjustments to balance the equities

Once an agent locates like-kind replacement property and its owner indicates a willingness to consider an exchange, the market value of the properties needs to be established. *Valuation* then becomes the single most important task for negotiating an exchange agreement. The equity in each property is dependent on the value of each property.

Until a consensus exists between the owners about the approximate amount of equity in the properties, negotiations tend not to go forward. With a consensus on property valuations, the amount of the adjustment for the difference between the equities in each property can be set. A due diligence investigation cannot begin in earnest until a consensus about the equity in each property is reached.

At some point, the agent prepares an *exchange agreement offer*. The offer is based on the owner's and the agent's analysis of valuations, including:

- the *fair market value (FMV)* of each property to be exchanged [See **RPI** Form 171 §1.3 and 2.3];
- the *mortgage amounts* encumbering each owner's property, and whether they are to remain of record; and
- the *equity valuations* calculated as the FMV of each property, minus the principal amount of existing mortgages.

On determining the present value of the equity in each property, the agent proposes adjustments to cover the difference between the equity valuations in each property.

Negotiating adjustments

Since the equities in properties exchanged are rarely the same dollar amount, adjustments nearly always need to be negotiated. Thus, a contribution of money, carryback promissory note or personal property, collectively called *cash boot* – and possibly additional real estate – needs to be contributed. It is the owner of the property with the lesser amount of equity value who adds cash or other consideration to adjust for the dollar difference in equities.

When existing financing encumbers the properties being exchanged, negotiations may call for the mortgages to remain of record or be paid off and reconveyed. Refinancing of the replacement property may be necessary to generate cash funds to pay off and reconvey the existing mortgages and pay transactional costs. When additional cash is required for these purposes, a contingency provision for new financing needs to be activated.

Cultivating an exchange environment

Consider an agent with a working knowledge of income property transactions in the region served by their office. The agent regularly attends marketing sessions and visits brokers and agents whose clients have properties they want to convert to cash or directly exchange for other property that meets their needs.

The agent is working with an investor who wants to get out from under the management burdens of a smaller residential rental property they own. The investor prefers to own a single-user property requiring little of their time to oversee maintenance and repairs, a net lease agreement situation. The investor has owned the property for some time and their remaining cost basis in the property is low compared to the property's present FMV.

The agent and the investor discuss selling the units and locating a more suitable property to meet the investor's ownership objectives. A property listing is entered into, employing the agent's broker.

A *reinvestment provision* in the listing calls for the location and acquisition of like-kind replacement property. Thus, the owner's agent is employed to maintain the client's continuing investment in replacement real estate, as required to qualify the profit taken on a sale for the §1031 exemption. [See **RPI** Form 102 §9]

The agent locates an industrial property owned by an entrepreneur. Their company occupies the entire building. The entrepreneur's agent explains their client wants to lease back the property from the buyer rather than move. The entrepreneur's objective is to reduce debt so they can enlarge the credit line for their business.

The agent asks the entrepreneur if they might be a "taker" of the residential income units (with a much smaller mortgage) in exchange for their property. The agent gets a positive response. The entrepreneur already owns residential rental properties, so property management does not pose a challenge.

Preliminary due diligence investigation

Information on the properties is exchanged. The investor's units are priced at \$1,500,000 with a debt of \$500,000 and equity of \$1,000,000. The entrepreneur's industrial building is listed at \$3,000,000 subject to a mortgage of \$1,750,000 with equity of \$1,250,000.

When the investor analyzes the information on the industrial property as a probable replacement property under a net lease with the owner-occupant, the investor finds its just what they are looking for. They will be acquiring a property with a higher value to add to their investment portfolio and the demands on management will be minimal. The flow of rental income will cover payments on the mortgage, generate spendable income and provide an acceptable rate of return on the investment.

The agent then conducts a preliminary investigation into the property, the mortgage encumbering it, and refinancing.

The agent prepares an exchange offer. Besides the routine due diligence investigation into each property, typical contingencies and closing provisions, the agent needs to negotiate:

- the adjustment for the \$250,000 difference between the equities in the two properties; and
- the *terms of a lease* for the entrepreneur's continued occupancy of the industrial building.

Analyzing the flow of considerations

The terms offered in the investor's exchange agreement for payment of the \$3,000,000 price for the industrial property, include:

- the \$1,000,000 equity in their residential units to be transferred — the down payment consideration;
- an assumption of the \$1,750,000 mortgage on the industrial building to be acquired — the primary mortgage financing; and
- execution of a \$250,000 note and trust deed in favor of the entrepreneur — the amount of the *adjustment* needed to balance the equities between the two properties in the exchange.

On the flip side of this exchange, the consideration the investor asks of the entrepreneur, in exchange for the investor's mortgaged residential units and the investor's execution of a carryback note, includes:

- the \$1,250,000 equity in the industrial property; and
- an assumption or refinance of the \$500,000 mortgage on the residential units.

Thus, with the entrepreneur's receipt of a \$250,000 carryback note secured by the industrial building the total consideration the entrepreneur is to pay for the residential units is \$1,000,000 on acceptance of this offer.

Closing the deal

The *leaseback arrangement* the investor offers is based on the FMV of the industrial property and rents recently agreed to for comparable properties. The terms of the lease are set in an addendum attached to the exchange agreement offer (which may well be a proposed lease agreement).

On receiving and reviewing the offer, the entrepreneur's agent submits a counteroffer to the investor including the terms of the exchange agreement, modified as follows:

- the carryback note provision is deleted; and
- the amount of $250,000 to be paid in cash to adjust the equities.

Ultimately, escrow is opened based on a downward adjustment of $25,000 in the price of the industrial building. The adjustment for the difference in equities becomes $225,000, payable by a $125,000 note and $100,000 in cash.

Talented Californian real estate agents can be clever when pushed to be creative by owners who want each other's property. Initially, an agent's motivation is in the transaction fees they receive — but innovation generates goodwill, which generates future business by referral and awareness of the transaction by other professionals.

Chapter 23 Summary

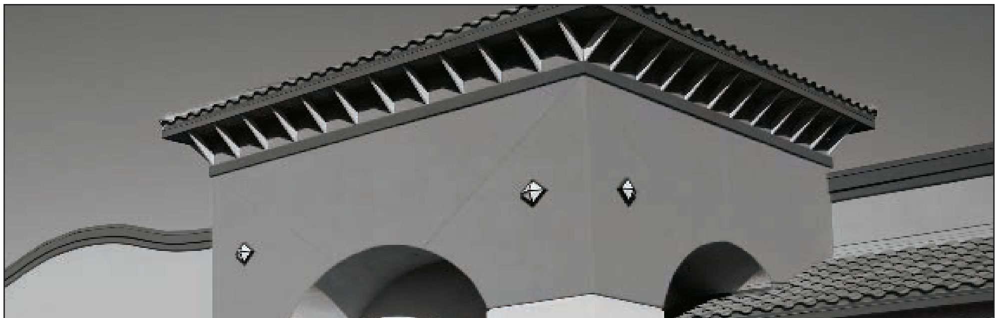
A multi-property transaction structured as a barter agreement — a swap — entered into by the separate owners of two or more parcels of real estate is called an exchange of properties. By agreement, they transfer to one another the ownership of their properties, conveying them concurrently in consideration for the value of the equity in the property they receive from the other.

The exchange transaction, often called a trade, is in fact two separate sales of properties, owned by different persons, which are purchased by the other person. Financial adjustments are arranged for the difference in the dollar amount of equity in each property based on the values given each in the exchange agreement. Exchanges frequently have little to no cash involved beyond transactional costs.

A client considering an exchange of real estate usually intends to complete a §1031 reinvestment plan. With tax avoidance properly in mind, the real estate acquired needs to have equal or greater debt and equal or greater equity than exists in the property they now own.

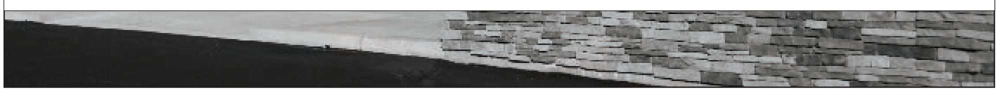
With a consensus on property valuations, the amount of the adjustment for the difference between the equities in each property can be set. A due diligence investigation cannot begin in earnest until a consensus about the equity in each property is reached.

Chapter 23 Key Terms



Chapter 24

§1031 like-kind property by intended use



Learning Objectives

After reading this chapter, you will be able to:

- determine whether the property owned or acquired is like-kind property; and
- identify intent and conditions which disqualify a property as like-kind property.

Key Terms

dealer property **disposition property**

Qualified to sell or buy as §1031 like-kind property

Properties owned either for *productive use* in a trade or business, or for rental or other investment purposes, are referred to as **like-kind property** sold and acquired in a §1031 reinvestment plan.[1]

The profit taken by an investor on the sale of real estate is exempt from taxation only when both the real estate sold or transferred in an exchange, and the real estate purchased or acquired in exchange, qualify as Internal Revenue Code (IRC) *like-kind property* in the hands of the investor.

Property which does not qualify as like-kind property includes:

- **dealer property**, such as inventory items and real estate bought for resale other than for business use, rental income, or for increase in value due to inflation and appreciation;
- a principal residence; and
- **foreign** real estate.[2]

dealer property
Real estate held for sale to customers in the ordinary course of an owner's trade or business, where the earnings on the sales of the properties are taxed as business inventory at ordinary income rates.

1 Internal Revenue Code §1031(a)(1)

2 IRC §§1031(a)(2), (h)

Further, properties acquired in an exchange between *related persons* need to be held for two years after acquisition to qualify as like-kind property. When during the two year related-persons holding period for ownership the property acquired is sold or further exchanged, the §1031 exemption is lost and the profit on the property sold in the failed §1031 investment plan is taxed. The property acquired from the related person has not yet qualified as like-kind property. [IRC (f)(1)]

When a resale of a property acquired in an exchange between related persons occurs within two years of closing, the property acquired is considered **disposition property** held by the person acquiring it. *Disposition property* is not like-kind property due the intent to use it to cash out of the real estate investment. Thus, the property received fails to qualify as like-kind property. In turn, the profit realized on the property exchanged is taxed in the year the exchange closed.

Investment vs. trade or business property

Like-kind property consists of two classifications of property:

- investment property; and
- trade or business property.
- *Investment property* includes:
- rental properties, both residential and commercial, held as passive income category property;
- vacation homes held for profit on resale [See Chapter 27]; and
- real estate held as portfolio income category property.[3]

The business-use and investment property criteria for like-kind property does not include *dealer property*. Dealer property is held primarily for sale to customers of the owner's trade or business.

Recall that inventory such as subdivided lots, land held as inventory by builders, or properties purchased at auction for the purpose of renovation and resale are held for immediate sale in the ordinary course of the owner's trade or business. Thus, dealer property is not business-use property held by a trade or business, even though it is owned by the trade or business. It is inventory held for resale.[4]

Like investment property, real estate used as the premises to operate the owner's trade or business, or in the operation of a hotel or motel, is like-kind property.

However, trade or business use property needs to be owned for a *one-year holding period* before it qualifies as like-kind property for sale or exchange in a §1031 reinvestment plan.[5]

3 IRC §1221
4 IRC §1231(b)(1)(B)
5 IRC §1231(b)(1)

Investment property may be sold and replaced by trade or business use property or other investment property in a §1031 reinvestment plan. Likewise, in the reverse situation of a business-use property sold it may be replaced by purchasing investment property .

Small investors may exchange too

Many novice investors who own one-to-four unit properties and small business entrepreneurs who own property the business occupies mistakenly believe §1031 benefits are available exclusively to wealthy investors who own large income projects. However, no investment or business-use property is too small, or too big, to qualify for §1031 tax-exempt treatment. The property's *dollar value* is not relevant.

By coupling their sales and acquisitions, an investor further builds their personal net worth by avoiding the diminution of wealth wrought by profit taxes when unwanted property is sold so other preferred property can be acquired. The investor organizes a §1031 reinvestment plan to sell the property they no longer want, avoid receipt of some or all of the net sales proceeds, and timely identifies and purchases replacement property with some or all of the sales proceeds.

Also, a *leasehold interest* in real estate qualifies as §1031 property when the remaining term of the lease period exceeds 30 years, including options to extend or renew, when sold or acquired by assignment. [Revenue Regulations §1.1031(a)-1(c)]

No limitations are placed on size, value or location of the property involved in a §1031 reinvestment plan, so long as the properties are located within the United States. An owner may reside in California, sell Texas real estate and purchase Hawaiian replacement property.

A §1031 reinvestment plan may involve the sale of one or more parcels of undeveloped real estate and the purchase of one or more parcels of improved real estate for use in a business or operated as rentals.

Two or more investors may be brought together in a syndicated transaction, called a *consolidation exchange*. Each investor sells their solely owned like-kind property and combines the net sales proceeds with those of other investors, each owner acquiring a pro rata fractional tenant-in-common (TIC) interest in one replacement like-kind property.

For example, a $300,000 equity in one parcel of real estate plus a $700,000 equity in another parcel of real estate may be sold and replaced by acquiring a single parcel of real estate with an equity of $1,000,000 or more.

§1031 tax-free reinvestment of sales proceeds encourages net worth enhancement by acquiring bigger, more efficient, and more suitable investment property. An investor, who takes a profit exempt from taxes under §1031, retains a dollar amount of property value equal to the tax they avoided. The adverse financial consequences of a sale and acquisition are limited to the transactional costs incurred and any negative variation in the risk of loss in the property acquired compared to the property sold.

Thus, the investor increases their after-tax dollars capital interests when they participate in a **§1031 reinvestment plan**. Conversely, they cash out, report profits, pay unrecaptured and capital gains taxes and later reinvest the diminished after-tax funds when the timing for pricing is right. These cash-out sales take place during boom years with the sales proceeds held in reserve for their *option value,* then used to acquire investment opportunities during recessionary and initial recovery years.

Adaptation for §1031 treatment

Based on intended use, an owner holds real estate for one of four economic purposes:

- *immediate resale* for business income, as with dealer property;
- *business use*, as with real estate used to operate the owner's trade or business;
- *investment,* as with rental property for income from operations or land held for long-term profit on resale; or
- *personal use*, as with an owner's principal residence.

Dealer property generates *ordinary income* on resale, not profit. Profit occurs on the resale of a property held and productively used by the business for *more than 12 months*. Thus, the sale of dealer property is not entitled to §1031 tax-exempt benefits or profit tax treatment.[6] [See Chapter 7]

Property used in a business or held for investment, such as unimproved land, may become reclassified as dealer property and no longer qualify as like-kind property. This transformation may occur at any time during ownership.

The owner alters the tax status of their ownership by simply modifying their intent and conduct in the use of the property. For example, an owner shifts their objective in holding a parcel of unimproved property from investment to retail sales purposes by taking steps to subdivide and market the resulting lots for sale. Same situation for an apartment building conversion to condo units, renovation, and resale of units.

Property held for investment

Capital assets make up the investment classification of §1031 property, except for a principal residence. Capital assets do not include:

- dealer property;
- property used to house a trade or business (however, it also qualify as §1031 like-kind property when held for more than one year);
- copyrighted material and literary, musical or artistic compositions held by the creator of the material or the person for whom it was produced;
- accounts receivable, such as unpaid rent; and
- government debt obligations, such as treasury bills, notes, and bonds.[7]

6 IRC §§1031(a)(2), 1231(b)

7 IRC §1221(a)

Capital assets include real estate, furnishings, stamps/coins, gems, paintings, antiques, precious metals, manuscripts, and other valuables held for long-term appreciation. Again, when these assets are held or acquired for immediate resale, they are inventory in a trade or business, not capital assets.

Consider an owner with several individual residential rental properties held for investment and one residence held for personal use. All are capital assets.

The rental residences held for investment purposes may be sold and purchased in a §1031 reinvestment plan. However, an owner's personal residence does not qualify as §1031 property since it is not owned and operated as either a rental or to house their business.

Yet, a personal residence is a capital asset. The sale of a personal residence reports profits as portfolio category capital gains, not ordinary income as with inventory. Further, profits on the sale of a personal residence are not taxed when owners qualify for the personal residence profit exclusion up to $250,000 per qualifying owner. While profits on a personal residence sale are reported as excluded or taxed, any loss on the sale of a personal residence is disallowed and cannot offset any income or profits.

Investment properties include leasehold estates in property with a remaining period on the lease term of over 30 years at the time of assignment (including extension or renewal periods), fee or equitable ownership of residential and commercial rental properties, vacation homes and land held for long-term profit. Thus, these assets qualify as like-kind properties.

Property used in a trade or business

Trade or business property includes real estate used primarily by the owner to house and operate their trade or business. These business-use properties are not strictly classified as capital assets. Recall that for §1031 treatment, business-use property is subject to a holding period of more than one year. After one year of ownership, it is "treated" as a capital asset for profit tax reporting and the §1031 exemption.

Examples of business-use property include land and its improvements, parking lots, timberland, hotels, motels, inns, and vacation rentals not personally used by the owner.

Property owned by the business, but not used to house and operate the business, includes:

- inventory property, such as lots or homes in a subdivision created by the owner;
- dealer property, bought to be immediately resold, or held to be improved and sold such as the business of a property flipper;
- copyrights;
- timber, coal, or domestic iron ore held for less than one year;
- cattle and horses held for less than two years;
- other livestock held for less than one year; and

- unharvested crops on land used for trade or business — unless the land is held for more than one year and the crop and the land are sold or exchanged at the same time and to the same person.[8]

Disposition property nullifies use of §1031 exemption

Replacement properties acquired in a §1031 exchange, when intended to be immediately resold in a cash-out sale or conveyed to another individual or taxable entity, are called **disposition property**.

disposition property
Replacement property acquired in a §1031 reinvestment plan and immediately resold in a cash-out sale or conveyed to another individual or taxable entity, disqualifying it as like-kind property when received.

Disposition property does not qualify as like-kind property. The attributes of ownership regarding the intended use and operation of disposition property by the owner are identical to dealer property.

When replacement property is acquired on the sale or exchange of other property and put to some dealer activity, such as cashing out, subdividing, restoring, renovating, building or improving the property and then immediately reselling it in a cash-out sale, the disposition disqualifies the replacement property as like-kind property.

Without the replacement property being like-kind property, the profit in the like-kind property sold or exchanged is taxed. Both properties in a §1031 reinvestment plan must be like-kind property or the exemption does not apply.

Properties acquired to be cashed out on a resale are tainted with the intention to manage them as dealer property, often by spending time and effort to prepare (and upgrade) them for resale. Simply put, the properties are acquired to be upgraded and "flipped" for a profit in a cash-out sale as inventory of a trade or occupation.[9]

Property acquired by an individual as replacement property for property sold and promptly conveyed to a corporation under IRC §351 (in a §351 tax-free exchange for stock) is classified as disposition property. When the owner immediately conveys property they acquired in a §1031 transaction to a corporation, the profit realized in the transaction is taxed as the exemption does not apply.[10]

Conversely, when an owner acquires replacement property and then deeds it to a partnership or LLC – disregarded passthrough entities – for the same percentage of ownership they held in the replacement property, such as in a syndicated or consolidation exchange, the further conveyance does not make it disposition property.

Further conveyance to a partnership or LLC entity does not alter the tax reporting by the owner. After acquiring the property, the owner's income tax reporting produces the same tax result, whether they retain title or further conveyed the property to a partnership or LLC.

8 IRC §§1231(b), 631
9 **Little** v. **Commissioner of Internal Revenue** (9th Cir. 1997) 106 F3d 1445
10 Revenue Ruling 75-292

However, this is not so for further conveyances to a corporation on completion of a §1031 reinvestment plan.[11]

11 **Magneson** v. **Commissioner** (1985) 753 F2d 1490

Chapter 24 Summary

Properties owned either for productive use in a trade or business, or for rental or other investment purposes, are referred to as like-kind property in a §1031 reinvestment plan.

Property which does not qualify as §1031 like-kind property includes:

- dealer property, such as inventory items and real estate bought for resale rather than for business use, (rental) operating income or for increase in value due to appreciation or inflation;
- a principal residence; and
- foreign real estate.

Disposition property is not like-kind property due to the intent to use it to cash out of the real estate investment.

Like-kind property consists of two classifications of property: investment property and trade or business property. Investment property includes:

- rental properties (both residential and commercial) held as passive income category property;
- vacation homes held for profit on resale; and
- real estate held as portfolio income category property.

Dealer property is not included as it is held primarily for sale to customers of the owner's trade or business.

A taxpayer's principal residence does not qualify as §1031 like-kind property (even though it is a capital asset) since it is not used in a business or held for investment purposes.

The profit taken on the sale of real estate is exempt from income tax when both the real estate sold and the real estate purchased qualify as Internal Revenue Code (IRC) §1031 like-kind property in the hands of the owner seeking the profit tax exemption.

Chapter 24 Key Terms

dealer property .... **pg. 195**
disposition property .... **pg. 200**

Chapter 25

The delayed purchase of replacement property

Learning Objectives

After reading this chapter, you will be able to:

- implement the control an investor may assert over the acquisition and improvement of like-kind replacement property purchased in a §1031 reinvestment plan; and
- understand the limited involvement of a third-party trustee used to avoid an investor's actual or constructive receipt of proceeds on the sale of property in a §1031 reinvestment plan.

Key Terms

§1031 trustee **trust account**

Replacement property purchased as a §1031 reinvestment

§1031 reinvestment plans are structured from the outset for an investor to:

- sell or exchange one property; and
- acquire another property by purchase or exchange.

The investor uses one of two procedures for closing these §1031 transactions:

- a *concurrent exchange* of one property for another in a two-way, equity-for-equity transfer of property between two owners, or alternatively, coordinate the *concurrent closing* of a sales escrow to directly fund the closing on a purchase escrow to acquire the replacement property; or
- a *delayed exchange* comprising two independent transactions closing at different times, one for the sale of the investor's property, and one for the investor's purchase of replacement property. The nexus is the

arrangement with a trustee or intermediary to receive, hold, and disburse the net proceeds from the property sold to fund the purchase of the property acquired to complete the §1031 reinvestment plan.

Handling of the net sales proceeds from the sale of a property in a *delayed exchange* is critical to qualifying profits for §1031 exemption. When the investor is in escrow to sell property in a delayed exchange and has not yet opened a purchase escrow to acquire replacement property, a third party must receive the investor's net sales proceeds at the time of closing, directly from the sales escrow for the property sold.

The investor may not receive the funds on closing. Nor can they constructively receive the funds through putting them to their beneficial use following the closing of the sale, like as collateral for a loan. Thus, the funds must be placed at risk with a third-party trustee under one of two sets of at-risk rules:

§1031 trustee
A third party who, in lieu of the seller in a §1031 reinvestment plan, receives and holds the net sales proceeds from the sale of property, and on demand from the seller deposits the funds in a purchase escrow the seller opens to acquire replacement property.

- the *general rule* calls for placing the sales proceeds at risk until the sales proceeds fund the purchase escrow to acquire replacement property. This approach allows the investor to appoint a **§1031 trustee** to receive, hold and disburse sales proceeds on the investor's instructions to fund their purchase of replacement property to close out their §1031 reinvestment plan; and
- *safe harbor rules,* established by regulations, allow the alternative use of a "qualified intermediary" to facilitate the risk by their receipt of the sales proceeds on closing the sales escrow and hold them for their later disbursement to fund the closing of the investor's purchase escrow for the replacement property.

Conduct connected to direct deeding

The sale of an investor's business or investment property is typically the first step taken in a §1031 reinvestment plan. The second step is locating and acquiring replacement property to complete the plan. Thus, the investor will:

- transfer title to the property sold by a grant deed conveyance directly to the buyer acquiring the property; and
- take title to the property purchased by grant deed directly from the seller of the replacement property.

Consider a different staging, the reversal of the sale and purchase events. Here, the investor first locates a replacement property, contracts to buy it, and acquires the replacement property via a *parking transaction* title-holding arrangement using personal funds. On closing the purchase escrow for the replacement property, title and ownership will be parked with a third party operator while the investor sells the property they no longer want. On closing the sales escrow on the property to be sold, the net sales proceeds are transferred to a purchase escrow for the investor to acquire title to the "parked" replacement property, completing the §1031 reinvestment. [See Chapter 28]

More typically, an investor's acquisition of replacement property is delayed until after the investor closes the sales escrow for the property sold. Here, prior to closing the sales escrow, the investor appoints a *§1031 trustee* to hold the net proceeds from the sale. The funds held by the trustee are placed in an interest-bearing **trust account** as instructed.

trust account
An account in the name of the trustee in which funds held for a client are deposited, separate and apart from the trustee's personal funds.

Thus, the funds remain available on demand (and protected in any bankruptcy) to fund the investor's purchase of replacement property and the cost of any construction or renovation to be completed prior to taking title.

Neither the buyer of the investor's property nor the §1031 trustee are involved in the investor's location, selection, due diligence approval, title-holding (except in the event of a parking transaction) or construction of improvements on the replacement property.

The trustee's sole task, under the general rules for §1031 reinvestment plans, is to disburse funds for the investor's purchase and any construction of improvements on the replacement property from the sales proceeds held by the trustee.[1]

Use of any type of agreement to buy

An investor uses any type of agreement to control and purchase the replacement property, including:

- a purchase option;
- a purchase agreement;
- a purchase escrow, with or without an underlying purchase agreement or option; or
- an exchange agreement.

Full involvement purchasing the replacement property

When purchasing replacement property, the investor, as the buyer in a typical purchase transaction, may personally:

- negotiate the price and terms for payment directly with the sellers, as well as all conditions and contingencies;
- make a good-faith deposit with the purchase offer, payable to escrow for the account of the investor, using their own funds or the sales proceeds held by the §1031 trustee;
- enter into the acquisition agreements and escrow instructions as the named buyer;
- handle the due diligence investigations and personally satisfy or waive conditions and contingencies;
- oversee and direct renovation or construction on the property prior to closing and assume liability for any funding such as by co-signing or guaranteeing a construction loan. The investor may not undertake personal liability for renovation or construction of improvements. However, they may sign the note as a co-signer or guarantor obligated to pay borrowings which fund the renovation or improvements but may not be a vested owner of the property until closing;[2]

1 **Biggs** v. **Commissioner** (5th Cir. 1980) 632 F2d 1171
2 **Coastal Terminals, Inc.** v. **United States** (4th Cir. 1963) 320 F2d 333

- originate purchase-assist financing, or assume loans encumbering the replacement property on taking title to the replacement property;
- advance at any time any additional funds or properties necessary to fund the closing of the purchase escrow on the replacement property;
- execute any notes and trust deeds which finance the purchase of the replacement property;
- assign an *interim owner* in a *parking transaction* the investor's rights to purchase and possess the replacement property prior to the sale of the investor's property, together with the simultaneous entry into a purchase agreement/escrow to acquire the property from the interim owner on close of the sales escrow for the property sold; and
- receive all interest earned on the net sales proceeds held by the §1031 trustee, minus trustee fees, the right to receive the interest always deferred until replacement property is acquired.[3]

§1031 provisions included in agreements

To assure the investor is able to avoid receipt of net sales proceeds when they close escrow on the sale of their property, purchase agreement provisions need to include the buyer's consent:

- to perform under a mutual §1031 *cooperation clause* [See **RPI** Form 159 §10.6]; and
- to enter into supplemental escrow closing instructions to cooperate to redirect receipt of the seller's net sales proceeds to a third party on closing. [See **RPI** Form 172-2 and Form 173-2 accompanying this chapter]

For tax reporting, the sale of the investor's property and the purchase of replacement property are treated as *one complete transaction* comprising two steps, occurring concurrently or over a 180-day period. On completion of the reinvestment, the tax consequences are calculated based on withdrawal of any net *mortgage boot* or cash boot from the property sold and whether the withdrawals are timed to be offset by the price and terms of payment for the replacement property. [See Chapter 23]

However, limitations exist on the structure of a §1031 reinvestment plan, including:

- the investor may not *refinance* the property they sell as part of a financing arrangement to implement the §1031 reinvestment plan;
- the investor may have *actual and constructive receipt* of some, but not all of the net proceeds from the sale of the property;[4]
- the investor may not receive interest accruing to their account on the net sales proceeds held by the §1031 trustee or intermediary until on or after acquisition of all replacement property;
- the investor must identify the replacement property within 45 days after close of escrow on the property sold [See Chapter 30];[5]

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3 **Starker** v. **United States** (9th Cir. 1979) 602 F2d 1341

4 **Carlton** v. **United States** (5th Cir. 1967) 385 F2d 238

5 Internal Revenue Code §1031(a)(3)(A)

Form 173-2

Supplemental Escrow Instructions

SUPPLEMENTAL ESCROW INSTRUCTIONS

§1031 Reinvestment In Lieu of a Cash-Out Sale — Part cash, Part Paper

Prepared by: Agent ____________________ **Phone** ____________________

Broker ____________________ **Email** ____________________

NOTE: For use to comply with the general rules for avoidance of actual or constructive receipt of sales proceeds. [IRS Regs. §1.1031 (k)-1(a)]

DATE: __________, 20_____, at ______________________________, California.

To ______________________________

____

Attention ______________________________

Escrow No. ______________________________

Seller ______________________________

Buyer ______________________________

§1031 Trustee ______________________________

1. All prior instructions in this escrow and underlying agreements between the parties are amended as follows:

1.1 Seller shall at no time receive cash or paper as consideration for the conveyance of the subject property, except the sum of $______________; cash through escrow.

1.2 You are authorized to close this escrow when you cause or confirm that the §1031 Trustee named below, as Trustee for the Trust entitled: The ______________________________Trust, holds the following:

a. cash sum of $______________; and

b. a promissory note in the face amount of $______________ executed by the Buyer in favor of the Trustee and secured by a deed of trust on the subject property.

1.3 You are to prepare Seller's closing statement showing the agreed-to charges and credits to include "Exchange Valuation Credits" due Seller in the amount of $______________, in lieu of the disbursements of items originally provided for in your instructions.

1.4 You are instructed to draft the promissory note and trust deed, which your present instructions call for the Buyer to execute, to reflect the payee of the note and beneficiary of the trust deed to be:

"______________________________, as the Trustee,

for The ______________________________Trust."

Address ______________________________.

a. You are instructed to deliver these documents or cause them to be delivered to the trustee on the close of escrow.

2. The following are conditions with which escrow need not be concerned:

2.1 Seller intends the sale to qualify as an Internal Revenue Code §1031 transaction, exempt from profit reporting. The ultimate tax status of the sale provides no consideration for the agreement between the parties, and failure to qualify under Internal Revenue Code §1031 provides no grounds for rescission.

2.2 Buyer and §1031 Trustee, concurrent with the signing of these instructions, shall execute a declaration of trust creating a trust to receive and hold as the trust estate the amounts and items delivered to the Trustee by escrow on the close of this escrow.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: __________, 20_____

Seller: ______________________________

Seller: ______________________________

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: __________, 20_____

Buyer: ______________________________

Buyer: ______________________________

Date: __________ 20_____

Trustee: ______________________________

FORM 173-2 03-11

- the investor must acquire ownership to the replacement property within 180 days after close of escrow for the property sold [See Chapter 30];[6] and
- the owner may not own both properties concurrently, thus, the *title-parking* arrangements.[7]

The receipt of excess proceeds from any refinancing or equity financing of the property the investor is selling, or receipt of a portion of the net sales proceeds prior to acquiring the replacement property is cash boot. Cash prematurely

6 IRC §1031(a)(3)(B)

7 **Bezdjian** v. **Commissioner** (9th Cir. 1988) 845 F2d 217

withdrawn from the property sold prior to acquiring the replacement property is treated as profit and cannot be offset on acquiring replacement property.[8]

Escrowing the replacement property

Consider an investor who opens an escrow to purchase a replacement property.

As the named buyer, the investor approves or disapproves all *buyer contingencies* in the purchase escrow. Contingencies include preliminary title reports, zoning, new loan commitments, leases and rental operating data, inventories, termite reports/clearances, structural condition and property inspections.

The investor fulfill all performance of the purchase agreement and escrow instructions for acquisition of the replacement property. The §1031 trustee holding the net sales proceeds from the property sold is instructed by the investor to deposit the funds in escrow when escrow calls for a wire of funds to close. The funds are deposited directly into the purchase escrow for the account of the investor as buyer.

Here, the investor never receives the net sales proceeds used to purchase the replacement property. Purchase escrow instructions do not permit the release of funds once deposited into escrow without the signed authorization from both the seller and the buyer. Thus, the funds deposited directly in the purchase escrow from the investor's sales escrow or from the §1031 trustee avoid constructive receipt of the funds by the investor.

When the §1031 trustee holds the investor's net sales proceeds, the purchase price and the cost of any improvements for the replacement property are funded by the trustee using the proceeds.

Any additional funds required from the investor beyond the amount held by the trustee may be advanced by the investor. Again, all funds go through the purchase escrow the investor opened to buy the replacement property, including any funds remaining that are not needed to close the purchase escrow.

The investor takes title to the replacement property directly from the seller of the replacement property. The §1031 trustee, or a facilitator, never need to hold title or any interest in the replacement property. [9]

The policy of *title insurance* on the replacement property is issued in the name of the investor, as the buyer and new owner of the property.

Unused sales proceeds

Occasionally, funds held by the trustee remain undisbursed on completion of the §1031 transaction. Here, the trustee, after deducting their fee, may deliver the remaining funds as well as any *interest accrued* directly to the investor.

8 Revenue Regulations §1.1031(k)-1(f)]

9 **Alderson** v. **Commissioner** (9th Cir. 1963) 317 F2d 790; Revenue Ruling 90-34

Receipt of unused funds from the sales proceeds on or after acquiring replacement property is reported as a cash item received in the §1031 transaction.[10]

The interest accrued on the sales proceeds held by the §1031 trustee is separately reported as portfolio category income for the year the interest accrued.[11]

10 Rev. Regs. §1.1031(k)-1(f)
11 Rev. Regs. §1.1031(k)-1(h)

Chapter 25 Summary

§1031 reinvestment plans are structured from the outset for an investor to sell or exchange one property and acquire another by either purchase or exchange. For closing these transactions, an investor has a choice between a concurrent exchange or delayed exchange.

A concurrent exchange is the exchange of one property for another in a two-way, equity-for-equity transfer of property between two owners. A delayed exchange is comprised of two independent transactions closing at different times, one for the sale of the investor's property and one for the investor's purchase of replacement property.

A trustee or intermediary is needed to receive, hold and disburse the net proceeds in a delayed exchange. The funds must be placed at risk with a third-party trustee under one of two sets of at-risk rules: general rule and safe harbor rules. General rule calls for placing the sales proceeds at risk until the sales proceeds fund the purchase escrow to acquire replacement property. This approach allows the investor to appoint a §1031 trustee to receive, hold, and disburse sales proceeds on the investor's instructions to fund their purchase of replacement property to close out their §1031 reinvestment plan.

Safe harbor rules, established by regulations, allow the alternative use of a "qualified intermediary" to facilitate the risk by their receipt of sales proceeds on closing the sales escrow and hold them for their later disbursement to fund the closing of the investor's purchase escrow for the replacement property.

Understanding the limited involvement of a third-party trustee used to avoid an investor's actual or constructive receipt of proceeds on the sale of property in a §1031 reinvestment plan, optimizes the control they may assert of the acquisition and improvement of like-kind replacement property.

Chapter 25 Key Terms

Chapter 26

Tax deferred installment sale coupled with a §1031 exemption

Learning Objectives

After reading this chapter, you will be able to:

- advise clients about the tandem use of exempt and deferred profit reporting when an installment sale is coupled with a partial §1031 reinvestment; and
- discuss the structuring of a carryback note as a regular note to maximize the amount of profit exempt under §1031 when a mortgage exists on the property sold.

Key Term

partial §1031 reinvestment

Profit tax deferred and tax-exempt profit as the plan

Consider an investor who owns and operates an income-producing parcel of improved real estate. Taxwise, the property is classified as both:

- *like-kind property,* qualifying profit on a sale for exemption from taxes on reinvestment;[1] and
- *rental property,* with income, profit, and losses reported in the *passive income category*.

The investor's property is encumbered with a mortgage principal balance greater than the remaining cost basis in the property. Here, the financial situation is called *mortgage-over-basis,* the result of refinancing unrelated to selling the property. On a sale, the amount of the mortgage exceeding the

1 Internal Revenue Code §1031

cost basis represents profit. Conceptually, on a *cash-out sale*, the more the mortgage balance exceeds the basis the greater the percentage of net sales proceeds consumed to pay profit taxes.

In a partial §1031 reinvestment plan such as an installment sale or the withdrawal of cash on closing the sale, part of the profit is not exempt from taxes. However, taxation of the profit allocated to principal in the carryback is deferred until principal is received.

Counseling your seller on listing a cash-out sale

In this scenario, the investor's objective is to sell the property and invest the cash proceeds in management-free interest-bearing investments to maintain a constant flow of monthly income. Alternatively, the investor will take income-producing commercial real estate that generates a net spendable income — but only if the property requires considerably less time and effort to manage than the residential property being sold.

The investor's agent in a counseling session determines the investor will sell on terms that include an appropriate down payment from a buyer and a carryback note for the balance of the investor's equity as an acceptable source of future income.

To meet the investor's income objectives, the terms of any carryback note will include monthly installments, ending with a final payoff due date. A prepayment penalty provision will be included in the note to fund payment of the profit tax liability the investor will incur on a premature payoff of the carryback note.

Although the investor does not need to withdraw cash from a sale, a significant down payment is necessary to shift most of the risk of loss to the buyer in the event of a default on the carryback note.

Mortgage-over-basis profit tax reduction

Occasionally, due to refinancing, the mortgage encumbering a property listed for sale exceeds the investor's cost basis in the property, as in the above scenario. Thus, both the net equity in the property and a portion of the unpaid mortgage balance represent an amount equal to the profit taken on the sale. The portion of the mortgage balance *not reported* as profit represents the investor's adjusted cost basis in the property — an untaxed recovery of invested capital.

The investor who withdraws all the net sales proceeds for their equity on closing a sale is also relieved of the mortgage debt, whether assumed or refinanced by the buyer. Further, on a carryback sale with a mortgage-over-basis situation, the entire amount of a standard carryback note (not an AITD) is profit, taxed in the year principal payments are received.

The deferred tax result is the same when the cash proceeds from an installment sale are used to purchase §1031 replacement property – but the allocation of profit to the carryback is handled differently. [See **RPI** Form 354.5 §2]

Again, the payment of taxes on the profit allocated to the note is automatically deferred, shifted for calculation and payment of profit taxes from the year of the sale to later years when principal is paid on the note.[2]

Combining a carryback with a §1031

The agent advises the investor that an installment sale of their property does not trigger profit reporting on the sale when:

- all the net proceeds from the sale (both the cash and the carryback note) are used to purchase replacement real estate in a §1031 reinvestment plan; and
- the replacement property is encumbered by debt equal or greater in amount than the remaining mortgage principal on the property sold.[3]

A question arises. May an investor, on an installment sale structured as a tandem IRS §453-§1031 tax avoidance combination, do the following:

- receive, hold, and report the carryback note as an installment sale *to defer taxes* on the profit allocated to the note; and
- use some or all of the cash proceeds from the down payment to purchase replacement property in a §1031 reinvestment plan *to exempt profit* not allocated to the carryback note.

The answer? Yes to both! When some or all the cash proceeds from the carryback sale of property fund the purchase of §1031 property and the investor retains the carryback note created by the sale, the profit as allocated is either §453 *deferred* for later recognition or §1031 *exempt* from taxes. Thus, the investor pays no taxes in the year of the sale, except for principal received in note payments. Here, the tax treatment for the cash and carryback sale includes:

- installment sale reporting — automatic *deferral* of taxation — on the profit allocated to principal in the note; and
- §1031 reporting for all remaining profit as *exempt* in a §1031 reinvestment.[4]

When an investor receives a carryback note in an installment sale and some or all of the proceeds from the cash down payment are used to acquire replacement property, the §1031 reinvestment plan is reported as a **partial §1031 reinvestment**. The note carried back and retained by the investor in the *partial §1031 reinvestment* is classified as *cash boot*. It is not mortgage boot since it is an extension of credit, not the lending of money.

partial §1031 reinvestment
A sales transaction triggering reporting and taxes of a portion of the profit realized on the sale of property in an Internal Revenue Code (IRC) §1031 reinvestment plan when less than all the sales proceeds are reinvested in replacement property.

Again, the profit allocated to a carryback note the investor receives on closing is treated as a tax-deferred installment sale.[5]

2 IRC §453
3 Revenue Regulations §1.1031(d)-2
4 IRC §453(f)(6)
5 IRC §1031(b)

Profit allocated to the carryback in a partial §1031

In an installment sale, when some or all of the net cash proceeds are used to purchase property in a §1031 reinvestment plan, all the profit not allocated to the carryback note is exempt from taxes under §1031. When cash proceeds from a carryback sale are reinvested in a §1031 replacement property, the profit realized on the sale is allocated as follows:

- First, calculate the profit taken on the property sold or exchanged (remember, price minus basis equals profit) [See **RPI** Form 354 §3.13];
- Second, allocate profit to the cash reinvested in the property acquired in the amount of cash reinvested;
- Third, allocate profit to the principal in the carryback note, limited to the amount of the carryback note;[6]
- Next, any unallocated profit is tax exempt and automatically reflected in the value of the property acquired as the remaining cost basis is carried forward to the property acquired; and
- Finally, adjust the cost basis carried forward to the replacement property to net out by offsets the debt relief and cash items (carryback note) withdrawn on the sale.

However, a combined installment sale and partial §1031 reinvestment plan raises related profit allocation aspects:

- How is the carryback note best structured to minimize the allocation of profit to the carryback note?
- Is the carryback note best structured as an all-inclusive trust deed (AITD) note or a regular note to maximize the amount of exempt profit on the sale?

No AITD in a mortgage-over-basis §1031 transaction

Consider a property sold in a carryback sale with a mortgage-over-basis situation as in the opening scenario above. The net sales proceeds are *not reinvested* in a replacement property. No §1031 aspects exist in this example.

Here the use of an AITD note to wrap the existing mortgage(s) instead of a regular carryback note reduces profit taxes in the year of sale. The profit taxed in the year of sale is limited to the amount of the cash received on closing and any principal paid on the AITD note that year.[7]

And again, in an installment sale, the use of an AITD note maximizes the allocation of profit to the AITD note while minimizing the profit allocated to the cash proceeds from the sale.

However, when property sold in a partial §1031 reinvestment plan has a mortgage-over-basis situation, use of an AITD note becomes a profit tax disaster — the use of an AITD increases the amount of profit allocated to the carryback note and that is not a §1031 objective. The AITD automatically works to reduce the amount of tax-exempt profit in a §1031 reinvestment plan.

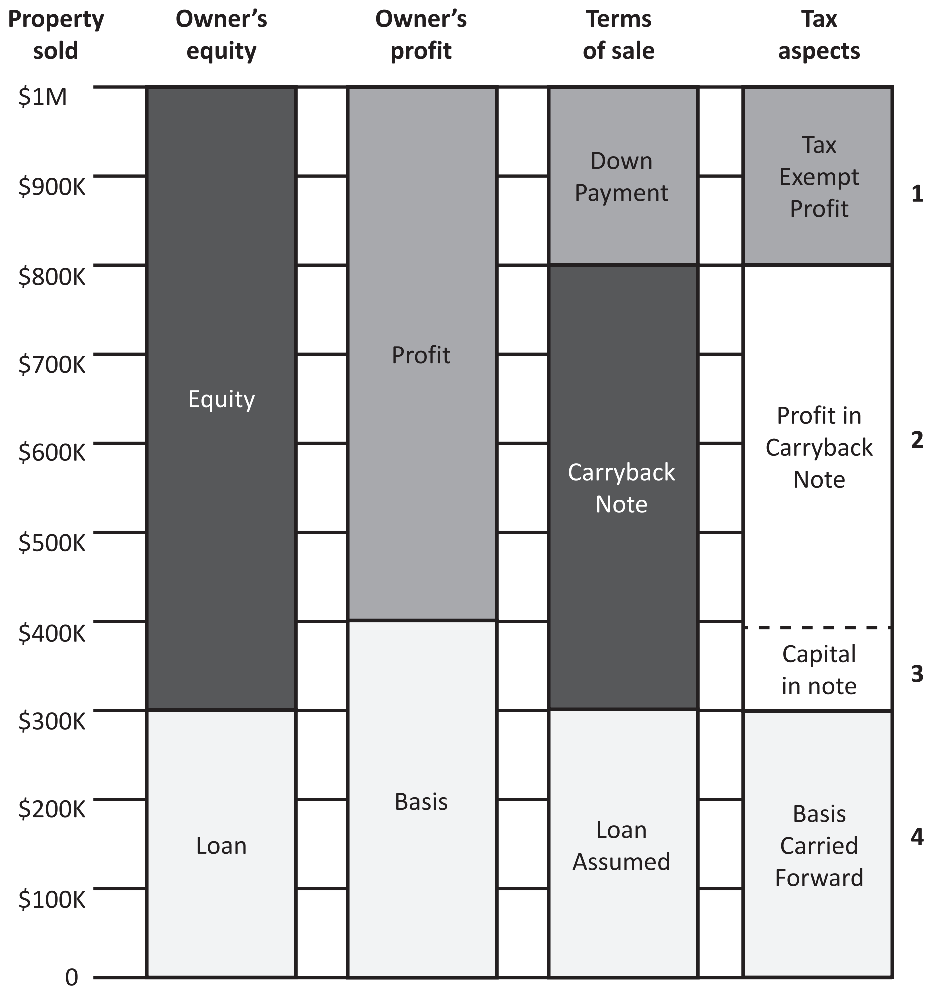
6 IRC §453(f)(6)(A); Rev. Regs. §15a.453-1(b)(2)(iii)

7 Professional Equities, Inc. v. Commissioner (1987) 89 TC 165

Figure 1

Tax analysis on the property sold in a combined §453/§1031

Basis exceeds mortgage



1. *§ 1031 equity used to purchase replacement property.*
2. *§453 tax deferred profit which is 80% of the principal in the carryback note.*
3. *Tax free return of capital which is 20% of principal in carryback note.*
4. *Basis carried forward to the replacement property.*

Each column represents a separate set of facts, each column having the $1 ,000,000 sales price as its common factor. The tax exempt profit in Column 4 is tax exempt only if the loan assumed by the buyer in Column 3 (debt relief) is offset by the owner's assumption of equal or greater debt or the contribution of cash items to purchase the replacement property.

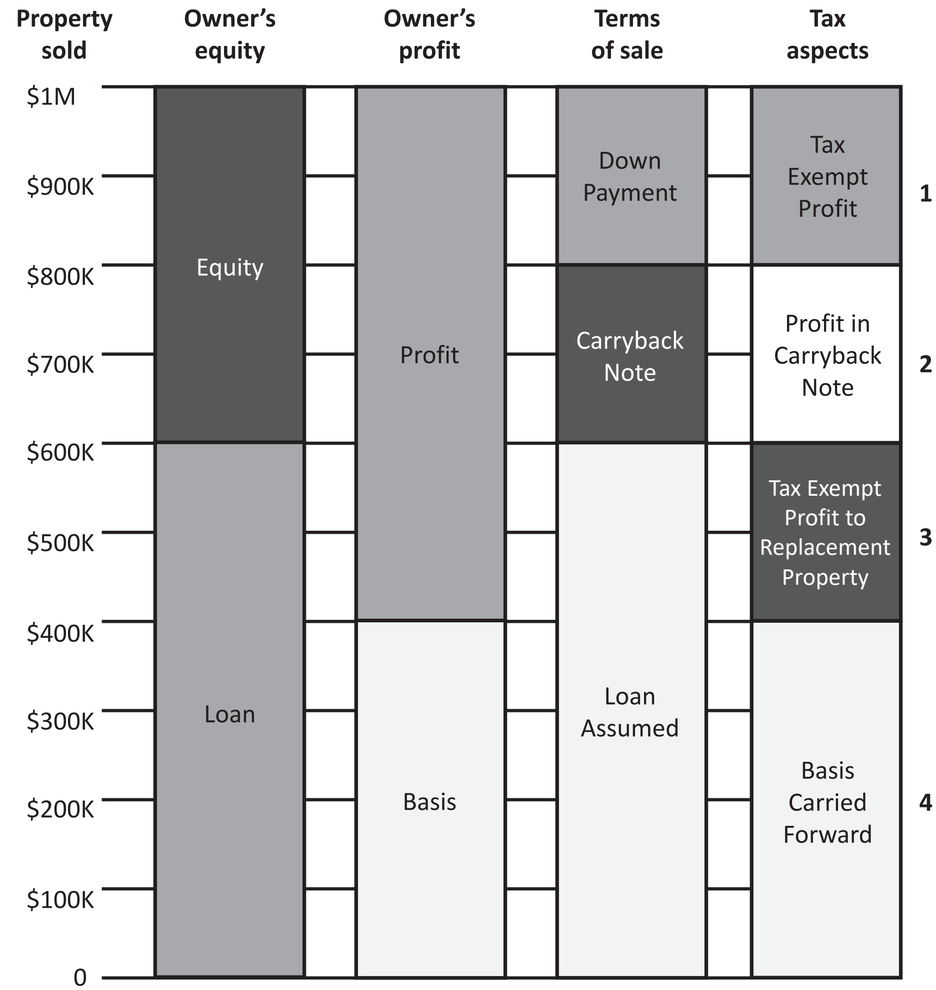
For example, consider a real estate investor who agrees to sell property with a mortgage-over-basis situation on terms that include:

- a cash down payment;
- the buyer's assumption/refinance of the existing mortgage; and
- a regular carryback note for the balance of their equity.

Figure 2

Tax analysis on the property sold in a combined §453/§1031

Mortgage exceeds basis



1. *§ 1031 equity used to purchase replacement property.*
2. *§453 tax deferred profit which is 100% of the principal in the carryback note.*
3. *§1031 rules control, when combined with §453 rules to allow debt relief and the profit in it to be offset and exempt.*
4. *Basis carried forward to the replacement property.*

Each column represents a separate set of facts, each column having the $1 ,000,000 sales price as its common factor. The tax exempt profit in Column 4 is tax exempt only if the loan assumed by the buyer in Column 3 (debt relief) is offset by the owner's assumption of equal or greater debt or the contribution of cash items to purchase the replacement property.

Here, the profit the investor realizes on the sale is greater than the investor's net equity in the property sold — due to the property's mortgage-over-basis situation. On closing the sale, the profit is greater than the investor's net sales proceeds (cash and carryback note).

The use of a regular carryback note in a mortgage-over-basis situation allocates a smaller amount of profit to the regular note than occurs with the use of an AITD note. While an AITD produces a beneficial tax result in a sale without a §1031 reinvestment, an AITD produces an adverse tax result in a §1031 transaction.

In contrast, with use of an AITD note instead of a regular note for the balance of the equity after the down payment, all profit not allocated to the cash used to purchase the replacement property is allocated to the AITD note.

Calculating profit in a §1031 carryback sale

Consider an investor who sells real estate for $1,000,000. The property's adjusted cost basis is $400,000; the profit $600,000. The existing encumbrance is $300,000; the equity $700,000.

The terms of the buyer's purchase include:

- a cash down payment of $200,000;
- assumption or refinance of the existing $300,000 mortgage; and
- execution of a $500,000 carryback note payable to the investor.

The investor uses the cash proceeds from the installment sale to purchase replacement property in a §1031 reinvestment plan. The amount of profit exempt under §1031 and the amount of profit deferred as allocated to the carryback note are calculated as follows:

- The profit is $600,000;
- First, allocate profit of $200,000 to the $200,000 cash down payment as tax exempt, as it is used to purchase the replacement property;
- Next, allocate the remaining $400,000 in profit to the $500,000 carryback note (Rule: not to exceed the amount of the note).

As you note, $400,000 profit allocated to the $500,000 carryback note sets a profit ratio of 80%. Thus, 80% of each principal payment received on the carryback note is reported annually as profit recognized – taxed. The other 20% of all principal payments on the note represents a tax-free return of invested capital. [See Figure 1]

Now consider the same $1,000,000 property with its $400,000 basis, but due to refinancing in the past is encumbered with a larger mortgage amount of $600,000 — the mortgage-over-basis situation.

At the $1,000,000 selling price with a $200,000 cash down payment, the investor carries back a note in the principal amount of $200,000 to evidence the balance remaining due for payment of the investor's $400,000 equity.

Again, to determine exempt profit and allocation of profit to the carryback note:

- First, deduct the $200,000 cash down payment reinvested in §1031 replacement property from the $600,000 profit on the sale;
- Next, allocate the remaining $400,000 in profit to the principal in the $200,000 carryback note (but not to exceed the amount of the note);

- Thus, the remaining $200,000 of profit unallocated is exempt under §1031 and not taxed – it is implicitly carried forward to the replacement property.

100% of each payment of principal on the carryback note is reported as profit, taxed annually as received. [See Figure 2]

In this mortgage-over-basis situation, had an $800,000 AITD note been carried back to evidence the balance of the purchase price remaining after the cash down payment, the amount of profit allocated to the AITD after deducting the cash used to purchase the replacement property would be less than the amount of the AITD note. Thus the entire remaining profit is allocated to the AITD note. No further profit remains to be implicitly carried forward with the cost basis to the replacement property. Not what an investor wants.

Chapter 26 Summary

An investor who owns and operates an income-producing parcel of improved real estate, taxwise, classifies the property as both like-kind property and rental property. Like-kind property qualifies profit on a sale for exemption from taxes on reinvestment and rental property reports income, profit and losses in the passive income category.

When the investor's property is encumbered with a mortgage principal balance greater than the remaining cost basis in the property, this financial situation is called mortgage-over-basis. Mortgage-over-basis is the result of refinancing unrelated to selling the property.

On a sale, the amount of the mortgage exceeding the cost basis represents profit. The portion of the mortgage balance not reported as profit represents the investor's adjust cost basis in the property – an untaxed recovery of invested capital.

The investor who withdraws all the net sales proceeds for their equity on closing a sale is also relieved of the mortgage debt, whether assumed or refinanced by the buyer.

Further, on a carryback sale with a mortgage-over-basis situation, the entire amount of a standard carryback note (not an AITD) is profit, taxed in the year principal payments are received.

The use of a regular carryback note in a mortgage-over-basis situation allocates a smaller amount of profit to the regular note than occurs with the use of an AITD note. While an AITD produces a beneficial tax result in a sale without a §1031 reinvestment, an AITD produces an adverse tax results in a §1031 transaction.

Chapter 26 Key Term

partial §1031 reinvestment .... pg. 213

Chapter 27

Vacation home sales — talk taxes

Learning Objectives

After reading this chapter, you will be able to:

- identify allowable deductions for property taxes, mortgage interest, operating expenses, and depreciation the owner of a vacation home may take to subsidize ownership;
- explain what constitutes personal use of a vacation home and whether a vacation home qualifies as a passive, portfolio, or trade or business income category property; and
- advise clients selling a vacation home whether it qualifies as like-kind property in a §1031 reinvestment plan.

Key Term

vacation home

Held for investment and personal use

A **vacation home**, also known as a second home, is a dwelling unit, such as a house, apartment, condominium, mobile home, recreational vehicle, or boat, personally used by the owner or co-owners and their families or friends as a residence other than the owner's principal residence. The vacation home may be used by *guests* who pay rent, also called *transient occupants*, and retain its status as a vacation home.

Property taxes and interest, accrued and paid on purchase-assist mortgages secured by a vacation home, are itemized and deducted from the owner's adjusted gross income. Property taxes, when combined with other state and local taxes, are collectively limited to the amount of the standard personal deduction.

vacation home
Any dwelling unit, such as a house, apartment, condominium, mobile home, recreational vehicle, or boat, personally used by the owner or co-owners and their families or friends as a residence other than the owner's principal residence.

The use of the property and the length of occupancy by the owner or paying guests does not affect the itemized deduction for mortgage interest.[1]

However, the **deduction of expenses** incurred for repair and maintenance of a vacation home is not permitted unless the property is rented to guests and the amount of expenses deductible is prorated based on the total days of all types of occupancies.

Further, *depreciation deductions* are permitted when the vacation home is occupied by paying guests during the year and the owner occupies the unit for not more than 14 days during the year.

Finally, the owner reports the vacation home income, expenses, and depreciation in one of the three income categories —passive, portfolio or trade or business — depending on the nature of occupancies during the year.

Interest deductions for second homes

Recall that the owner of a first or second home deducts interest accrued and paid on mortgages, secured by either home, under the mortgage interest deduction (MID) rules. The MID has a ceiling limiting interest accrued and paid on a combined $750,000 in principal on mortgages used to fund the purchase or improvement of the home securing the mortgage.[2]

Interest paid on mortgage balances exceeding $750,000 in principal is not deductible. [See Chapter 1]

The deduction allowed for interest paid on the first and second home mortgages is subtracted from the owner's adjusted gross income. Thus, the owner reduces their taxable income under both the *standard income tax (SIT)* and *alternative minimum tax (AMT)* reporting rules.

In contrast, the real estate property tax deduction on the first and second homes only reduces the owner's taxable income for SIT, not AMT tax liability. The owner of a vacation home may deduct the full amount of property taxes they paid from their SIT income, without reduction for having rented the property for any period. Again property and state tax write offs are limited by the personal deduction ceiling which is separate from the ceiling for the MID.[3]

Deductibility of expenses

The owner's deductibility of expenses incurred to repair and maintain the vacation home is determined by whether:

- the vacation home is used *exclusively* by the owner and their family or friends and is not rented – here, the expenses for repair and maintenance are not deductible against any income;[4]

1 Internal Revenue Code §§163(h)(4)(A)(iii), 280A(e)(2)
2 IRC §163(h); IRS News Release 2018-32
3 IRC §164
4 IRC §280A(a)

- the vacation home is rented for *not more than 14 days* during the taxable year – here, no expenses may be written off (and the owner reports no rental income);[5] or
- the vacation home is rented for *more than 14 days* – here, a pro rata amount of the expenses incurred to operate the vacation home is deductible, determined as a percentage of the number of days rented over the number of days occupied for personal use, family or friends (other than days occupied for property repairs and maintenance). [IRC §280A(e)]

Exception for repairs and maintenance

The days of personal use for setting the percentage of expenses and depreciation which may be deductible, excludes days during which the owner conducts a full-time schedule of repair and maintenance of the property.[6]

Consider the owner of a vacation home who arrives at the property with their family on a Saturday afternoon to stay until the following Saturday. The primary purpose for the stay is relaxation and the performance of annual repairs and maintenance to prepare the property for the vacation rental season. They do no maintenance work on Saturday, the day of arrival. The owner and their spouse relax the entire week, fishing, walking and visiting neighbors. They occasionally assist other family members in the maintenance of the property.

However, some members of the family work on the property full-time each day, except for the days of arrival and departure. They all leave the following Saturday.

Here, the mixed use of the vacation home is not treated as personal use — it is primarily for repairs and maintenance of the property. Tax-wise, none of the days spent at the property are personal use days.

Depreciation deductions based on use

The owner of a vacation home may take depreciation deductions to recover the cost of the improvements, unless the owner, their family, or friends occupy the vacation home during the year for periods totaling more than 14 days or 10% of the days the property is rented, whichever is greater.[7]

Consider the owner of a vacation home who rents it during the year at a fair rental rate for a total of 140 days or less. The owner, and people who pay less than fair rent, occupy the property for no more than 14 days. Here, the owner may take the full amount of the scheduled depreciation deduction.[8]

However, should the property be rented out for more than 140 days during the year, the total number of days the owner may personally use the vacation home without losing the right to depreciation deductions may exceed 14 days, limited to 10% of the days rented. For example, the owner of a vacation home

5 IRC §280A(g)
6 IRC §280A(d)(2)
7 IRC §280A(d)(1)
8 280A(d)(1)

who rents the property 200 days during the year is allowed up to 20 days of personal use of the vacation home. Owners who exceed their occupancy limit may not take depreciation deductions on the vacation home.[9]

For income tax reporting, the owner of a vacation home uses two depreciation schedules:

- 27.5 years straight-line depreciation for SIT reporting; and
- 40 years straight-line depreciation for AMT reporting.

Vacation home reporting, but in which income category?

The ownership of a vacation home is reported, depending on the owner's personal use of the home and the average length of the occupancies of paying guests and tenants, as an asset in one of the three income reporting categories:

- trade or business;
- passive/rental; or
- portfolio/investment.

A vacation rental property is reported as a *trade or business income category asset* when the owner, their family or friends do not occupy it at any time but manage the property as a vacation rental. Here, the owner or their agent takes reservations from guests under occupancy agreements with an average period of occupancy 30 days or less. As a trade or business asset, the owner reports the income, expenses, interest, and depreciation for the vacation rental property as they would for a motel, inn, or hotel operation.

Conversely, a vacation home personally used for any period during the year is not classified as a trade or business category asset, even when guests renting the property are transient occupants with an average occupancy of 30 days or less.[10]

When the vacation home is sometimes used by the owner, family, friends, and at other times rented to tenants or guests, the ownership of the home is reported as either:

- a rental property in the passive income category; or
- an investment property in the portfolio income category.

To be a rental property, the vacation home income needs to be occupied by tenants for periods *more* than 30 days on average. Typically, a residential month-to-month rental agreement is used to document the tenant's agreement to pay rent. When the average figure for different occupancies during the year is 30 days or less, the vacation home is not a passive income category property.

Thus, vacation homes occupied by transient occupants for periods of several days to a week or two, under a guest occupancy agreement, disqualify the property for passive income category treatment as it is a trade or business asset due to average occupancy (if family and friends never occupy).

9 IRC §§163(h)(4)(A)(i)(II)

10 Revenue Regulations §1.469-1T(e)(3)(ii)(B)

However, when a capital asset is held for investment, such as a vacation home *personally used* by the owner, their family and friends, and at other times used to generate income under reservation agreements with transient occupants, its income and expenses are reported in the portfolio income category.

A vacation home as §1031 property

Consider the buyer of a vacation home who purchases the property for the personal use of family and friends. The owner's intent is to own and enjoy the property until it is no longer of use as a vacation home.

Having acquired ownership of the vacation home, the owner is now working with an agent to buy another, more expensive vacation home in a different recreational area of more interest to their family members. The owner informs the agent they are in escrow on the sale of their current vacation home. They are taking a profit and are unsure of the tax consequences of selling and buying these properties.

The owner is aware they may avoid profit taxes under:

- the $250,000 principal residence profit exclusion for each owner or occupant;[11] and
- the §1031 profit tax exemption for the sale of property held for investment, when sold as part of a §1031 reinvestment plan.

However, the owner is unaware of any method of tax avoidance for profits from the sale of a vacation home that the owner and their family enjoyed intermittently for personal use and rented on occasion. The owner asks their agent what they know about the profit tax situation on a vacation home.

The broker points out that the personal use of a vacation home by the family and friends to enjoy is not a factor in the property's tax status. Rather, the intention to hold the vacation home for eventual resale at a profit establishes the vacation home as an investment in a capital asset held for profit in the portfolio income category — and thus it is §1031 like-kind property.

The owner erroneously believed their personal use of the vacation home did not qualify the property as like kind for a §1031 reinvestment plan.

Here, the vacation home was never intended to be retained in the family as property held in trust, such as a retreat estate made available for the personal use of succeeding generations. Thus, a vacation home used exclusively or primarily for personal use and held as an investment for eventual resale may be sold as part of a §1031 reinvestment plan to acquire a replacement vacation home or any other §1031 like-kind property.[12]

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11 IRC §121

12 IRC §1031(a); IRS Private Letter Ruling 8103117]

Chapter 27 Summary

A vacation home, also known as a second home, is a dwelling unit, such as a house, apartment, condominium, mobile home, recreational vehicle, or boat, personally used by the owner or co-owners and their families or friends as a residence other than the owner's principal residence.

To retain its status as a vacation home, it may be used by guests who pay rent, also called transient occupants. Property taxes and interest, accrued and paid on purchase-assist mortgages secured by a vacation home, are deductible from the owner's adjusted gross income.

The use of the property and the length of occupancy by the owner or paying guests does not affect the amount the deductions for property taxes or interest. The deduction of expenses incurred for repair and maintenance of a vacation home is not permitted unless the property is rented to guests and the amount of expenses deductible is prorated based on the total days of all occupancies.

Depreciation deductions are permitted when the vacation home has been occupied by paying guests during the year and the owner occupies the unit for less than 15 days.

The ownership of a vacation home is reported, depending on the owner's personal use of the home and the average length of the occupancies of paying guests and tenants, as an asset in one of the three income reporting categories – passive, portfolio or trade or business.

Chapter 27 Key Term

Chapter 28

A delay in the §1031 reinvestment

Learning Objectives

After reading this chapter, you will be able to:

- advise clients regarding the concurrent running of time periods and the notices to be prepared for identifying and acquiring replacement property in a delayed §1031 reinvestment.

Key Terms

incidental property

tenants in common (TIC)

reverse §1031 transaction

Identification and acquisition periods run from closing

Consider an investor who enters into a purchase agreement to sell business-use or investment real estate they no longer want. The agreement negotiated by the investor's agent provides for a 90-day escrow period. The purchase agreement contains boilerplate provisions which are activated calling for:

- the buyer's cooperation with the funding of the investor's §1031 reinvestment plan; and
- the investor's location of replacement property as a condition for closing escrow.

The agent confirms they are to coordinate the sale of exchange of the investor's with the investor's purchase of replacement property to achieve the investor's tax objective — the exemption of profit on the sale from taxes.

The agent locates replacement property and the investor enters into a purchase agreement with the property's co-owners, a **tenants in common (TIC)** investment group. The separate escrows for the property sold and the

tenants in common (TIC)
Co-ownership of real estate by two or more persons, who each hold equal or unequal undivided interest, without the right of survivorship.

replacement property are scheduled to close concurrently. The investor's sales proceeds will be transferred directly from the sales escrow to the purchase escrow, funding the down payment on the replacement property.

However, one of the *TIC* co-owners dies before signing the deed to transfer the replacement property to the investor. Title to the deceased co-owner's interest has not yet been cleared for conveyance to the investor.

The investor does not want to waive the condition for closing requiring replacement property to be located until title to the replacement property can be conveyed and a title insurance policy issued for conveyance of fee simple by all co-owners.

No concurrent closing of the sales and purchase escrow

As the deadline for closing both escrows draws near, it is evident title to the replacement property cannot be cleared in time for the purchase escrow for the replacement property to close as scheduled. Thus, a concurrent closing of the sales escrow and the purchase escrow will not be possible without an extension of closing dates. The investor considers waiving the purchase-of-other-property contingency and closing escrow on the sale of their property before the escrow for the replacement property can close.

Here, the risk of losing the 1031 exemption arises when the investor closes escrow on the property sold before the purchase escrow for the replacement property can close. When title to the replacement property is not delivered within 180 days after the close of the investor's sales escrow, the profit on the sale will not qualify for the §1031 exemption.

The investor's real estate attorney on investigating the conveyancing advises that the delay in clearing title is temporary and no other foreseeable obstacles exist to prevent the transfer of title and the issuance of title insurance in the next few weeks.

To waive the condition regarding the location of other property and close escrow on the property sold, the investor is now involved in a *delayed §1031 reinvestment*. The result is the investor closes escrow on the sale of one property and later acquires ownership of the replacement property.

The investor is still engaged in two mutually exclusive transactions, they just are not closing concurrently. The delayed closing of the purchase escrow does not prudently allow for the direct transfer of the investor's funds from one escrow to another in the belief the purchase escrow will close. Funds ought not be deposited for closing in a purchase escrow until escrow calls for closing funds.

So, what happens to the investor's sales proceeds?

To qualify the investor's profit for the §1031 exemption when the purchase escrow for the replacement property cannot be closed concurrent with the investor's sales escrow, the investor needs to:

- prepare mutual closing instructions directing the sales escrow to hand the investor's net proceeds to a 1031 trustee, commonly called a *facilitator* [See Chapters 25 and 26];

- prepare mutual closing instructions directing the sales escrow to credit the investor in the closing settlement statement with *Exchange Valuation Credits (EVCs)* in lieu of a check from escrow for the net sales proceeds;
- select an entity or individual the investor knows and trusts to be appointed as the *trustee* under a 1031 trust agreement the buyer is to execute for receiving and holding the investor's net proceeds from the sale for funding the investor's purchase of replacement property;
- identify the replacement property plus two alternative replacement properties within 45 days after closing the sales escrow [See Form 174 accompanying this chapter]; and
- close escrow on the purchase of a replacement property within 180 days after the sales escrow closes.

The investor decides the risk for failure to timely close the purchase escrow is sufficiently minimal to justify waiving their purchase-of-other-property contingency.

Again, the 180-day *reinvestment period* includes the 45-day *identification period*. Both commence on the day escrow closes for the property sold and run concurrently but for different lengths of time.[1]

When an investor fails to comply with either the identification or reinvestment deadlines, any property acquired outside these parameters will not qualify as replacement property under §1031. Thus, some or all the profit in the property sold will not be exempt from taxes under §1031.[2]

Further, when an investor sells two or more properties and *consolidates* their net sales proceeds into one replacement property, the identification and acquisition periods run from the closing date of the first property sold.[3]

Replacement property identification period

An investor processing a delayed §1031 reinvestment plan identifies the replacement property to be acquired, in writing, by midnight on the 45th day after the date the sales escrow closes on the property sold. Day one is the day after the date escrow closes.[4]

Replacement property when ownership is acquired within the 45-day identification period is treated as identified without further documentation on a §1031 property identification form.[5]

Thus, an investor may avoid the identification process entirely by closing the purchase escrow(s) on all replacement property within the 45-day period.

1 Internal Revenue Code §1031(a)(3)
2 Revenue Regulations §1.1031(k)-1(a)
3 Rev. Regs. §1.1031(k)-1(b)(2)(iii)
4 Rev. Regs. §1.1031(k)-1(b)(2)(i)
5 Rev. Regs. §1.1031(k)-1(c)(1)

Form 174

§1031 Property Identification Statement

§1031 PROPERTY IDENTIFICATION STATEMENT

For Delayed §1031 Transactions

Prepared by: Agent ____________________ **Phone** ____________________

Broker ____________________ **Email** ____________________

NOTE: This form is used by a seller's agent when a seller in a delayed §1031 reinvestment plan locates suitable replacement property(ies) within 45 days after closing a sale of property, to prepare the notice needed to identify suitable replacement property(ies) to be acquired within 180 days of closing the sale.

DATE:____________________, 20________, at ____________________, California.

FACTS:

This is an addendum to the following agreement:

☐ Sales escrow instrustions

☐ ____________________

dated ______________, 20________, at ____________________, California.

with ____________________ escrow company,

entered into by ____________________, as the Seller/Taxpayer,

and ____________________, as the Buyer or Buyer's Trustee,

regarding replacement of real estate referred to as ____________________

____________________.

TO ESCROW: This addendum is intended to comply with Internal Revenue Code §1031(a)(3)(A) within 45 days after closing the sale by identifying property to be received to complete a §1031 reinvestment plan.

DECLARATION:

One or more of the following properties will be purchased to complete the terms of the above-referenced agreement.

1. ($______________) ____________________

2. ($______________) ____________________

3. ($______________) ____________________

4. ($______________) ____________________

5. ($______________) ____________________

6. ($______________) ____________________

7. ($______________) ____________________

NOTE: If four or more properties are identified within the 45-day identification period, the fair market value of each property identified or previously contracted for or received must be listed and comply with the 200% aggregate-value rule or the 95%-of-value acquisition rule. [Rev. Regs. §§1.1031(c)-3(c)(4)(i), (ii)]

Escrow Officer:
Receipt is hereby acknowledged.
Date: __________, 20_______
Name: ____________________

Signature: ____________________
Address: ____________________
____
Phone: ____________________ Cell: ____________
Email: ____________________

Seller/Taxpayer:
I hereby submit the above.
Date: ___________, 20_______
Name: ____________________

Signature: ____________________
Name: ____________________

Signature: ____________________
Address: ____________________
____
Phone: ______________ Cell: ____________________
Email: ____________________

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The failure to acquire ownership of multiple replacement property within the 45-day identification period compels the investor to prepare, sign, and deliver a written §1031 property identification statement *within* the 45-day period to either:

- the owner who is conveying the replacement property to the investor; or
- any entity or individual involved in the §1031 transaction, except the investor or disqualified persons.[6] [See **RPI** Form 174]

6 Rev. Regs. §1.1031(k)-1(c)(2)

Although the sales escrow has already closed, the identification statement may be delivered to the escrow agent or title company involved in the sale of the investor's property.

Persons to be notified of the identification

Consider a real estate agent who lists investment real estate for sale. When listing the property, the investor advises the agent they intend for the sale of the property to be the first leg of a §1031 reinvestment plan.

During the previous 12 months, the agent has acted as the investor's agent in real estate transactions. All sales and purchases handled by the agent on behalf of the investor relate to §1031 transactions.

Is the agent qualified to receive the property identification statement?

Yes! Persons disqualified (DQed) for receipt of the property identification notice include only those real estate agents, attorneys, employees, accountants and investment bankers who, within two years prior to the closing of escrow on the property sold, performed any professional services on behalf of the investor that were *not* part of a §1031 transaction.

Since the agent's activities as the investor's agent only consisted of §1031-related transactions, the agent is qualified to receive an identification statement.[7]

Financial institutions, title insurance companies or escrow companies that perform routine financial, title insurance, escrow or trust services for the investor are also qualified to receive an identification statement, even when those services are unrelated to §1031 transactions.[8]

Persons disqualified to receive the property identification notice include:

- close *family members*, including half-siblings, spouses, ancestors, and lineal descendants; and
- a corporation or partnership in which the investor or the investor's agents own *more than 10%* of outstanding stock, capital interest or profit-sharing interest.[9]

To avoid qualification issues, the investor delivers the identification form to the escrow office or title company that handled the closing on the property sold, not the escrow or title company they intend to use for the replacement property (although it is proper to do so). A cover letter advising them where to file the identification form is appropriate, so the notice is not misplaced on receipt.

The identification form need not be delivered to the buyer's §1031 trustee. While the trustee may be an unrelated person, they may well be a disqualified person such as the investor's personal attorney, CPA or investment banker who rendered services unrelated to the investor's §1031 transactions.

7 Rev. Regs. §1.1031(k)-1(k)(2)
8 Rev. Regs. §1.1031(k)-1(k)(2)(ii)
9 Rev. Regs. §1.1031(k)-1(k)(3)

Location and quantity of properties identified

Written identification of the selected replacement properties includes the legal description and street address, or assessor's number of each property identified.[10]

The investor may identify more than one replacement property. However, the number of potential replacement properties identified places different limitations on which identified properties the investor may or must acquire, such as:

- when identifying three or fewer properties, regardless of *their value*, any one or more may be purchased;
- when identifying four or more properties and the total of the *combined values* of all properties identified does not exceed twice the price received for the property sold, any one or more may be purchased; or
- when identifying four or more properties, and the *combined value* of all properties exceeds twice the price received for the property sold, the investor is required to purchase 95% of the total value of all replacement properties identified to qualify for the §1031 profit tax exemption (an absurdity).

The investor who identifies four or more properties when their combined values exceed the 200% value ceiling and then does not purchase 95% of the total value of all replacement properties identified, no properties identified and purchased qualify as a replacement property. The 95% acquisition requirement renders the use of this condition unlikely as highly improbable to be attained, unless all identified properties have one owner and the status of title is not an issue – such as a group of SFRs, fourplexes or small industrial buildings.[11]

Included automatically to determine the number of properties identified are any replacement properties the investor acquires ownership to during the 45-day identification period.

For example, consider an investor who closes escrow on their purchase of a replacement property within the 45-day identification period. The price paid for it is less than the price the investor received for the real estate they sold. Thus, the amount of mortgage debt or equity in the property purchased, or both does not fully offset the debt and equity in the property sold to exempt all profit on the sale from taxes.

To complete a fully exempt profit under §1031, the investor needs to purchase an additional replacement property using the funds remaining from their sale.

10 Rev. Regs. §1.1031(k)-1(c)(3)

11 Rev. Regs. §1.1031(k)-1(c)(4)(ii)

Here, the replacement property acquired during the identification period is automatically included as one of the *properties identified*. Thus, the investor who acquires property within 45 days of closing escrow on the property sold is limited after the 45 days to either:

- identifying two additional replacement properties (for a total of three as the acquired property is automatically included) of any combined fair market value (FMV) and purchase one, both or neither additionally identified properties; or
- identifying three or more additional properties whose total values (including the value of the replacement property already purchased) *do not collectively exceed* twice the price the investor received for the property sold and purchase any or none of the newly identified properties.[12]

The investor who is in escrow to purchase a replacement property before the running of the 45-day period, but not scheduled to close until after the identification period expires includes it as one of the three properties identified.

Identification in the case of construction

Replacement property with improvements to be constructed prior to closing under a purchase agreement, option, or escrow instructions qualifies as §1031 property.

Further, the property identification form while including a legal description or parcel number for the real estate needs to include an adequate reference to existing plans and specifications for the improvements to be constructed on the identified parcel.[13]

When substantial changes in construction deviate from the plans and specifications in the identification notice and those changes produce a structure for an entirely different use than the one identified (an apartment versus a mini-storage facility, for example), the replacement property with improperly identified construction will not be considered substantially the same property.[14]

The 15% incidental personal property rule

Consider an investor who purchases an apartment building as replacement property in a §1031 reinvestment plan. The purchase price includes personal property transferred by bill of sale such as furnishings, washing machines and maintenance equipment located on the property. The fair market value of the personal property does not exceed 15% of the portion of the price allocated to the real estate.

Is the investor required to list the personal property as part of the replacement property on the 45-day §1031 property identification form?

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12 Rev. Regs. §1.1031(k)-1(c)(4)(iii)

13 Rev. Regs. §1.1031(k)-1(e)(2)

14 Rev. Regs. §1.1031(k)-1(e)(3)(i)

incidental property
Personal property used in the operation and management of real estate.

No! Personal property used in the operations of real estate — called **incidental property** — is considered included with the legal description of the replacement property on the identification form unless the market value of the personal property exceeds 15% of the *separate value* of the real estate. This rule typically applies to hotels, motels, transient housing, and fully furnished apartments.[15]

Also, when personal property valued at a figure within the 15% incidental property rule is acquired as part of the purchase of a replacement property, the value of the personal property is not reported as *cash boot* received in the §1031 reinvestment plan.

Revoking an identification statement on modification

Consider an investor who locates three suitable replacement properties for purchase to complete a §1031 reinvestment. The investor prepares a property identification notice listing the three properties and sends it to the §1031 trustee.

Before the end of the 45-day identification period, the investor locates further potential replacement properties that are more suitable. The investor sends another, entirely new identification form to the §1031 trustee, listing three of the newly located properties substituting these to replace the properties originally identified.

To accomplish the substitution, the new identification form contains a provision *revoking* the prior notice which identified replacement properties.

Does the investor need to comply with the 200% value rule since a total of six properties have now been identified?

No! The investor revokes the first identification of replacement properties by including a provision revoking the prior identification statement in the statement identifying the newly located replacement properties. Critically, the new statement and revocation is delivered to the same person who received the initial property identification statement. Oral revocation or merely identifying more properties does not revoke prior identifications.[16]

The investor may revoke a notice of identification of replacement property and identify different properties at any time before the 45-day identification period runs.

The 180-day acquisition period after closing the sale

When identifying replacement property, ownership of the replacement property needs to be acquired within the 180-day §1031 reinvestment period — also called the *delayed exchange period*. The period for acquiring the replacement property by closing the purchase escrow ends on the earlier of:

- 180 days after the date escrow closed on the sale of the property the investor originally sold;
- the date the taxpayer files their return for the year of the sale for the property sold; or

15 Rev. Regs. §1.1031(k)-1(c)(5)
16 Rev. Regs. §1.1031(k)-1(c)(6)

- the scheduled due date for filing the investor's tax return for the year of the sale, including any extensions.

For example, consider the sale of real estate with a profit the investor intends to exempt in a §1031 reinvestment plan. Escrow closes on December 22. The investor's federal income tax return for the year in which the property was sold is due the following April 15 — less than 180 days after closing on the property sold.

The investor files their return on April 15, before acquiring ownership of the replacement property. The investor takes ownership of the replacement property within the 180-day reinvestment period following the close of the escrow on the property sold. As a result, the investor's tax return is amended to report the acquisition and closing out of their §1031 reinvestment plan.

The IRS claims the profit on the sale of the property does not qualify for the §1031 tax exemption. The investor failed to acquire the real estate prior to filing their tax return for the year of the sale. Thus, the reinvestment period expired before the investor acquired the replacement property.

The investor claims the reinvestment period ended on June 20, not April 15, since they were entitled to an automatic six-month extension for filing of their tax return for the year of the sale, whether or not they filed a return on April 15.

Does the transaction qualify for the exemption?

No! The investor needed to extend their tax return filing date to take advantage of the entire 180-day reinvestment period.

The investor closed out their tax year (and their §1031 reinvestment plan) simply by filing their return. When filing, they were unable to couple the sale of their property, which was reported on their tax return, with the transfer of its basis to the replacement property, which was *not* reported. They had not yet acquired the replacement property and improperly filed their return without the linkage needed to carry forward the basis from the property sold to the replacement property.

To avoid profit reporting, the investor needed to file for the automatic six-month extension (and pay any taxes due), not their tax return. Thus, by the filing for the extension the reinvestment period ends midnight of June 20, 180 days after the sale of the investor's property, before the extended due date for filing their return.[17]

Basic character of property acquired

After the 45-day period during which property is identified (but not acquired), and before the 180-day reinvestment period expires, the investor needs to acquire ownership to **substantially the same property** as the property identified in the 45-day notice.[18]

17 Rev. Regs. §1.1031(k)-1(b)(3)

18 Rev. Regs. §1.1031(k)-1(d)(1)(ii)

For example, consider an investor who identifies an unimproved parcel of real estate in their 45-day notice as replacement property. Before expiration of the reinvestment period — and before they close escrow on the purchase of the replacement property — the investor constructs a fence on the periphery of the property.

On closing, the investor receives substantially the same property as the property identified, even though they made minor improvements before closing escrow and acquiring title. The fence does not change the basic *character* of the parcel of real estate identified as the replacement property.[19]

Now consider an investor who identifies 20 acres of unimproved real estate with a fair market value of $2,500,000 as the replacement property. The investor ultimately purchases only 15 acres of the real estate for $1,875,000.

Here, the property acquired is substantially the same property they identified. As in the previous example, the character of the property does not change by acquiring only a portion of the property identified. The investor purchased 75% of the property identified at 75% of the fair market value of the whole.[20]

For a further example, consider an investor who identifies a parcel of real estate including a description of improvements to be constructed before acquiring ownership. However, construction will not be finished when the 180-day reinvestment period expires. The investor closes escrow within the 180 period and takes ownership of the property before construction is complete.

Here, the real estate is still substantially the same real estate as the property identified. The improvements, to the extent they exist, are the same improvements the investor identified in the 45-day notice — just not all of them.[21]

However, the value of improvements constructed after the investor closes escrow is not part of the price paid (or debt assumed) for §1031 purposes. Thus, the value of the portion of the construction not yet completed is *not* part of the debt or equity in the replacement property. The value of the portion of the improvements not yet completed does not exist at the time of closing. Thus, they are not part of the value received in the replacement property on closing.[22]

120-day extensions for disaster relief

An extension exists for meeting §1031 reinvestment deadlines interrupted by a disaster.

The disaster may have been a tsunami, earthquake, wildfire, drought, flood, or be brought about by a terrorist or military action. The President of the United States needs to declare the area affected a disaster area.

19 Rev. Regs. §1.1031(k)-1(d)(2), Example 2
20 Rev. Regs. §1.1031(k)-1(d)(2), Example 4
21 Rev. Regs. §1.1031(k)-1(e)(3)(iii)
22 Rev. Regs. §1.1031(k)-1(e)(5)(iii)

When declared, the IRS publishes a Notice or News Release extending the 45-day identification and §1031 reinvestment deadlines, stating the duration of the extension (called a postponement by the IRS) and the location of the disaster area.

Qualifying for an extension

To qualify for the 120-day disaster extension, an investor involved in a §1031 reinvestment plan needs to be affected by one of the following situations:

- the investor's principal residence or their place of business is located within the area covered by the IRS Notice or News Release; or
- the investor has difficulty meeting their §1031 deadlines due to the disaster for one of the following reasons:
    - either an identified replacement property or, in a reverse exchange under safe harbor rules, the property to be sold, is located within the disaster area;
    - the principal place of business of any individual or person connected to the §1031 transaction, such as an intermediary, buyer, seller, attorney, mortgage holder, escrow, or title company is located within the disaster area;
    - any individual or employer connected to the §1031 transaction was killed, injured, or went missing as a result of the disaster;
    - a document prepared in connection with the §1031 transactions or a relevant title record was destroyed, damaged, or lost as a result of the disaster;
    - a mortgage holder decides not to fund a closing, permanently or temporarily, due to the disaster or a disaster-related unavailability of hazard insurance; or
    - a title insurance company refuses to issue a policy due to the disaster.

The 120-day postponement in transactions affected by the disaster applies to §1031 deadlines running on or after the disaster's occurrence, and to 45-day identification periods which ran before the disaster.

The 120-day disaster extension does not apply to the investor's tax return for the year of the sale. But to qualify for the §1031 extension the investor needs to obtain extensions and file their tax return only after replacement property is acquired.

When the investor is in a **reverse §1031 transaction** — also known as a *parking transaction* — and a disaster occurs after acquisition of replacement property, but before closing a sale on the property identified to be sold, the investor may apply the 120-day disaster extension to these deadlines:

- the five-business day period expiration date for entry into an interim title-holding agreement with a qualified intermediary;
- the 45-day identification period expiration date for the property to be sold;

reverse §1031 transaction
An Internal Revenue Code (IRC) §1031 transaction in which an investor controls title to replacement property before disposing of the property to be sold. Also called a parking transaction.

- the 180-day period expiration date for the sale of the property identified; and
- the 180-day combined time period expiration date for the qualified intermediary to release the replacement property and property to be sold.

Now consider a disaster which occurs after the expiration of a 45-day identification period. A property identified was substantially damaged. The property needs reconstruction or repair, or another property needs to be substituted for it in a new notice of property identification.

Here, the investor may use the 120-day disaster extension to identify other properties by:

1. revoking the original notice of property identification (which listed the substantially damaged property); and
2. preparing a new identification notice.

The investor needs to deliver the new notice and revocation to the appropriate person prior to expiration of the additional 120 days.[23]

23 Revenue Procedure 2004-13 as modified by IRS Notice 2005-3

Chapter 28 Summary

When a concurrent closing of the sales escrow and the purchase escrow will not be possible without an extension of closing dates, an investor finds themselves in a delayed §1031 transaction. In a delayed §1031 transaction, the investor closes escrow on the sale of one property and later acquires ownership of the replacement property.

The investor is still engaged in two mutually exclusive transactions, they just are not closing concurrently. However, the 180-day reinvestment period and the 45-day identification period deadlines run concurrently from the close of sale.

Failure to comply with either the identification or reinvestment deadlines, any property acquired outside these parameters will not qualify as replacement property under §1031. Replacement property when ownership is acquired within the 45-day identification period is treated as identified without further documentation on a §1031 property identification form.

When ownership of any replacement property is to be acquired after the 45-day identification period, the investor needs to sign and deliver a written §1031 property identification statement within the 45-day period

Chapter 28 Key Term

Chapter 29

The §1031 trustee in a delayed reinvestment

Learning Objectives

After reading this chapter, you will be able to:

- understand the use of a §1031 trustee to receive, hold, and disburse proceeds from the sale of a property under the general rules for the seller to avoid receipt of sales proceeds in a §1031 reinvestment plan; and
- identify persons who qualify to act as a §1031 trustee.

Key Term

deferred exchange corporation

Control over the disbursement of funds

Recall that an investor orchestrates a *concurrent closing* of a sales escrow for the property sold and a purchase escrow for the replacement property in a §1031 transaction when the investor:

- is in escrow for their sale of a property;
- locates and opens a purchase escrow to acquire replacement property;
- coordinates the closing of both the sales escrow and the purchase escrow on or about the same date; and
- authorizes by mutual escrow instruction the transfer by escrow of the sales proceeds from the property sold directly to the purchase escrow for the account of the investor.

Thus, due to the relatively concurrent closing of both the sales and purchase escrows and the transfer of funds between escrows, the sales proceeds remain contractually beyond receipt by the investor on demand. Thus, a 1031 trustee is not needed to hold the sales proceeds.

Because of this direct transfer between escrow accounts, the investor avoids *actual or constructive receipt* of the proceeds from the property sold. At all times, the funds are held in one or another bilateral escrow. Accordingly, all participants are required to enter into any release of funds to the investor.

Typically, concurrent closings are not often possible. The closing date for a sales escrow frequently arrives before the investor locates a replacement property, contracts to purchase it, eliminate contingencies, and has a purchase escrow ready to close on replacement property.

Without concurrent closings, the sales escrow is instructed to deposit the investor's sales proceeds with a §1031 trustee. The trustee will hold and disburse the funds under the terms of a trust agreement entered into by the buyer of the investor's property. The trustee receives and holds the sales proceeds until the investor is able to close on the purchase of the replacement property and complete the reinvestment. [See **RPI** Form 172-4]

Further, the settlement closing statement for the sales escrow will credit the investor with *Exchange Valuation Credits (EVCs)* in lieu of a "check herewith" for the sales proceeds. [See **RPI** Form 172-2 §1.3]

After the sales escrow closes, the buyer of the investor's property is no longer involved in the investor's reinvestment plan. On receipt of the sales proceeds, the §1031 trustee carries out the buyer's duty under the §1031 cooperation provision in the purchase agreement to fund the purchase escrow for the replacement property.

The investor's control and access to the funds held by the trustee is limited to directing the trustee to disburse the sales proceeds to the investor's account in the purchase escrow opened to fund the closing for the replacement property selected by the investor. [See **RPI** Form 172-3]

A §1031 trustee acts as a facilitator

Consider a buyer of §1031 property who does not agree to a contingency provision in the purchase agreement conditioning closing on the purchase of other property. Such a contingency provision allows the investor to first locate a suitable replacement property for acquisition. When a replacement property is not located by the scheduled date for closing, the investor has the right to either cancel the sale or extend the closing date until replacement property is located.

However, the buyer does agree to a boilerplate §1031 *cooperation clause* for the disbursement of funds to meet the investor's objective of accomplishing a §1031 reinvestment, whether by a concurrent or delayed closing.

The investor advises escrow the sale will be the first leg of a delayed §1031 reinvestment plan. Thus, mutual closing instructions need to accommodate the transfer of their sales proceeds to a §1031 trustee.

The escrow officer informs the investor about the escrow company's affiliated **deferred exchange corporation**. It acts under safe harbor rules as a facilitator in delayed acquisitions of replacement property to ensure the seller avoids receipt of the sales proceeds.

deferred exchange corporation
A corporate facilitator retained to act as a trustee in a delayed §1031 transaction to receive, hold and disburse proceeds from the sale of a property under safe harbor rules for the seller to avoid receipt of their sales proceeds.

The escrow officer then explains the sale, the impounding of funds and the purchase of the replacement property can all be handled out of the same escrow office to ensure compliance with §1031 rules for avoiding the receipt of the sales proceeds.

Does the investor need to use a *deferred exchange corporation*, whether or not it is affiliated with the escrow company, to avoid actual or constructive receipt of the net sales proceeds?

No, but they may! Under the general rules for avoidance of receipt of sales proceeds, the investor is free to select their §1031 trustee, as well as a different escrow company to handle documents and instruments for the purchase of replacement property.

However, the investor may not use an entity controlled by the investor or any person – individual or entity – considered to be related to the investor as the §1031 trustee.[1]

The investor's attorney, accountant or broker may act as the trustee when the buyer, not the investor, establishes the trust. Thus, the trustee holds the sales proceeds as the agent of the buyer, not the investor, with authorization limited to funding a purchase escrow on instructions from the investor.[2]

The risk with unregulated facilitators

Deferred exchange corporations claiming to be facilitators often present themselves as "§1031 specialists" with expert analysis and creative handling.

However, these corporations are separate from the licensed activity of the escrow company that might recommend their use. California licensees who operate an affiliated "facilitator business" do not act in the capacity of a licensed real estate broker or independent escrow agent.

Despite a deferred exchange corporation's "affiliation" with an escrow or brokerage office, they are not part of an escrow transaction covered for losses by the *Escrow Agents' Fidelity Corporation (EAFC)*.

In fact, when they do not act under an agreement that establishes a trust for their holding of the funds as a trustee, facilitators may commingle §1031 funds in their general accounts.

A prudent investor will use a regulated, bonded, or insured entity, such as a title company, bank or thrift, or select an individual the investor knows to be trustworthy to act as a §1031 trustee. Otherwise, the investor risks losing their funds to an incompetent individual or entity.

1 Internal Revenue Code §§267(b), 707(b)
2 Revenue Regulations §1.1031(k)-1(k)(2)

Form 172-2

Supplemental Escrow Instructions

SUPPLEMENTAL ESCROW INSTRUCTIONS
§1031 Reinvestment In Lieu of a Cash-Out Sale

NOTE: This form is used by a seller's agent or escrow officer when handling the seller's cash sale of property in a delayed §1031 reinvestment plan, to authorize escrow to disburse the cash sales proceeds to a trustee for funding the seller's future acquisition of replacement property.

DATE: ____________________, 20______, at ____,California.
To ____
____
Attention ____________________________________ Escrow No. ____
Seller ____
Buyer ____
§1031 Trustee ____

1. All prior instructions in this escrow and underlying agreements between the parties are amended as follows:

1.1 Seller will at no time receive cash or paper as consideration for the conveyance of the subject property, except the sum of $_______________ cash through escrow.

1.2 You are authorized to close this escrow when you cause or confirm that Trustee holds for Buyer the sum of $_______________ under the Trust entitled ____.

1.3 You are to prepare Seller's closing statement showing the agreed-to charges and credits to include "Exchange Valuation Credits" due Seller in the amount of $_______________, in lieu of the net proceeds originally provided for in your instructions.

2. The following are conditions with which escrow need not be concerned:

2.1 Seller intends the sale to qualify as an Internal Revenue Code §1031 transaction, exempt from profit reporting. The ultimate tax status of the sale provides no consideration for the agreement between the parties, and failure to qualify under Internal Revenue Code §1031 provides no grounds for rescission.

2.2 Buyer and §1031 Trustee, concurrent with the signing of these instructions, will execute a trust agreement creating a trust to receive and hold as the trust estate the proceeds of this sale.

☐ See attached Signature Page Addendum. [**RPI** Form 251] ☐ See attached Signature Page Addendum. [**RPI** Form 251]

Date: ____________________, 20______ Date: ______________________, 20______

Seller: ________________________________ Buyer: ____

Seller: ________________________________ Buyer: ____

Date: ____________________, 20______

§1031 Trustee: ______________________

By: ______________________________

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Further, any bankruptcy petition filed by or involuntarily imposed on a §1031 trustee will not jeopardize the availability of the trust funds under the §1031 trust agreement.[3]

The buyer cooperates as agreed

A listing agent begins the §1031 reinvestment process at the time the investor enters into a purchase agreement to sell the listed property. The purchase agreement entered into includes a boilerplate §1031 cooperation provision calling for the buyer to accommodate, through mutual closing

3 **In re Sale Guaranty Corporation** (9th Cir. BAP 1998) 220 BR 660

instructions, the investor's need to re-route disbursement of the investor's net sales proceeds from the sales escrow directly to a trustee for later funding the purchase of a replacement property.

Before closing the sales escrow, the investor determines they will reinvest the proceeds in replacement property. The investor decides to exercise the right granted to them by the §1031 cooperation provision in purchase agreement with the buyer to reroute the net sales proceed to a §1031 trustee the investor selects.

Two documents are prepared and handed to the buyer to sign and return as the paperwork needed to perform under the cooperation provision, including:

- *supplemental closing instructions* calling for escrow to disburse the net sales proceeds on closing to the trustee selected by the seller and identified in the instructions, and not disburse the funds to the investor as called for in the original instructions [See Form 172-2]; and
- a *declaration of trust* executed by the buyer to establish a trust and appoint the trustee selected by the investor to hold the net sales proceeds until the trustee is further instructed by the investor to disburse the money to the purchase escrow handling the investor's acquisition of a replacement property. [See Form 172-4]

The inclusion of the **cooperation provision** in the purchase agreement eliminates any need for the investor to later resort to the riskier election to use the **safe harbor rules** to avoid receipt of their sales proceeds, unless the buyer refuses to cooperate as agreed.

Prior to preparing closing instructions for the sales escrow and the trust agreement, the investor needs to select the person who will be appointed by the buyer as the §1031 trustee. Any person may be selected by the investor to be the §1031 trustee, except for a family member and any business entity controlled by the investor, called *related persons*.[4]

The cooperation needed from the buyer is limited solely to establishing a facilitator — a §1031 trustee or "buyer's trustee." Thus, the buyer fulfills their promise to cooperate in the disbursement of funds for the purchase of replacement property yet to be acquired by the investor.

After the sales escrow closes, the buyer is no longer involved in arrangements for the investor's §1031 reinvestment. The trustee carries on in place of the buyer and escrow, holding the net sales proceeds until disbursed to fund the investor's purchase of a replacement property.

§1031 instructions for escrow

Prior to closing the sales escrow, the agent dictates supplemental escrow closing instructions to be prepared for signatures from the investor, buyer and §1031 trustee. [See Form 172-2]

The supplemental escrow instructions in no way alter the buyer's rights and obligations under the purchase agreement or original escrow instructions.

4 IRC §267(b); Rev. Regs. §1.1031(k)-1(k)

Form 174-2

Declaration of Trust for §1031 Proceeds

Page 1 of 2

DECLARATION OF TRUST FOR §1031 PROCEEDS
Cash-Out Sale

NOTE: This form is used by a seller's agent when closing escrow on the cash sale of property in the seller's §1031 reinvestment plan and the escrow for the seller's acquisition of the replacement property cannot be closed concurrently, to set up a trust to hold the net sales proceeds until needed to fund acquisition of replacement property.

DATE: _____________, 20_____, at ____, California,

FACTS:

1. This declaration of trust is entered into between
1.1 ____, as the Trustor and Beneficiary,
1.2 and ____, as the Trustee,
1.3 to create a trust entitled "The ____ Trust."

2. This Trust is to perform Trustor's obligations under the terms of a §1031 provision in a purchase agreement dated ___________, 20_______, and escrow instruction No.____________ with __________________________, between ____, as the Buyer, and ____, as the Seller.

DECLARATION:

3. Trustor hereby transfers and delivers to Trustee all of the property described hereunder to constitute, together with any other property that may become subject to this Declaration, the Trust Estate of an express trust to be held, administered and distributed by the Trustee as provided herein.

4. Trust Estate:
4.1 The Trust Estate will consist of cash in the amount of $_________________, caused to be delivered to Trustee by Trustor.

5. Responsibility for Costs:
5.1 Trustee's fee for establishing the Trust and its management fee thereafter of $____________ per month will be payable out of funds received and held by Trustee.
5.2 In the event Trustee becomes involved in any litigation arising out of this Trust or the transaction between Trustor and Seller, reasonable attorney fees incurred by the Trustee are recoverable from the Trust Estate.

6. Powers of the Trustee:
6.1 General powers of the Trustee: In addition to all other powers and discretions granted to or vested in the Trustee by law or by this Declaration, the Trustee has power with respect to the Trust Estate, or any part of the Trust Estate, to:
a. Retain in the Trust any property received by it.
b. Fund the purchase of §1031 replacement property to perform Trustor's obligations under the supplemental escrow instructions for the §1031 treatment dated ____________, 20_____, escrow no. _______________ with ____.
6.2 Special powers of the Trustee:
a. Trustee is instructed and directed to use the Trust Estate to fund Seller's acquisition of §1031 replacement property(ies) selected by Seller. Seller's selection and request for funding will be in writing directed to the Trustee.
b. Any remaining money in the Trust Estate after payment of expenses and funding of Seller's acquisition of replacement property(ies) to be delivered to Seller in complete and full performance of Trustor's obligations under the §1031 provision between Trustor and Seller.
c. During the existence of the Trust, and prior to the funding by the Trust of the purchase of §1031 property, the Trustee will have the authority, in their sole discretion, to invest prudently in the name of the Trust, any sums constituting part or all of the Trust Estate into federally insured savings accounts or certificates of deposit or other like quality interest earning investments.

7. Termination of the Trust:
7.1 When the Trust Estate is disbursed by the Trustee to fund acquisition of §1031 property, the Trust will terminate. On termination, the Trustee will deliver to Seller any remaining assets and money held in the Trust Estate.

8. Income of the Trust:
8.1 The Trustee will pay or apply all of the Trust Estate, including any interest earned thereon, toward the performance of powers of the Trustee.

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The mutual supplemental escrow instructions direct the escrow officer to disburse funds that accrue to the account of the investor to the §1031 trustee on close of escrow, except for prorations and any portion of the net sales proceeds withdrawn by the investor.

The supplemental closing instructions authorize the sales escrow to:

- disburse the investor's net sales proceeds, less any withdrawals made by the seller, by issuing a check on the close of escrow made payable to the §1031 trustee for the amount of the investor's net proceeds; and

PAGE 2 OF 2 — FORM 172-4

9. Trust is Irrevocable:

9.1 This Trust is irrevocable pursuant to California Probate Code §15400 and may not be amended or modified in any way.

10. Spendthrift Provisions:

10.1 No Beneficiary of this Trust will have any right, power or authority to alienate, encumber or hypothecate their interest in the principal or income of this Trust in any manner, nor will such interest of any Beneficiary be subject to claims of their creditors or liable to attachment, execution or other process of law.

11. Successor Trustee:

11.1 If the Original Trustee becomes unable or unwilling to act as Trustee, then ______________________________ ______________________________ is to become Trustee of this Trust, will succeed to all title of the Trustee to the Trust Estate and to all powers, rights, discretion, obligations, and immunities of the Trustee under this Declaration.

12. Law for construction of the Trust:

12.1 The Trust provided for in this Declaration will be governed by the laws of the State of California.

EXECUTED ON ____________, at ____, California.

Trustor: ____ Trustee: ____

Trustor: ____ Trustee: ____

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Form 172-4

Declaration of Trust for §1031 Proceeds

Page 2 of 2

- issue a closing statement to the investor noting the investor received **Exchange Valuation Credits (EVCs)** in lieu of a "check herewith," in an amount equal to the amount of the cash proceeds disbursed by escrow to the §1031 trustee. [See Form 172-2]

The dollar amount of the EVCs in the closing statement represents the amount of funds disbursed to the §1031 trustee and available to fund the investor's purchase of replacement property.

Even though disbursement of the net sales proceeds is, as a condition of closing escrow, diverted away from the investor to the §1031 trustee, the investor retains **control** over the funds for their use as a down payment on the purchase price of replacement property selected and contracted for by the investor.

Investor's receipt of accrued interest

The §1031 trustee is instructed, by the terms of the trust agreement, to hold the trust funds on deposit in government-insured, interest-bearing accounts.

The interest earned and credited to the account first pays the costs of maintaining the savings account and payment of any trustee's fee. Interest remaining after payment of the trustee's costs and fees belongs to the investor (and is taxed as the investor's portfolio income). The investor may, but need not, apply the remaining interest toward the purchase of the replacement property.

The investor is entitled to the interest earned on the funds impounded with the trustee since interest is the economic product of the investor's net sales proceeds while they are held in trust.

Form 172-3

Instruction to Trustee to Fund Acquisition (Cash Only)

INSTRUCTION TO TRUSTEE TO FUND ACQUISITION
Cash Only

NOTE: This form is used by a seller's agent when a §1031 trustee holds proceeds from the seller's cash sale of property in a delayed §1031 reinvestment plan, to instruct the trustee to forward funds to a purchase escrow for acquisition of replacement property.

To Trustee: ______________________________

Name of Trust ______________________________

1. You are hereby advised of my selection and intended acquisition of real estate referred to as
____
______________________________.

2. Further, you are hereby requested, on a demand by escrow on you for funds, to disburse cash from the Trust Estate, for credit toward the purchase price to be paid for the property, in the amount of $ __________, payable to (Escrow Company) ____________________ Escrow # __________
Address ______________________________

Dated: __________, 20______

Seller: ______________________________
(As named in declaration of trust)

Seller: ______________________________
(As named in declaration of trust)

Critically, the interest may not be disbursed to the investor before they acquire ownership of all the replacement property to be received in their reinvestment plan. When interest earned on the §1031 money is prematurely disbursed to the investor (to an escrow is fine) before completing the purchase of all replacement property to be acquired, the investor loses the entire §1031 exemption.[5]

The investor reports the interest income as **portfolio** earnings of the investor. Interest is not part of the net sales proceeds, but merely taxable earnings generated by the net proceeds of the sale.[6]

5 Rev. Regs. §§1.1031(k)-1(g)(5), 1.1031(k)-1(g)(6)(iii)(A)

6 **Starker** v. **United States** (9th Cir. 1979) 602 F2d 1341

Funding the purchase of replacement property

The final stage of a delayed §1031 reinvestment plan begins when the investor enters into a purchase agreement to acquire replacement property. On opening an escrow to purchase the replacement property, the investor instructs the §1031 trustee to forward funds to the purchase escrow when escrow **calls for funds**. The call occurs at the time escrow is able to close. [See Form 172-3 accompanying this chapter]

When no further property is to be acquired by the investor to close out the reinvestment plan, the call for funds by escrow demands all funds held by the trustee. This transfer of funds from the trustee to the investor's purchase escrow removes the trustee from any further disbursement or any withholding of funds for the Franchise Tax Board (FTB).[7]

On the purchase escrow's receipt of funds from the trustee, the funds are credited to the account of the investor as the buyer. The investor takes title to the replacement property by a grant deed conveyance directly from the owner of the property to the investor. With the conveyance, the reinvestment plan is complete.

Any funds unused by escrow to pay the investor's down payment and transactional costs are disbursed to the investor. Funds disbursed to the investor on or after acquiring the replacement property will be taxed as profit unless they are interest earned during the delay or offset by the amount of any purchase-assist mortgage or carryback note executed by the investor to purchase the replacement property. [See Chapter 23]

7 Calif. Revenue and Taxation Code §18662(e)(3)(D)

Chapter 29 Summary

In a §1031 transaction, due to the relatively concurrent closing of both the sales and purchase escrows and the transfer of funds between escrows, the sales proceeds remain contractually beyond receipt by the investor on demand. Thus, a §1031 trustee is not needed to hold the sales proceeds.

The investor avoids actual or constructive receipt of the proceeds from the property sold because of the direct transfer between escrow accounts. The funds are held in one or another bilateral escrow, so accordingly, all participants are required to enter into any release of funds to the investor.

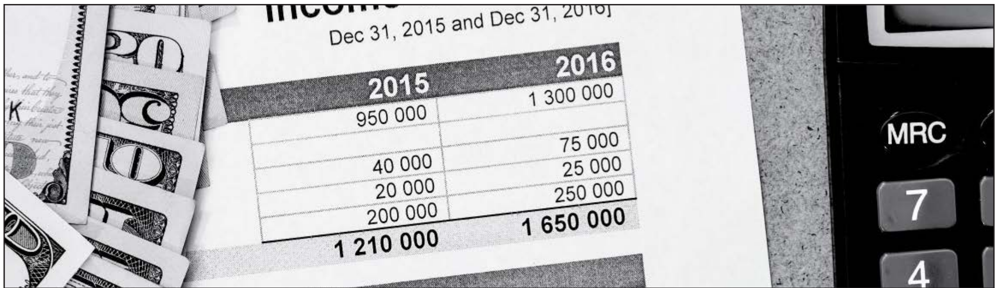
Without concurrent closings, the sales escrow is instructed to deposit the investor's sales proceeds with a §1031 trustee. The trustee will hold and disburse the funds under the terms of a trust agreement entered into by the buyer of the investor's property.

The trustee receives and holds the sales proceeds until the investor is able to close on the purchase of the replacement property and complete the reinvestment. After closing the sales escrow, the buyer of the investor's property is no longer involved in the investor's reinvestment plan.

On receipt of the sales proceeds, the §1031 trustee carries out the buyer's duty under the §1031 cooperation provision in the purchase agreement to fund the purchase escrow for the replacement property.

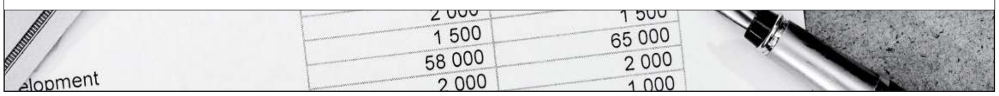
The investor's control and access to the funds held by the trustee is limited to directing the trustee to disburse the sales proceeds to fund the investor's purchase of the selected replacement property.

Chapter 29 Key Term



Chapter 30

The §1031 Profit and Basis Recap Sheet



Learning Objectives

After reading this chapter, you will be able to:

- explain the §1031 concepts of cost basis, capital offsets and taxable profit experienced in a reinvestment plan based on use of a §1031 profit and basis recap sheet.

Key Terms

cash boot	**net debt relief**
mortgage boot	**offsets**
net cash items	**recapitalization**

Offsets on reinvestment eliminate profit taxes on sale

The tax objective sought by an investor when selling an investment or business-use property is to eliminate, or at least minimize taxes on the *profit realized* on the sale. To meet this tax objective, an investor reinvests their **capital interest** in the property sold – its market value comprised of mortgage principal and equity value – in a replacement property.

The reinvestment maintains their **continued investment** in real estate without the payment of profit taxes on the sale, the foundational premise for the §1031 profit exemption.

What is "exchanged" in a §1031 transaction is the investor's equity in one property for the equity in another property. The transfer of equity to a replacement property is accomplished either directly in a two-way exchange or indirectly using the net proceeds from the property sold.

The nexus between the property sold and the property purchased is the net sales proceeds generated by the sale of a like-kind property – §1031 money.

The perfect tax-free match for a property sold and a property purchased is an unencumbered property sold or exchanged to purchase another unencumbered property of the same value. This is an exchange of same-price property, but not likely to occur. Here, no adjustments are required as mortgage amounts do not exist and no cash items are involved. Just equity for equity.

Usually, properties in §1031 reinvestment plans are differently capitalized with various amounts of **capital values.** Most properties are encumbered with differing mortgage amounts and have unequal amounts of equity. These variables of mortgage debt and equity – the investor's capital – trigger tax consequences for the profit realized on a sale or exchange of property unless a replacement property of equal or greater market value is purchased.

Remember: cost basis and profit are the opposite sides of one coin and mortgage debt and equity are the opposite sides of a another.. The only link between them is the fair market value of the property sold. Again, the cost basis in a property is never the same amount as the debt on the property. The same is true of profit and equity. These distinctions are at work in every paragraph in this chapter.

Capital interest as mortgage and equity

A tax analysis of a sale of §1031 property goes beyond the mechanics of avoiding receipt of the net sales proceeds from the property sold and complying with time limitations and procedures for identifying and acquiring replacement property.

For example, consider the three **capital events**, one or more manifesting when a property is sold. Each, when present, triggers some level of profit reporting on the sale, unless *offset* by capital events built into the terms of purchase for the replacement property. The *capital events* on the sale of a property include:

- **mortgage relief** on the sale or exchange of a property, consisting of the principal amount of existing mortgages whether assumed, taken over or paid off by the buyer of the property sold;
- **equity sold** for *cash* and *carryback notes* on the sale of property; and
- **equity exchanged** for *unqualified property*, also called *other property*.

To trade up or trade down alters the effect of offsets

No profit reporting occurs when an investor uses all the net proceeds from their sale (or exchange of their equity) to purchase replacement property which has equal-or-greater mortgage and equal-or-greater equity than the mortgage and equity existing in the property sold. The investor has continued their investment in real estate without withdrawing capital. Further, they have avoided reporting taxable profit on the sale, the product of offsetting.

Conversely, when an investor "trades down" by acquiring property for a lesser price than the property sold, some amount of profit is reported on the property sold. Profit reporting results from withdrawing capital, such as the receipt of cash, a carryback note or unqualified property on a sale. Further, the replacement property, being of lesser value than the property sold, has either lesser mortgage principal, lesser equity value or both, than the property sold. Thus, the offsets available are insufficient to avoid profit reporting.

cash boot
Items of value received on a sale of property or contributed to purchase replacement property in a §1031 reinvestment plan which include money, carryback notes, purchase-assist financing for the replacement property, and equity in property not qualified as §1031 like kind property. Also called money and other properties.

The investor, on acquiring a lesser-valued replacement property, withdraws capital from the property sold or exchanged in the form of:

- mortgage reduction, also called *net debt relief* by the Internal Revenue Service (IRS) and more commonly called *mortgage boot*; or
- cash, a carryback note or unqualified property, collectively called *cash items* and *other property* and commonly called **cash boot**.

An agent's spreadsheet for a client's reinvestment

A §1031 Basis and Profit Recap Sheet is a checklist of all the §1031 issues to be considered. An agent uses the *Recap Sheet* to prepare a tax analysis of a proposed purchase of replacement property for review with the client – an investor or business owner. The Recap Sheet is used to approximate the **tax consequences** of a potential §1031 transaction on locating a potential replacement property. [See Form 354 accompanying this chapter]

On the agent's review of a filled-out Recap Sheet with the investor, the investor visually grasps the tax impact of acquiring a specific property as a **continuing capital investment** in real estate.

The Recap Sheet is also used to display the different tax consequences of acquiring one suitable property as opposed to another. A client's selection of one replacement property among other suitable properties might be influenced by disclosure of the tax consequences of acquiring it.

When an investor has entered into an agreement to sell a property, enterprising agents use the Recap Sheet to inform the investor about the tax benefits of **converting the sales transaction** into a §1031 reinvestment plan prior to closing. [See Chapter 26]

§1031 expertise and a little knowledge of basic math

Most agents tend to know what type of real estate is referred to as §1031 property or **like-kind property**. Also, agents usually know how to develop an opinion of a property's value, its equity and how to balance equities in an exchange. They certainly know how to control the sale or purchase of a property using written agreements and escrow instructions.

However, when an agent discusses the tax consequences of a §1031 reinvestment with their investors, they usually fear uncertainty for lack of sufficient training or personal experience: How do you anticipate and calculate the *capital investment variables* that generate profit reporting and taxes – the math underpinning §1031 tax results?

The agent who decides to discuss the tax aspects of purchasing replacement property with an investor needs to:

- know the *accounting variables* common to §1031 transactions; and
- understand their application to transactions.

Investment variables comprise capital created or transferred on the sale/exchange of one property or the purchase of another. The **investment variables** include:

- the equities in both properties;
- existing mortgages;
- cash;
- purchase-assist mortgage;
- carryback notes;
- unqualified property; and
- the remaining cost basis from investments in the property sold.

While this chapter presents the knowledge and understanding of §1031 issues and math, the next chapter puts this knowledge to work in practice through case examples.

The Recap Sheet

An agent uses the Recap Sheet to analyze the flow of capital invested, withdrawn or contributed by an investor when selling and buying properties in a §1031 reinvestment plan.

The Recap Sheet contains five sections.

Section One nets out the **capital withdrawn** from existing mortgage and cash items on the sale or exchange of the property sold and **capital contributed** to purchase of the replacement property.

Section Two analyzes any **unqualified properties** an investor contributes to purchase the replacement property, such as personal property or dealer property held by a developer. The contribution of unqualified property produces a taxable profit or loss as though sold for cash.

Section Three calculates the **profit realized** on the sale. Here, the amount of profit taken by the investor on the property sold in their §1031 reinvestment plan is determined.

Section Four calculates the **profit recognized** and thus reported and taxed on the §1031 reinvestment.

Section Five establishes the **cost basis** for the replacement property. The cost basis is allocated to land and improvements based on their respective percentages of the property's value. The cost basis allocated to improvements is a requisite to calculating the annual depreciation deduction allowed the investor acquiring replacement property.

§1031 PROFIT AND BASIS RECAP SHEET

Prepared by: Agent ______________________ | Phone ______________________
Broker ______________________ | Email ______________________

NOTE: To be prepared to estimate reportable profit (§ 4.5) and basis (§ 5.5) in a proposed §1031 reinvestment plan. This form provides for a complete accounting for IRS 8824 off-form reporting.

DATE: _______________, 20______.
PREPARED BY ______________________
OWNER'S NAME ______________________
PROPERTY SOLD/EXCHANGED ______________________
____
COMMENTS ______________________
____
REPLACEMENT PROPERTY ______________________
COMMENTS ______________________
____

1. NET DEBT RELIEF AND CASH ITEMS:

Net existing debt:

1.1 Balance of debt(s) owner is **relieved** of on all property sold/exchanged. . . . . (+) $_______________
1.2 Balance of debt(s) owner **assumed** on §1031 property acquired . . . . (–) $_______________
1.3 **Total net existing debt:** Enter the sum of 1.1 & 1.2 as either:
(a) **Net debt relief** (amount by which 1.1 exceeds 1.2) . . . . (+) $ 0.00
(b) **Net debt assumed** (amount by which 1.2 exceeds 1.1) . . . . (–) $ 0.00

Cash items received on close of the property sold:

1.4 Amount of cash **received** on sale (excluding prorations). . . . . . . $_______________
1.5 Amount of carryback note **received** on sale . . . . $_______________
1.6 Equity value in unqualified property **received** on sale . . . . $_______________
1.7 **Total of cash items received on closing the property sold** (The sum of 1.4, 1.5 & 1.6). . . . . (+) $ 0.00

Net cash items received or transferred on close of the replacement property:

1.8 Amount of cash items **received** with replacement property (excluding prorations). . . . . (+) $_______________
1.9 Amount of cash owner **contributed** (excluding prorations) . . . . . . $_______________
1.10 Transactional costs **disbursed** at any time on either property (excluding prorations and loan payoffs) . . . . $_______________
1.11 Amount of purchase-money notes **owner executed** in part payment for the replacement property . . . . $_______________
1.12 Equity value of any unqualified property owner **exchanged** . . . . . $_______________
1.13 Subtotal of cash items owner **transferred** (1.9 through 1.12) . . . . (–) $ 0.00
1.14 **Total net cash items:** Enter the sum of 1.8 & 1.13 as either:
(a) **Net cash items owner received:** (amount by which 1.8 exceeds 1.13) . . . . (+) $ 0.00
(b) **Net cash items owner transferred:** (amount by which 1.13 exceeds 1.8) . . . . (–) $ 0.00

Netting all debt relief and cash items:

1.15 Enter net debt **relief** from 1.3(a) . . . . (+) $ 0.00
1.16 Enter net cash items
(a) owner **received** from 1.14(a). . . . . (+) $ 0.00
(b) owner **transferred** from 1.14(b) . . . . (–) $ 0.00
1.17 Net debt relief and cash items (1.15 & 1.16, but not less than zero) . . . . (+) $ 0.00
1.18 Cash items received on sale from 1.7 . . . . (+) $ 0.00
1.19 **TOTAL net money and other properties owner received** (The sum of 1.17 & 1.18) . . . . (+) $ 0.00

— — — — — PAGE ONE OF TWO — FORM 354 — — — — —

Form 354

§1031 Profit and Basis Recap Sheet

Page 1 of 2

Once the annual depreciation allowance is determined, the agent and investor can review the replacement property's annual reportable income or loss from operations and ownership. The analysis of a property's year-end income, expenses and deductions is accomplished by preparing an Annual Property Operating Data sheet (the APOD form). [See Chapter 28]

While the Recap Sheet estimates the amount of profit reported and taxed on the sale in the §1031 reinvestment, the Recap Sheet does not determine the amount of taxes an investor might pay.

Form 354

§1031 Profit and Basis Recap Sheet

Page 2 of 2

— — — — — — PAGE TWO OF TWO — FORM 354 — — — — — —

2. PROFIT/LOSS ON TRANSFER OF UNQUALIFIED PROPERTY:

2.1 Market value of unqualified property owner transferred. . . . . . (+) $________

2.2 Remaining cost basis in unqualified property owner transferred . . . . (–) $________

2.3 **Total profit/loss on unqualified property owner transferred** . . . . . . (+ or –) $ 0.00

3. PROFIT REALIZED ON THE §1031 PROPERTY SOLD OR EXCHANGED:
(before applying the §1031 exemption)

Consideration owner received:

3.1 Debt relief: Enter amount from 1.1 . . . . $ 0.00

3.2 Market value of §1031 replacement property owner acquired . . . . $________

3.3 Total cash items received from property sold Enter amount from 1.7 . . . . $ 0.00

3.4 Total cash items received with replacement property Enter amount from 1.8 . . . . $ 0.00

3.5 Total consideration owner received (3.1 through 3.4). . . . . (+) $ 0.00

Consideration owner transferred:

3.6 Debt owner assumed: Enter amount from 1.2 . . . . $ 0.00

3.7 Enter remaining cost basis in all §1031 properties owner transferred . . . . $________

3.8 Cash owner contributed: Enter amount from 1.9 . . . . $ 0.00

3.9 Transactional costs disbursed: Enter amount from 1.10 . . . . $ 0.00

3.10 Purchase notes owner executed: Enter amount from 1.11 . . . . . . $ 0.00

3.11 Remaining cost basis in unqualified property owner transferred: Enter amount from 2.2 . . . . $ 0.00

3.12 Total consideration owner transferred (3.6 through 3.11) . . . . (–) $ 0.00

3.13 **Total profits realized in §1031 property sold or exchanged** (3.5 less 3.12). . . . . (+ or –) $ 0.00

4. REPORTABLE PROFIT/LOSS ON THE §1031 TRANSACTION:

4.1 Total net debt relief and cash items owner receives: Enter amount from 1.19, but not less than zero . . . . . . (+) $ 0.00

(a) Carryback basis allocation: Amount by which 3.7 exceeds 1.1, but not more than the amount at 1.5 . . . . . . (–) $ 0.00

4.2 Total profit/loss on unqualified property owner transferred: Enter amount from 2.3. . . . . (+ or –) $ 0.00

4.3 Subtotal: The amount of equity withdrawn: (the sum of 4.1(a) & 4.2) . . . . (+ or –) $ 0.00

4.4 Total profits realized in §1031 property sold/exchanged: Enter amount from 3.13 (but not less than zero). . . . . $ 0.00

4.5 **Total reportable profit/loss:** (Enter lesser of 4.3 or 4.4). . . . . (+ or –) $ 0.00

5. BASIS OF ALL PROPERTY(IES) RECEIVED:

5.1 Debt relief. Enter amounts from:

(a) 1.3(a) Net debt relief . . . . (–) $ 0.00

(b) 1.3(b) Net debt assumed . . . . (+) $ 0.00

5.2 Cash items. Enter amounts from:

(a) 1.7 Cash items received on the sale . . . . (–) $ 0.00

(b) 1.8 Cash items received on purchase. . . . . (–) $ 0.00

(c) 1.9 Cash contributed . . . . (+) $ 0.00

(d) 1.10 Transactional costs disbursed. . . . . (+) $ 0.00

(e) 1.11 Purchase-money notes executed . . . . (+) $ 0.00

5.3 Remaining cost basis in all property transferred. Enter amounts from:

(a) 3.7 . . . . (+) $ 0.00

(b) 3.11 . . . . (+) $ 0.00

5.4 Reportable profit/loss. Enter amount from 4.5. . . . . (+ or –) $ 0.00

5.5 **Basis of replacement property(ies) and cash items:** (The sum of 5.1 through 5.4). . . . . $ 0.00

(See **ft** Form 355 for allocation to cash items, multiple replacement properties and improvements.)

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The amount of taxes paid on the recognized profit depends on the investor's adjusted gross income, itemized deductions and tax credits available to them. Further, the types of gains comprising the profit taken on the sale of improved property have their own tax bracket rates. [See **RPI** Form 351; see Chapter 10]

Off-form calculations for offsets

To report a completed §1031 reinvestment plan when filing annual tax returns, use IRS Form 8824. The form's checklist does not provide for the line-by-line offsetting of the various capital events flowing from the purchase of replacement property, comprising mortgage amounts, cash items and unqualified property.

To properly report a §1031 reinvestment on IRS Form 8824, an investor's accountant separates:

- the existing mortgages the investor assumed on acquiring the replacement property; and
- cash items the investor contributes, including any notes they execute as carrybacks or to mortgage lenders to fund the purchase of the replacement property.

Then, they net the capital withdrawals and contributions. To file the tax return, they go **off form** to use a form such as the Recap Sheet to complete the netting process. The Recap Sheet is attached to the IRS Form 8824 [See Form 354]

Mortgage relief and cash items

Cash boot, called **money and other properties** by the IRS, comprises carryback notes, purchase-assist mortgages, the investor's principal residence, dealer status properties, assumed and personal unsecured debt and real estate unqualified for §1031 treatment. These cash boot items are either withdrawn on the sale of the property sold or contributed to purchase the replacement property. Cash boot items include every capital item contributed or received that is not an existing mortgage or equity in like-kind property sold, exchanged, or purchased.

mortgage boot
The amount by which the mortgage balances existing on the property sold, whether assumed or paid off by the buyer, exceeds the sum of the mortgage balances taken over on the replacement property purchased in a §1031 reinvestment plan and the net value of cash items contributed in the plan. Also called net debt relief. Contrast with cash boot.

Mortgages existing on the property sold by the investor are part of their capital investment made as owner of the property. On a sale or exchange, the mortgage amounts existing on the property sold/exchanged always constitutes debt relief, called **mortgage boot**. When the property sold is encumbered, the investor has been relieved of their commitment to repay the mortgage principal amount. It is assumed or prepaid by funds from the buyer using their cash reserves or new financing.

Thus, **mortgage relief** is a withdrawal of capital by the investor. Mortgage relief triggers reporting – recognition – of some or all the profit on the sale/exchange of a property unless the mortgage amounts are **offset** on acquiring a replacement property. *Offsets* include the investor's assumption of mortgages and contributions of cash, unqualified property or the execution of carryback note and lender-funded mortgages used to pay the purchase price of the replacement property.[1]

offsets
A reduction, typically reducing an amount received by an amount contributed by an individual in a §1031 reinvestment plan.

Cash boot received by the investor at the time of the sale/exchange of their property **cannot** be later offset by any method. An investor's later assumption of mortgages, addition of cash (from reserves or mortgage lender financing) or execution of a carryback note to purchase the replacement property, does not offset any amount of prior withdrawals of cash items and unqualified property.

Conversely, mortgage relief on a sale is later offset by the terms of a purchase of replacement property when the price is greater than the price of the property sold.

1 Revenue Regulations §1.1031(b)-1(c)

Two categories of boot

An investor purchases replacement property by reinvesting the proceeds from their sale of a property or by the exchange of the equity in their property. All other **forms of capital** withdrawn or contributed by an investor in a §1031 reinvestment plan is inevitably classified for tax analysis as either:

- existing debt, called **mortgage boot**; or
- cash items and other property, called **cash boot**.

When analyzing the two categories of boot, existing mortgages are accounted for separate from cash items (such as origination of purchase-assist mortgage financing) and other property. Only as separate items does the netting of withdrawals and contributions occur.

This separation determines whether the investor has taken a **taxable profit** within each of the two categories of capital withdrawals – mortgage boot and cash boot. Critically, mortgage boot does not offset cash boot, but cash boot offsets mortgage boot.

For instance, the investor's **debt relief** on the property sold is a reduction in their capital invested in the form of debt relief income. Critically, debt relief is later offset when the investor either:

- **assumes or takes over** mortgages of an equal or greater amount which encumber the replacement property; or
- **contributes cash items** to purchase the replacement property, such as advancing cash, executing a carryback note, originating purchase-assist mortgages to fund the purchase and exchanging other real estate or personal property not qualified as or incidental to §1031 property.

Thus, the dollar amount of *equity value* in other property (a cash item) an investor contributes to purchase replacement property is additional capital invested. The contributions offset an equal amount of mortgage relief on the sale of the property sold.

Conversely, the investor cannot later offset the capital withdrawal of cash items they receive on the sale of their property. They received cash items before they acquired ownership of the replacement property. While the investor's assumption of an existing mortgage increases their capital investment in the replacement property, the assumption does not offset any cash withdrawn at any time, just mortgage debt relief on the property sold.

For example, on the purchase of replacement property, the mortgage assumed by the investor often has a greater balance than the mortgage balance on the property the investor sold. While taking on greater existing mortgage debt fully offsets the debt relief on the property sold, the greater amount of mortgage principal assumed on the replacement property does not spill over to offset cash received by the investor before or on closing out the §1031 reinvestment plan.[2] [Example 2]

2 Rev. Regs. §1.1031(d)-2

Only cash items contributed or executed (carryback note, new mortgage) by the investor offset cash items received by the investor. Again, the cash offset only applies to cash items received on or after the closing of the purchase escrow to acquire the replacement property. [See Form 354 §1.7]

Netting existing mortgage separately from cash items

Essentially, the **existing debt** section of the Recap Sheet demonstrates how profit reporting for the sale of the property sold is avoided by offsets to the investor's **mortgage relief**, when:

- the investor *assumes mortgages* on their purchase of replacement property with principal balances greater than the mortgage balances on the property they sold; or
- they *contribute cash items* toward their purchase of the replacement property sufficient to offset the mortgage relief on the property sold.

When mortgages on the property sold are greater in amount than the mortgages assumed on the replacement property, the result is **net debt relief**. The investor has decreased their capital contribution to the §1031 reinvestment plan in the form of reduced mortgage debt. Critically, net debt relief is offset by the terms for payment of a greater purchase price for replacement property. [See Form 354 §§1.3(a), 1.14(b) and 3.13]

net debt relief
The amount of the existing mortgage balance encumbering the property sold not offset by the assumption of mortgage balances or contribution of cash items on acquiring replacement property in a §1031 reinvestment plan. Also called mortgage boot.

Offsetting mortgage relief is accomplished by contributing cash, equity in unqualified property, originating purchase-assist financing or executing a carryback note to purchase replacement property with a greater purchase price. [See Form 354 §§1.8, 1.9 and 1.10]

The netting process for existing mortgages includes:

- *debt relief* – mortgages taken over or paid off by the buyer of any type of real or personal property the investor sells or exchanges in the §1031 reinvestment plan [See Form 354 §1.1]; and
- *debt assumed* – mortgages encumbering the replacement property taken over by the investor and any unsecured debt the investor formally assumes. [See Form 354 §1.2]

For example, an investor sells property encumbered by a mortgage. The buyer takes over the mortgage (subject to or by assumption) or funds the payoff of the mortgage. Thus, **debt relief occurs** for the investor.

However, the mortgage relief on a sale/exchange is later offset by:

1. equal or greater mortgage amounts taken over by the investor on their purchase of the replacement property, or
2. cash items contributed to purchase replacement property of equal or greater market value.

As a result, there is no net debt relief and no part of the profit on the sale/exchange is reported and taxable.

When **unsecured debt** is taken over on the purchase of replacement property, it is formally assumed to qualify and offset debt relief on the sale.

A formal assumption is accomplished by a written agreement with either the lender or the seller of the replacement property. The writing imposes an enforceable legal duty on the investor for payment of the unsecured debt. [See Form 431 accompanying this chapter; see **RPI** Form 432]

Netting cash items separately from existing mortgages

Cash items include:

- cash withdrawn or contributed by the investor;
- notes carried back by the investor on the property sold or executed by the investor to purchase the replacement property;
- money advanced by a lender originating a purchase-assist mortgage to fund the investor's purchase of replacement property; and
- unqualified properties, also called **other property**, received on the sale or exchange of the property sold or contributed to purchase replacement property.

The reasons cash items are **withdrawn** or **contributed** by an investor when selling and buying real estate include:

- to cover the difference between the equity in the property sold and the equity in the replacement property;
- to generate cashback on purchase of the replacement property; or
- a substitute for using cash, such as the execution of a carryback note or a purchase-assist mortgage to fund part of the purchase price paid for the replacement property.

Cash items, like existing mortgages, are not §1031 property. Cash, carryback notes, unqualified property, purchase-assist mortgage funding, and existing mortgage do not represent an equity in a §1031 property, which is the sole like-kind *capital interest* held by the investor property.

Critically, cash items withdrawn by the investor **prior to acquiring** any replacement property cannot be offset. The premature receipt of cash items by the investor triggers the reporting of profit realized on the property sold up to the face amount or the equity value in the cash items withdrawn. [See Form 354 §§1.4, 1.7, 1.18]

The terms for payment of the purchase price of the replacement property set the stage for a cash withdrawal without profit being allocated to the cash and taxed. On the purchase the replacement property, payment of the purchase price needs to include the investors execution of a carryback note or purchase-assist mortgage for amounts equal to or greater than the cashback they receive on closing their purchase escrow.

recapitalization
The restructuring of an owner's capital interest in a property between equity and mortgage debt or vice versa, often achieved by refinancing or further financing of the property.

The investor's continuing capital investment in the replacement property remains the equal or greater amount. They have merely restructured the form of their continued capital investment from equity to debt, called **recapitalization**.

A carryback note executed to pay part of the purchase of replacement property is a cash item, as is a lender originated purchase-assist mortgage. These cash items also offset mortgage relief incurred on the sale of the property sold that is not offset by any mortgages assumed on the purchase of the replacement property. [See Form 354 §1.17]

Critically, cash withdrawn from interest accrued on the impounded net sales proceeds held by a §1031 trustee before acquiring replacement property disallows any §1031 exemption. All profits are then taxed.

First account for §121 profits, then the §1031 profits

On occasion, a rental property sold in a §1031 reinvestment plan has previously been occupied by the seller as their **principal residence** and is now occupied by a tenant, called the *sequential use* of property.

Alternatively, the property might be currently occupied by the seller as their principal residence with part of the premises used and depreciated as either their home office space or a unit rented to a tenant, called a mixed-use property. Mixed-use situations occur for an owner-occupant of a one-to-four unit residential property or a single-family residence with a granny flat, casita unit, etc. which are in part rented to others for a fair rental value.

In sequential-use and mixed-use situations, the homeowner exchanging their principal residence is entitled to an Internal Revenue Code (IRC) §121 homeowner's **profit tax exclusion** of $250,000. A homeowner qualifies when they have owned and occupied the premises as their **principal residence** for two years within the five-year period prior to the close of the sale or exchange of the home. [See Chapter 3]

A homeowner entitled to the §121 exclusion on the sale or exchange may **withdraw cash** from the sales escrow up to the total amount of the profit exclusion. The cash withdrawal has no effect on their reinvestment of the balance of the sales proceeds in a like-kind replacement property.

A seller exchanging their personal residence may want to withdraw only a portion of their §121 exclusion in cash. Here, the entire amount of the profit exclusion is deducted **before accounting** for profits in the §1031 transaction.[3]

Thus, §121 money excluded from profit taxes represents **after-tax dollars.**

Further, the profit attributable to the §1031 portion of the residence used as a rental or for business purposes includes all the unrecaptured depreciation gains and any long-term capital gains remaining after the exclusion of §121 monies. The withdrawal of any §121 money is not reflected on a §1031 Recap Sheet.

Conversely, when all or a portion of the §121 money is reinvested in the §1031 replacement property the seller acquires, the contribution of the §121 money, being after-tax dollars, is accounted for in the §1031 Recap Sheet as a **cash contribution**. [See Form 354 §1.9]

3 Revenue Procedure 2005-14

Form 431

Assumption Agreement

ASSUMPTION AGREEMENT
Unsecured and Subrogated

NOTE: This form is used by a seller's agent or escrow officer when the sale of a property calls for the transfer of title with the buyer taking over an existing mortgage, to document the buyer's unsecured promise to the seller to fully perform all terms of the mortgage.

DATE: ________________, 20_______, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This assumption agreement is entered into by

1.1 ____, as the Buyer,

1.2 and ____, as the Seller,

1.3 regarding Buyer's acquisition of real estate referred to as ______________________________________
____.

2. FIRST TRUST DEED NOTE:

2.1 Buyer is acquiring title to the real estate subject to a first trust deed dated __________________________,

2.2 executed by ____, as The Trustor,

2.3 in which ____ is the Beneficiary,

2.4 recorded on ________________________, as Instrument No. ____________________, in the Offical Records of ____ County, California, and

2.5 given to secure a promissory note of the same date for the principal sum of $___________________.

3. SECOND TRUST DEED NOTE:

3.1 Buyer is acquiring title to the real estate subject to a second trust deed dated _________________________,

3.2 executed by ____, as the Trustor,

3.3 in which ____ is the Beneficiary,

3.4 recorded on ____________________, as Instrument No.________________________, in the Official Records of ____ County, California, and

3.5 given to secure a promissory note of the same date for the principal sum of $___________________.

AGREEMENT:

4. Seller hereby assigns and delegates to Buyer all rights and obligations in the above note(s) and trust deed(s).

5. Buyer hereby assumes and agrees to timely pay the debt evidenced by the above promissory note(s) and to perform all of Trustor's obligations under the trust deed(s) securing the note(s).

6. This agreement is made for the benefit of the Beneficiary(ies) of the trust deed(s) securing the note(s).

7. If Buyer or Buyer's successors default in the performance of this agreement, the whole sum of the principal and interest on the assumed indebtedness(es) will become immediately due at the option of the holder of this assumption agreement.

7.1 On default, Seller is to become subrogated to the interest of Beneficiary under the defaulted note and trust deed.

8. In any action to enforce this agreement, the prevailing party is to receive attorney fees.

I agree to the terms stated above. Date:_______________, 20______	**I agree to the terms stated above.** Date:_______________, 20______
Seller: ____	Buyer: ____
Seller: ____	Buyer: ____

Cash contributions in a §1031 plan as an offset

Cash advanced by an investor to sell or purchase properties offsets cash items (unqualified properties) only when the investor receives them on or after they acquire ownership to the replacement property. [See Form 354 §1.13]

Cash invested includes all cash advanced by the investor in the §1031 reinvestment plan, **excluding** prorations paid or received on either closing. [See Form 354 §§1.9 and 1.10]

Examples of cash invested by the investor include:

- cash advanced by the investor toward the price paid to purchase the replacement property [See Form 354 §1.9]; or

- cash advanced or accruing to the account of the investor used to pay escrow closing costs on both the sale (or exchange) of their property and their purchase of replacement property, called *transactional costs*. [See Form 354 §1.10]

Cash does not include cash **paid by the buyer** to purchase the property sold (or funded by the buyer's lender) that is **disbursed by escrow** to pay off or reduce mortgages encumbering the property sold by the investor.

Here, the use of cash funds the buyer of the buyer's lender deposits in escrow which pay off a mortgage on the property sold does not constitute the receipt of cash by the investor. The funds were never available for disbursement to the investor on demand. The buyer's funds used for mortgage payoff are neither actually nor constructively received by the investor. Thus, the investor does not account for mortgage payoff funds deposited by the buyer or the buyer's lender.[4]

Again, mortgages whether paid off with the buyer's funds or taken over by the buyer are listed as debt relief. Any amount of mortgage relief not offset on the reinvestment is a withdrawal of capital, typical in a price trade-down situation. The withdrawal is taxed as profit recognized on the sale, limited as always to the total profit realized on the sale.[5]

Carryback notes and purchase-assist mortgages

An investor on the sale of the property sold carries back a trust deed note. The investor retains the note on closing rather than including it in the cash net proceeds sequestered with the §1031 trustee for reinvestment. Retaining the carryback note made payable to the investor triggers reporting and taxing of profit.

However, the amount of **profit allocated to principal** in a regular carryback note is not calculated on the profit-to-equity ratio for installment sale reporting. Allocation of profit to the carryback retained in a §1031 plan depends on whether the *cost basis* in the property sold is more or less than the principal balance on mortgages encumbering it.

Two profit allocation situations exist for an investor who withdraws capital by receiving a carryback note on the sale of the property sold in a §1031 plan:

1. The *mortgage principal* encumbering the property sold is greater than the amount of the property's cost basis, the **mortgage-over-basis situation** due to past refinancing of the property. Here, the entire amount of the carryback note is profit; or
2. The *cost basis* in the property sold is greater than the amount of the mortgage principal encumbering the property, the **basis-over-mortgage** situation. Here, the amount of cost basis exceeding the mortgage balance is first allocated to the note. Only then is profit allocated to the note for the portion of the principal not receiving the excess cost basis allocation [See Form 354 §5; see Chapter 28]

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4 **Garcia** v. **Commissioner** (1983) 80 TC 491

5 **Barker** v. **Commissioner** (1980) 74 TC 555

The investor avoids receipt of the carryback note and the reporting of profit by causing the note (and trust deed) to be made payable to and delivered to the §1031 trustee as part of the investor's net proceeds from the sale. All part of the mutual closing instructions given to escrow.

Carryback notes include all notes:

- **received by the investor**, secured or unsecured, in payment of the price received on their sale of a property [See Form 354 §1.5]; or
- **executed by the investor**, secured or unsecured, in part payment of the purchase price paid for the replacement property. [See Form 354 §1.11]

Critically, a carryback note executed by the investor to purchase replacement property offsets an equal amount of cash received by the investor **on or after** the date they close the purchase escrow. [See Form 354 §§1.8 and 1.11]

Managing the unqualified property's basis and profit

Unqualified properties, called *other property* by the IRS and commonly called *cash boot*, are properties exchanged which do not qualify as §1031 property. For example, an investor may:

- receive unqualified property on the sale of their property; or
- contribute unqualified property in part payment of the purchase price for the replacement property. [See Form 354 §§1.6 and 1.12]

Unqualified properties can be either real estate or personal property. Examples of **unqualified properties** include:

- the investor's **personal residence**, whether acquired in exchange for the property sold or exchanged to acquire replacement property. Here, they first deduct their $250,000 per individual §121 homeowner's exclusion for the profit in the home. Any profit remaining is subject to taxes depending on their §1031 withdrawals and contributions;
- **stocks**, **bonds** and **certificates for group investments** such as an existing co-ownership interest in a real estate investment group. Co-ownership includes fractional interests held in group investments vested in pass-through entities (LLC or partnerships) or as tenants in common (TIC) that, by vote, eliminate the unanimous approval of the right to buy or sell it;
- **personal property** exchanged or received in exchange, unless it qualifies for the 15%-of-value incidental property rule or as §1031 personal property exchanged for like-type personal property, such as trucks used in a business or furnishings in an apartment complex [See Chapter 24]; and
- **inventory** and other **dealer status property**, real or personal. [See Chapter 5]

Unlike other cash items such as cash, purchase-assist mortgages and carryback notes, **unqualified property** does not have a face value. Thus, the fair market value of unqualified properties needs to be set to determine the profit or loss reported on transferring or receiving it.

The investor's exchange of their unqualified property to purchase replacement property is treated as a sale of the unqualified property. The transfer is treated as though the investor sold the unqualified property for a cash price. The dollar amount set as the *value of the equity* in the unqualified property is additional capital contributed to purchase replacement property. [See Form 354 §2]

Occasionally, the unqualified property an investor contributes to purchase replacement property is encumbered by a mortgage. On transfer, the investor has debt relief in the amount of the existing mortgage. The debt relief is tracked in the reinvestment plan recap. [See Form 354 Instructions §§1.1 through 1.3]

Profit or loss on contribution of unqualified property

An investor contributes their equity in an **unqualified property** to pay part of the purchase price of replacement property. The equity is additional capital invested and is analyzed twice:

- first, the equity value offsets net debt relief from the property sold and any cash withdrawn on completion of the §1031 reinvestment plan [See Form 354 §§1.12 and 1.17]; and
- second, the transfer of unqualified property is treated as a "cash sale" and the profit or loss on its transfer is separately reported and taxed. [See Form 354 §2]

While the entire profit on the investor's sale of §1031 property might be exempt, the investor's contribution of unqualified properties toward the purchase of replacement property is separately reported as a sale since its transfer generates a taxable profit or loss.

The **profit or loss** on the investor's contribution of unqualified property is set as:

- the price of the unqualified property, when stated in the exchange or purchase agreement; less
- the investor's remaining cost basis in the unqualified property. [See Form 354 §§2.1 through 2.3]

Conversely, acceptance of unqualified property in exchange for the property sold triggers reporting of profits on the property sold. The profit reported on the property sold is equal to the value of the *equity* in the unqualified property received. No offset, then or later, can avoid profit reporting, unless the investor advanced cash when they sold their property, such as transactional costs. [See Form 354 §§1.6 and 1.18]

The value of the equity in the unqualified property the investor receives is included in the total profits realized on all aspects of the §1031 reinvestment plan. [See Form 354 §3.3]

Also, the profit or loss taken on the investor's contribution of unqualified property to purchase replacement property is entered in the Recap Sheet solely to set the overall profit or loss reported on all aspects of the §1031 reinvestment plan. [See Form 354 §4.2]

Unqualified property market value: priced or unpriced

The market values of all property exchanged between parties are arguably uncertain in amount. Without the involvement of any unqualified properties, the prices placed on the §1031 properties have no tax consequence.

However, when an equity in unqualified property is received or contributed by an investor, the investor needs to consider structuring the pricing of the §1031 properties to report taxable profit based on the lowest justifiable value they can place on the unqualified property.

Typically, prices set during negotiations for an exchange that includes unqualified property are all too often raised way out of proportion to cash values.

As a result, the purchase or exchange agreement ends up stating the negotiated price as the value of the unqualified property. These written agreements control the value of the unqualified property for tax purposes. Critically, the price in the exchange might justifiably be much lower, resulting in a lower reportable profit.

Alternatively, for negotiating agreements, the value of unqualified property received on a sale or contributed to purchase a replacement property is left **unpriced**. When the value of the unqualified property is unstated in exchange or purchase agreements, the transaction is called an *unpriced exchange*. The true price is left for determination on later reflection when reporting. Also, all properties in the exchange are left unpriced.

Hindsight, rather than negotiated prices, provides a better perspective for establishing values set to report profits or losses.

Both sides in an exchange transaction involving the transfer of any unqualified property want the lowest justifiable price. Both sides will report some profit (or loss) on its exchange due to the unqualified property.

All the profits on the property sold or exchanged

Without an *exemption or exclusion* of profit from taxes, the **profit realized** on all sales or exchanges of any property is reported and taxed, called a recognized gain.[6]

As tax policy, IRC §1031 either fully or partially *exempts* the profit on the sale or exchange of like-kind properties from being reported and taxed.

6 Internal Revenue Code §1001

In a **partial §1031 reinvestment**, the investor reports a portion of the profit they realize on the sale. To experience a partial exemption, the purchase price for the replacement property is less than the price the investor receives for the property they sold, called a *price trade-down* situation.[7]

For example, the price received for property the investor sold is greater than the price paid for the replacement property. The difference between property prices in this trade-down situation is the amount the investor reports as profit — limited of course to the total profit realized on the sale. [See Form 354 §3.13]

Reportable profit limited to the total profit, of course

The Recap Sheet sets the amount of all profits taken on the sale or exchange of property, called *realized gain* by the IRS. The **realized gain** is the maximum amount of profit reportable and taxed, as though the profit exemption did not exist. Realized gain always includes the profit exempt from taxation in a §1031 reinvestment.

However, the portion of the realized profit taxed in a §1031 reinvestment plan, called *recognized gain* by the IRS, is the lesser of:

- the profit the investor realizes (price minus basis) on the sale or exchange of the property sold [See Form 354 §3.13]; or
- the total of the net existing mortgages and *net cash items* the investor receives in a §1031 reinvestment plan (but not less than zero), plus the profit or loss on any unqualified property the investor contributes to purchase the replacement property. [See Form 354 §§ 1.19 and 2.3]

Profit reported on the §1031 transaction

The profit reporting analysis for the property sold in a reinvestment plan is concluded in the last section of the Recap Sheet. Further calculated is the reportable profit on the entire §1031 reinvestment plan.

No loss is reported on a §1031 transaction. Any loss in an exchange is implicitly carried forward with the cost basis as is the exempt profit. However, in an exchange where the investor contributes unqualified property with a value less than its remaining cost basis, the transfer of the unqualified property is separately reported as a cash sale. Here, the loss generated on its contribution is reported, separate from the §1031 transaction report.

The total taxable **profit** on a §1031 reinvestment is the lesser of:

- the total of the amounts of mortgage relief and cash items received by the investor which remains after offsets [See Form 354 §4.3]; or
- the total **profits realized** on all property sold or contributed by the investor (in which case a reinvestment plan and the §1031 exemption are unnecessary). [See Form 354 §4.4]

In §1031 transactions where the investor withdraws no capital by way of net debt relief or **net cash items**, no profit or loss is reported on the §1031 property sold or exchanged by the investor.

net cash items
The sum of the amount of cash items from the sale of the property sold received prior to acquiring replacement property, plus the amount of cash items received on or after the purchase of replacement property which exceed the contribution of cash items toward acquisition of the replacement property.

7 IRC §1031(b)

Consider a loss incurred on the sale of a like-kind property with a basis of $1,000,000 that has fallen in value to a current market price of $750,000. When the net proceeds from the sale are reinvested in replacement property, this loss is implicitly carried forward with the cost basis to the replacement property. The reporting of the loss is not allowed. In the opposite situation, however, a cash-out sale of the property with no further nexus to a purchase of replacement property produces a reportable loss of $250,000.[8]

8 **Redwing Carriers, Inc.** v. **Tomlinson** (5th Cir. 1968) 399 F2d 652

Chapter 30 Summary

When selling an investor or business-use property, an investor has a tax objective of eliminating or at least minimizing taxes on the profit realized on the sale. The investor reinvests the capital interest they had in the property sold in a replacement property (its market value comprised of mortgage principal and equity value) to meet this tax objective.

This reinvestment maintains the foundational premise of the §1031 profit exemption —continued investment in real estate without the payment of profit taxes on the sale. The investor essentially "exchanges" equity in one property for the equity in another property.

Cost basis and profit are the opposite sides of one coin and mortgage debt and equity are the opposite sides of another — the only link between them is the fair market value of the property sold. The cost basis in a property is never the same amount as the debt on the property and the same is true of profit and equity.

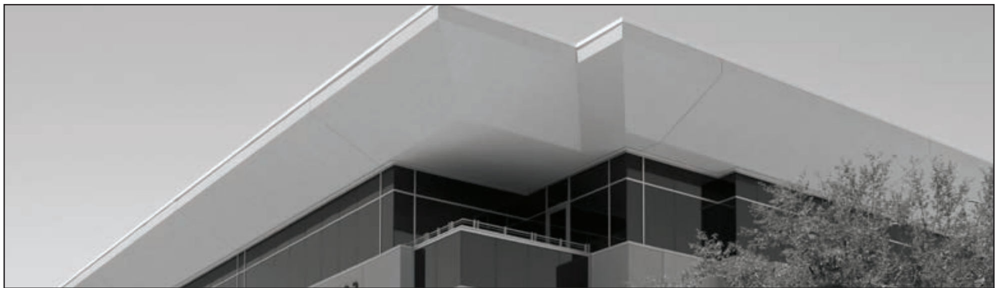
A tax analysis of a sale of §1031 property goes beyond the mechanics of avoiding receipt of the net sales proceeds from the property sold and complying with time limitations and procedures for identifying and acquiring replacement property. A §1031 Basis and Profit Recap Sheet, called the Recap Sheet is a checklist of all the §1031 issues to be considered.

The Recap Sheet is used to approximate the tax consequences of a potential §1031 transaction on locating a potential replacement property. An agent also uses the Recap Sheet to analyze the flow of capital invested, contributed or withdrawn by an investor may experience when selling and buying properties in a §1031 reinvestment plan. The Recap Sheet contains five sections.

The broker and investor must complete all the sections to fully appreciate the contrasting tax consequences of a reportable profit versus a §1031 reinvestment. While the Recap Sheet determines how much of the profit on the sale will be reported due to the §1031 reinvestment, the Recap Sheet does not determine the amount of taxes an investor might pay.

Chapter 30 Key Terms


NOW SHOWING
PROFESSOR BILL
SELLER'S AGENT
BUYER'S AGENT
VIDEO RENEWAL COURSE™
LOVE MOVIES?
LOVE MOVIES?
Knock out your CE with the only cinematic license renewal in California
Enroll now



Chapter 31

The cost basis for the replacement property

Learning Objectives

After reading this chapter, you will be able to:

- estimate the cost basis for a replacement property to be acquired so you can estimate the depreciation deductions and tax benefits of its ownership for your investor; and
- allocate the cost basis as a priority to set the basis and profit in any carryback note received by the investor and any unqualified property taken in exchange for the property sold.

Key Terms

cash boot **net debt relief**

The annual depreciation deduction offsets income

Again, consider an investor who enters into an agreement to sell real estate. Closing the sale is contingent on the investor's purchase of another property as part of a §1031 reinvestment plan.

When a replacement property suitable for the investor to buy is located, its operating data is gathered to prepare an Annual Property Operating Data Sheet (APOD form) as an aid to initially determine the economic feasibility of the property. [See **RPI** Form 352]

Tax-wise, you use the APOD form to estimate the investor's yearly *reportable income* or loss from annual operations and ownership. The estimate is based on the replacement property's current operating income and expenses as disclosed by the seller's agent and updated for new ownership – 12 months of interest in any mortgage payments, and the annual depreciation deduction.

However, the depreciation deduction to be entered on the APOD is derived from the investor's cost basis in the proposed replacement property. The deduction is computed differently for a replacement property in a §1031 reinvestment plan than for a stand-alone purchase.

To estimate the depreciation deductions in a §1031 reinvestment to reflect ownership of the replacement property, you first prepares a *§1031 Profit and Basis Recap Sheet*. The Recap Sheet, in addition to identifying any reportable profits or losses on the property sold, sets the adjusted *cost basis* for a proposed replacement property. [See **RPI** Form 354; see Chapter 21]

After the cost basis is set by a workup of the Recap Sheet, you allocate a portion of the cost basis to the property's *depreciable improvements*. The allocation of cost basis to improvements is worked up on a separate §1031 Basis Allocation Worksheet and entering the cost basis amount. The allocation of basis to improvements is based on the percentage of the replacement property's fair market value (FMV) represented by the value of the improvements, exclusive of the value in the land. [See Form 355 accompanying this chapter]

You then calculate the depreciation deduction allowed for 12 months of ownership on the allocation worksheet and enter it on the APOD form. The applicable depreciation schedule (either 27.5, 39 or 40 years) provides for the annual recovery of a portion of the investor's capital invested in the property's improvements as an untaxed offset from rental income.[1]

The annual amount of the depreciation deduction is then entered on the APOD form to finish the annual reportable operating income or loss estimated for the proposed replacement property to be reviewed with the investor.

As a point of confidentiality, the investor's cost basis in their property and the amount of their profit is uninvolved in *negotiations* between the investor and the buyer of the property sold. Likewise, the investor's basis and profit when considering a replacement property are of no legal, financial or tax concern to the seller of the replacement property.

*Editor's note —Section 5 of **RPI** Form 354 brings together the cost basis adjustments discussed above to establish the cost basis allocated to the replacement property. Allocations of the cost basis to cash items withdrawn by an investor or allocations between two or more replacement properties are calculated on a separate allocation worksheet form as discussed below. [See Form 355]*

Establishing the cost basis for replacement property

A separate cost basis and depreciation schedule is established for each replacement property an investor acquires in a §1031 reinvestment plan. An investor's agent anticipates the need for the cost basis to set the annual depreciation deduction by preparing approximations before the acquisition is fully negotiated and under contract.

1 Internal Revenue Code §168(c), 168(g)

The agent calculates the investor's likely basis in all proposed replacement property using the §1031 Recap Sheet, as follows:

- *carry forward* the remaining cost basis from all types of properties the investor sells or exchanges in the reinvestment plan [See Form 354 §5.3];
- adjust the cost basis carried forward to net out *differences in existing debt* on the property sold and the property purchased, and in the dollar amounts of **cash boot** contributed or withdrawn [See Form 354 §5.1 and 5.2];
- adjust the basis for *profit or loss* the investor reports for any contribution of personal property to acquire the replacement property [See Form 354 §5.4]; and
- total the above to set the *new cost basis* to be allocated between all types of properties received on completion of the reinvestment plan.[2] [See Form 354 §5.5]

cash boot
Items of value received on a sale of property or contributed to purchase replacement property in a §1031 reinvestment plan which include money, carryback notes, purchase-assist financing for the replacement property, and equity in property not qualified as §1031 like kind property. Also called money and other properties by the IRS.

The calculations for each of these adjustments and allocations is reviewed in the following subsections of this chapter.

After determining the amount of the new cost basis, you establish the cost basis for each replacement property individually. The new cost basis is allocated between all properties and cash items received in the following order of priority:

- for any carryback note received by the investor, enter the dollar amount by which the basis carried forward exceeds the mortgage amount on the property sold, limited to the amount of the carryback note [See Form 355 §2];
- for any *unqualified properties*, real or personal, received by the investor in exchange for their property, enter the dollar amount of the *equity* in the unqualified properties [See Form 355 §3];
- the *remaining basis* is entered as the cost basis for the §1031 replacement property; and
- allocate the cost basis entered for the replacement property between its land and improvements. [Rev. Regs. §1.1031(d)-1(c); see Form 355 §4.1]

The portion of a replacement property's cost basis allocated to its improvements represents the amount of invested capital the investor recovers during ownership as an untaxed offset from rents.[3] [See Form 355 §5]

The agent then calculates the annual depreciation deduction taken annually as a pro rata amount of the cost basis allocated to improvements over the number of years set by IRS schedules (27.5, 39 or 40 years). [See Form 355 §6] ,

Generally, an investor's cost basis in a property is the price paid to acquire it plus capitalized transactional costs and further improvements. However, in a §1031 transaction, the cost basis for the replacement property is not based on the price paid for the replacement property.

2 Revenue Regulations §1.1031(d)-1
3 Rev. Regs. §1.1031(d)-1(c)

The price paid for a replacement property comprises the sales proceeds reinvested (or equity exchanged) and mortgages assumed. The investor's capital interest in the replacement property contains unreported profits implicitly carried forward from the sale (or exchange) of the property sold.

Again, the unreported profit carried forward from the property sold, called unrecognized gain by the IRS, is the difference between the price paid for the replacement property and its cost basis on acquisition. [See Form 354 §3.13]

The following subsections lay out the calculations for adjustments to the cost basis carried forward to establish the adjusted cost basis to be allocated to one or more replacement properties received in a §1031 reinvestment plan.

Adjustments made to the cost basis carried forward

All property sold or exchanged by an investor has a cost basis of some amount, whether the property is §1031 property or unqualified property. Again, the cost basis in each property sold is carried forward, subject to adjustments, to establish the cost basis for the replacement property. [See Form 354 §5.3]

Adjustments are made to the cost basis carried forward for the following capital items:

- *existing debt*: adjust the basis for the net increase or decrease between the amount of the existing mortgages on the property sold or exchanged and the amount of the existing mortgages taken over on the replacement property. [See Form 354 §1.3 and 5.1]
- *cash items*: adjust the basis by a decrease for the amount of any cash, carryback notes and equity in unqualified property the investor withdraws or receives at any time, and further adjust the basis by an increase for the amount of cash the investor contributes, transactional costs paid on both the sale and purchase, any carryback notes the investor executes to buy the replacement property, and the value of the equity in any unqualified property contributed to purchase the replacement property. [See Form 354 § 1.7 to 1.12 and 5.2]
- *profits reported*: adjust the basis by an increase or decrease for the amount of any profits or losses reported on the sale of the property sold and in any unqualified property the investor contributes to acquire the replacement property. [See Form 354 §4 and 5.4]

The old basis carried forward, coupled with these adjustments, sets the new cost basis to be allocated among all personal and real property the investor purchases or acquires as part of a §1031 reinvestment plan. [See Form 354 §5.5]

Handling adjustments for existing mortgages and cash items

When the dollar amount of **net debt relief** on the property sold is not offset on acquisition of the replacement property. the investor reports and is taxed on profit they realize on the property sold in a §1031 reinvestment plan. Debt relief is offset by the investor's assumption of mortgages, execution of purchase-assist financing or contribution of cash items on the purchase of replacement property. [See Form 354 §1.3 and 4.1]

The lack of offsets produces *net debt relief* which is deducted from the basis carried forward. This adjustment reflects the investor's reduction of their continuing capital investment – debt is borrowed capital. As a result of profit taxed due to net debt relief, the profit reported is added to the basis carried forward. [IRC §1031(d); Rev. Regs. §1.1031(d)-1(c); See Form 354 §1.3 and 5.1]

net debt relief
The amount of the existing mortgage balance encumbering the property sold not offset by the assumption of mortgage balances or contribution of cash items on acquiring replacement property in a §1031 reinvestment plan. Also called mortgage boot.

Separate from debt relief but will offset debt relief, *cash items* include cash, carryback notes and unqualified properties, called *money and other property* by the IRS and commonly just called cash boot.

To net out cash items for adjustment to the cost basis carried forward, cash items are first grouped as either withdrawals or contributions by the investor in the reinvestment plan. Here, the dollar value of each cash item – the equity value in unqualified property – the investor withdraws or receives on either the sale of their property or their purchase of replacement property is deducted to decrease the cost basis carried forward. These represent a *withdrawal of capital* from the investment. [See Form 354 §5.2(a) and 5.2(b)]

Conversely, the amount of cash items the investor contributes – cash, carryback notes they execute, and the equity in unqualified property – to purchase replacement property is added to increase the cost basis carried forward. These additions to basis represent *additional capital investment*.[4]

Contributing unqualified property to acquire §1031 property

Property, including real estate not qualified as §1031 property, contributed by the investor in exchange for replacement property constitute the additional investment of a *cash item*. However, accounting for the contribution of non-§1031 property is handled differently from accounting for cash contributions, such as cash or the execution of a carryback note to acquire replacement property.

Critically, unqualified property the investor owns and contributes to the purchase of replacement property has a cost basis (and possibly a taxable profit) in their hands.

The fair market value (FMV) of the unqualified property the investor contributes, less the remaining cost basis in that property, sets the profit or loss taken when it is contributed to acquire replacement property. Remember: price minus basis equals profit. [See Form 354 §2]

Adjustments to the cost basis carried forward to the replacement property due to the investor's contribution of unqualified, non-§1031 property include:

- any *existing debt* encumbering the unqualified property contributed is entered as further debt relief by an adjustment to decrease the cost basis, equivalent to a withdrawal of invested capital whether the buyer assumes or refinances the mortgage [See Form 354 §1.1, 1.3 and 5.1];[5]
- the *cost basis* remaining in the unqualified property is added to increase the basis carried forward to the replacement property [See Form 354 §5.3(b)]; and

4 Rev. Regs. §1.1031(d)-2; see Form 354 §5.2(c), 5.2(d) and 5.2(e)

5 Rev. Regs. §1.1031(d)-2

Form 355

§1031 Basis Allocation Worksheet

§1031 BASIS ALLOCATION WORKSHEET

Replacement Property Depreciation Analysis
(Supplement to §1031 Recapitulation Worksheet Form 354)

Prepared by: Agent ____________ Phone ____________
Broker ____________ Email ____________

NOTE: This form is used to determine the annual depreciation deduction to be entered on APOD ft Form 352 to set the after-tax return on property to be acquired.

DATE: ____________, 20______, at ________________________, California.

Items left blank or unchecked are not applicable. References to forms includes their equivalent.

Prepared by: ____________

Property sold or exchanged: ____________

Replacement property: ____________

1. **Cost basis** allocable between replacement property and cash items received:
   - 1.1 Enter the cost basis for all replacement properties as calculated on **ft** Form 354 at line 5.5. . . . . $______________
     (If no unqualified property or carryback note was received for the property sold, go to line 4.1)
2. Priority allocation of basis to installment **note carried back** on the property sold:
   - 2.1 Enter the **cost basis carried forward** from the property sold (as shown on **ft** Form 354 at line 3.7) . . . . $______________
   - 2.2 Enter the **debt relief** on the property sold. . . . . . . (-)$______________
   - 2.3 **Cost basis of note**: If the amount of line 2.1 exceeds the amount of line 2.2, enter the difference, limited to the amount of the note (as shown on **ft** Form 354 at line 1.5) . . . . (-)$______________
3. Priority allocation of basis to **unqualified property received**:
   - 3.1 Enter the amount of the **equity** in the unqualified property received (as shown on **ft** Form 354 at line 1.6). . . . . . . (-)$______________
   - 3.2 Enter the amount of any **debt** which encumbers the unqualified property received. . . . . . . $______________
   - 3.3 **Cost basis for unqualified property**: Enter the total of line 3.1 plus 3.2 to set the cost basis in the unqualified property received in exchange for the property sold. $0.00
4. Allocation of the remaining cost basis to **§1031 Replacement Property:**
   - 4.1 Enter the sum of line 1.1 minus lines 2.3 and 3.1 as the cost basis of all **§1031 Replacement Property** received. . . . . . . (=)$0.00
   - 4.2 Allocation of basis between **two or more §1031 Replacement Properties**:

		Property 1	Property 2		Total
a.	**Identification**: (Enter an identification for each §1031 property received)	______	______		
b.	**Allocation for debt**: (Enter the amount of debt assumed on each property 1 and 2.) (Enter the total of the debts assumed on both properties.)	$______	$______	(-)	$0.00
c.	**Basis to be allocated**: (Enter the amount at line 4.1 minus the total from line 4.2 b.)				$0.00
d.	**Equity valuation**: (Enter the **equity value** given each property 1 and 2.) (Enter the total value of the equities in both properties.)	$______	$______	(=)	$0.00
e.	**Equity ratios**: (Enter the percentage of each property's pro rata share of the total value of all equities from line 4.2 d.)	____%	____%	=	100%
f.	**Allocation for equity**: (Enter the amount of each property's pro rata share of line 4.2 c. based on line 4.2 e. percentages.)	$0.00	$0.00		
g.	**New cost basis**: (Enter the total of the amounts allocated to each property at line 4.2 b. and 4.2 f.)	$0.00	$0.00		

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- the amount of profit reported as taxable triggered by the contribution of unqualified property is added to increase the cost basis carried forward.[6] [See Form 354 §2.3, 4.2 and 5.4]

For example, consider an investor who exchanges a $100,000 value in an airplane as partial payment toward the price paid for replacement property.

The transfer of the airplane is reported as a separate sales transaction. Any profit on the sale of the airplane does not qualify as *like-kind property* for the §1031 profit tax exemption. Any profit or loss included in the price of the airplane is separately reported and taxed. [See Form 354 §2.3 and 4.2]

6 Rev. Regs. §1.1031(d)-1(e)

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5. Depreciable cost basis for **a single replacement property**:

5.1 Enter the percent of the replacement property's market value represented by the market value of its improvements . . . . _____%

5.2 **Depreciable Cost Basis**: Enter that portion of the basis at line 4.1 (or 4.2 g.) which represents the percentage of value attributable to improvements at line 5.1 . . . . $0.00

6. Depreciation deduction from income for each year of ownership:

6.1 **Depreciation Schedule**: Enter the number of years for recovery of the cost of improvements . . . . ÷ ______ years
(27.5 years for residential; 39 or 40 years for nonresidential)

6.2 **Annual Depreciation Deduction**: Enter the result of dividing the depreciable cost basis at line 5.2 by the number of years at line 6.1 . . . . = $______________
(Enter this amount on APOD **ft** Form 352 as the annual depreciation deduction for the replacement property)

6.3 The estimated annual depreciation deduction at line 6.2 is probably understated. From the property sold, the amount of the annual depreciation deduction and the years remaining on the recovery period at the time of sale are carried forward (as is the cost basis) and reported as the *depreciable exchange basis* for the replacement property (or reported as extended 11.5 years if the property sold was residential property and the replacement property is nonresidential). Any upward adjustment in the depreciable basis in the replacement property over the remaining depreciable exchange basis from the property sold (due to a trade up into the replacement property) is separately set up as the replacement property's *excess depreciable basis*, and is deductible over the 27½- or 39-year depreciation schedule applicable to the replacement property.

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Form 355

§1031 Basis Allocation Worksheet

page 2

Since the airplane as unqualified property is capital contributed to acquire replacement property, both the basis and the profit reported as a sale of the airplane are added to increase the basis carried forward – an amount equal to its value it represents in the replacement property. [See Form 354 §5.3(b) and 5.4]

Further, the amount of any mortgage encumbering the airplane is a reduction in the basis – it is debt relief by assumption or refinance on its transfer by the buyer. [See Form 354 §1.1 and 5.1]

Priority allocation of the adjusted cost basis

When the investor does not receive a carryback note or unqualified property on the sale of their property, the cost basis carried forward, adjusted for net debt and net cash items, is allocated in its entirety to the §1031 replacement properties. [See Form 355 §4.1]

The adjusted cost basis, estimated using the §1031 Profit and Basis Recap Sheet, is allocated among all types of properties the investor acquires in a §1031 transaction - §1031 property, cash, carryback notes or unqualified real or personal property.

When the investor receives a carryback note or unqualified property on the sale or exchange of their property, the adjusted cost basis is first allocated to any carryback note, then to unqualified property the investor receives. The remaining cost basis is allocated to the 1031 replacement property.[7]

7 IRC §1031(d); Rev. Regs. §1.1031(d)-1(c)

Further, the priority allocation of basis to the carryback note only occurs when the amount of the cost basis in the property sold is greater than the mortgage amounts that encumber it, the typical *basis-over-mortgage* situation.

Again, when the basis in a property sold is $300,000 and the debt on the property is $200,000, the $100,000 difference is the amount of basis-over-mortgage. This difference in overriding basis is first allocated to the carryback note received by the investor. The allocation is limited to the amount of the note. [See Form 355 §2]

The basis-over-mortgage condition results in a *return of capital* (which is not taxed) due to installment sales reporting of a carryback note on the property sold in a partial §1031 reinvestment plan. After the priority allocation of the excess basis, the remaining portion of the principal in the note is profit, taxable on a pro rata basis each year as principal is received on the note.

An investor occasionally receives unqualified property such as a boat, car, plane, equipment, furnishings or a personal residence "in trade" on the sale of their real estate. Any unqualified property the investor acquires is given a *priority allocation* from the adjusted cost basis for the dollar value of its equity. [See Form 355 §3]

Thus, when the unqualified property the investor receives is encumbered, the amount of the adjusted cost basis allocated to it is equal to its *equity value*. Then added together, the debt on the unqualified property and the basis allocated to its equity become the cost basis in the unqualified property the investor receives — like when a cash price is paid to buy the unqualified property.

The basis remaining after all priority allocations becomes the basis for the §1031 replacement properties. [See Form 355 §4]

Basis allocated among two or more replacement properties

Occasionally, an investor acquires two or more §1031 replacement properties to complete a §1031 reinvestment. The new cost basis is allocated between the replacement properties based on the price paid for each — but only when the replacement properties are free of any mortgages.[8]

When the investor acquires two or more replacement properties, one of two situations arise:

- the multiple replacement properties are *unencumbered*, with no debt taken over by the investor, as mentioned above; or
- one or more of the multiple replacement properties is *encumbered* by debt taken over by the investor, as covered below.[9]

Allocation of the cost basis among multiple replacement properties has no relationship to the allocation of each replacement property's cost basis between its land and improvements. Critically, future depreciation deductions are based solely on the basis allocated to improvements.

8 Revenue Ruling 68-36

9 Rev. Rul. 68-36

Basis allocated among debt free replacement properties

Consider an investor who acquires two replacement properties to complete their §1031 reinvestment plan. The combined price paid is the same as the price received for the property sold.

All properties sold or exchanged and bought are free of debt. Thus, the investor receives no debt relief and no debt is acquired. Also, no cash boot is involved.

Here, the basis carried forward needs no adjustment before it is allocated between the two replacement properties. The cost basis to be allocated is the same amount as the basis in the property sold. No debt relief or cash items exist for adjustments.

The remaining basis in the property the investor sells is $600,000. Its sales price is $1,200,000. Both the property sold and the replacement properties are free and clear.

The price the investor pays for each of the replacement properties is $500,000 and $750,000, respectively, a total of $1,250,000. This is approximately the same total amount as the price received for the property sold.

To allocate the cost basis between the two replacement properties, the investor needs to first determine the percentage of each replacement property's pro rata share of the total value of all §1031 replacement properties received in the reinvestment plan:

- $500,000 of $1,250,000 total for the first property received — a 40% allocation of the cost basis; and
- $750,000 of $1,250,000 total for the second property received — a 60% allocation of the cost basis.

Of the $600,000 cost basis to be allocated, $240,000 (40%) goes to the first property, and $360,000 (60%) goes to the second. [See Form 355 §4.2]

Finally, the basis allocated to each replacement property is further broken down and allocated between its land and improvements. The allocation to improvements for each replacement property is based on the ratio of the value of the improvements on each property as a percentage of the total price paid for each property. [See Form 355 §5]

Basis allocated among encumbered replacement properties

Usually, multiple replacement properties are encumbered with different loan-to-value (LTV) ratios. However, IRS regulations do not address basis allocation among multiple encumbered replacement properties, except that the allocation is to occur. Existing regulations only discuss allocating basis when the replacement properties are free and clear of mortgage debt – a rare reinvestment situation easily understood as noted above.

To allocate basis among encumbered properties you set a ratio based on the value of equity in each property, not the price of each. You first allocate basis to each §1031 replacement property in the amount of the debt assumed on each property – the "debt basis." [See Form 355 §4.2(b) and 4.1]

The cost basis remaining after the priority allocation for debt is the "equity basis." This remaining "equity basis" is allocated to each property based on the ratio of the equity in each property. [See Form 355 §4.2(c), 4.2(d) and 4.2(f)]

Finally, total the basis allocated to each property for mortgage debt amounts and equity valuations to set the new cost basis in each of the replacement properties. [See Form 355 §4.2(b), 4.2(f) and 4.2(g)]

Thus, the mortgage-to-value disparity between two or more replacement properties does not cause a highly leveraged property to end up with a disproportionately low basis compared to its mortgage amount. This distortion occurs when the allocation is based on the value of each replacement property, rather than on the amounts of their debts and equities.[10]

10 Rev. Rul. 68-36

Chapter 31 Summary

As part of a §1031 reinvestment plan, once a suitable replacement property is located, its operating data is gathered to prepare an Annual Property Operating Data Sheet (APOD form). The APOD form is an aid to initially determine the economic feasibility of the property.

Taxwise, the APOD form is used to estimate the investor's yearly reportable income or loss from annual operations and ownership. The estimate is based on 12 months interest in any mortgage payments and the annual depreciation deduction.

The depreciation deduction is derived from the investor's cost basis in the proposed replacement property and is to be entered on the APOD form. The portion of a replacement property's cost basis allocated to its improvements represents the amount of invested capital the investor recovers during ownership as an untaxed offset from rents.

To estimate the depreciation deductions, the investor prepares a §1031 Profit and Basis Recap Sheet. The Recap Sheet, in addition to identifying any reportable profits or losses on the property sold, sets the cost basis to be allocated to the replacement property.

After the cost basis has been set on the Recap Sheet, the broker enters the basis on the separate §1031 Basis Allocation Worksheet to allocate a portion of the cost basis to the property's depreciable improvements. The allocation of basis to improvements is based on the percentage of the replacement property's fair market value (FMV), represented by the value of the improvements.

Property sold or exchanged by an investor has a cost basis (even when it is zero), whether the property is §1031 property or unqualified property such as dealer property, the investor's principal residence or personal property. The cost basis remaining in each property sold or exchanged by an investor in a §1031 reinvestment plan is carried forward to establish the cost basis for the replacement property.

Chapter 31 Key Terms


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Chapter 32

Change of ownership and assessment of replacement home

Learning Objectives

After reading this chapter, you will be able to:

- determine how the County Assessor sets a property's base year value assessment and taxable value on a change in ownership;
- recognize the exemptions and exclusions as claims by a new owner which lower a property's taxable value below the property's FMV;
- advise on the exclusions from taxable value on transfer of factored base year value to a replacement primary residence or on conveyance of the family home and farm between parent and child.

Key Terms

assessed taxable value
base year value
change of ownership
exclusions
exemptions
factored base year value

Property taxes geared to base year value assessment

Property taxes beginning in 1978 are limited in dollar amount to 1% of a property's **assessed taxable value**. To implement this change, each time a property has a **change of ownership** the County Assessor determines its *fair market value* (FMV) and maintains the FMV as the property's **base year value assessment**. The property's *taxable value* used to calculate property taxes is set annually as the amount of the **factored base year value** as adjusted annually for consumer inflation, minus any exemptions the owner qualifies to claim.

exclusions
Types of property-tax avoidance claims arising when a primary residence is replaced resulting in a base year value reassessment less than FMV and on transfers of the family home or family farm between parents and children eliminating up to $1,000,000 from assessed taxable value.

When the taxable value reflects a family exclusion (not an exemption), the taxable value is separately adjusted for inflation from the adjustment to the base year value. Transfers on the sale and replacement of a primary residence of the factored base year value are not **exclusions** or **exemptions**, as presented later in this chapter.

Before setting the amount of each year's assessed taxable value during ownership, the Assessor applies a rate of consumer inflation to the prior year's base year value assessment. This calculation sets the increased amount of the current year's factored base year value which the Assessor uses to determine the property's *assessed taxable value* for the Tax Collector to levy property taxes due from the owner.

The inflation adjustment rate is the lesser of California's consumer price index (CPI) figure for the prior year or 2%. This annual adjustment is a compounding of the rate of inflation.

base year value
The assessment set by the County Assessor for the first year following a change of ownership as the fair market value (FMV) of a property on the date the new owner acquired it.

For property acquired or constructed prior to February 1975, the property's **base year value** assessment is set as its FMV in *1975* (a recession year of low values). All **change of ownerships** after February 1975 have a base year value set as the property's FMV on the date of acquisition or completion of construction.[1]

change of ownership
A conveyance of title to real estate resulting in transfer of the beneficial use of the property which triggers reassessment of the property by the County Assessor to set the property's new base year value.

Before 1975, real estate was subject to reassessment every year. A property's assessed taxable value changed annually (or less periodically as a practical matter) to reflect annual changes in property values brought about by asset inflation or deflation and any appreciation due to the demographics of the local real estate market.

Today, assessed taxable values for setting property taxes result from the annual inflation adjustments rising from the base year value assessment initially set at FMV on a change of ownership, not a change in the property's FMV from year to year. Increases of a property's FMV in future years no longer controls the amount of a property's assessed taxable value. Thus, a rise in FMV during ownership does not influence the amount of property tax the owner will pay.

Conversely, in forward years when the FMV of a property drops below its factored base year value assessment (or the taxable value if less), the property's assessed taxable value becomes temporarily unanchored from the base year value assessment. During the years a property's FMV is less than the factored base year value, the Assessor sets the property's taxable value at the current fair market value (FMV).

Meanwhile, the calculation of the annual factored base year value assessment continues to set the ceiling for the property's assessed taxable value. When in future years the property's FMV rises above its factored base year value assessment, the taxable value returns to be set by the factored base year value and the greater FMV no longer controlling.

1 California Constitution, Article 13A

March 1st of each year is the *lien date* on which property taxes, based on the amount set as the assessed taxable value for the year, are imposed as a lien on the property for the upcoming fiscal year (July 1 through June 30).

The annual work of the property tax creep

Consider a parcel of real estate purchased this year in a conventional sale for the price of $1,000,000. Its base year value assessment is $1,000,000 on March 1, the lien date for the first year of the buyer's ownership. Since the buyer claims no exemptions or exclusions the **assessed taxable value** used for property tax purposes is set at $1,000,000 – the base year value assessment.

assessed taxable value
The annual valuation of property set by the County Assessor as the sum of the base year value, factored for inflation, minus exemptions and exclusions, for use by the County Tax Collector to levy annual property taxes, commonly referred to as the assessed taxable value or current taxable value for a property.

Here, the property taxes for the first fiscal year — July 1 to June 30 — are limited to 1% of the assessed taxable value, a tax due to the Tax Collector of $10,000.

Each year the base year value assessment is increased at the rate of consumer inflation, limited to 2%. The adjusted assessment amount for ownership after the first year is labeled the *factored base year value* assessment. Accordingly, the assessed taxable value of the property for the second fiscal year of ownership is increased to $1,020,000 – the factored base year value for the year. Thus, the property tax due for the second fiscal year of ownership is $10,200, 1% of $1,020,000.

Since the annual inflation increase is compounded, the 2% inflation adjustment for the base year value increase in the third fiscal year of the buyer's ownership is calculated on the prior year's factored base year value of $1,020,000, not the initial base year value at FMV for the year of purchase. Here, the property's assessed taxable value for the third fiscal year is $1,040,400, with a 1% property tax of $10,404.[2]

The inequities of California's evolving property tax experiment

Avoiding FMV reassessment is financially significant when you have family, have longevity of ownership, and great timing. Since 1980 (but not during the prior period back to WWII), California asset price inflation for the FMV of real estate has averaged around 3.5% annually, far exceeding the consumer inflation adjustment a property's assessed taxable value for setting property taxes is tied to.

The assessed taxable value over the years a property is held by a long-term owner comprises a constantly declining percentage of the property's inflated and appreciated asset value in California's real estate market. This market price movement was driven primarily by declining long-term interest rates during the past half-cycle of mortgage rates beginning in 1980. Interest rates, whether ascending or declining directly influence the capitalization rate for return on cash invested. This cap rate, in turn, sets asset values in all types of markets – the lower the cap rate the higher the price of assets, or conversely as in the reciprocal P/E ratio for stockholders as they like all things to rise higher.

2 **Armstrong** v. **County of San Mateo** (1983) 146 CA3d 597

As the ratio of assessed-value to asset-value increased after 1980 through 2020, say from 1:1 to 1:4 as with a four-fold price increase, the tax-to-FMV percentage for real estate ownership decreased from 1% to 0.25% of FMV. The same financials occur for income property operations where the percentage of rental income expended to pay property taxes drops in tandem.

These distortions between assessment figures and current FMV are in part the result of the annual base year value adjustment being restricted to consumer inflation, not *asset inflation*. Okay for the fixed income homeowner; a windfall for investors yet to be corrected.

As interest rates rise cyclically in the coming decades following 2020, annual market value increases will more closely align with the annual maximum 2% consumer inflation adjustments reflected in assessed taxable values.

Also of note: Because turnover of ownership - other than a family home and farm from parents to children - generates additional property tax revenue for local governmental agencies, the Prop 13 change-of-ownership property tax law is often referred to as the "Welcome Stranger" law. Said another way, "our community needs services the extra revenue will fund."

Single-family residence, owner-occupant, $7k exemption

California homeowners who occupy a dwelling they own as a principal residence are entitled to claim a $7,000 *exemption* from the property's annual assessed taxable value. This exemption translates into a property tax reduction of $70. California's housing policy uses the tax codes to encourage ownership of a residence rather than renting a residence. [Calif. Const. Art. 13 §3(k)]

exemptions
Types of property-tax avoidance claims made by the owner for setting the annual taxable value at zero or by subtracting a fixed dollar amount from the property's base year value.

For example, consider a homeowner whose principal residence has a factored base year value of $400,000. Due to the $7,000 exemption, the assessed taxable value is set at $393,000. The maximum property tax rate of 1% is applied only to $393,000 – the lesser assessed taxable value due to the exemption. Thus, the owner pays $3,930 annually in property taxes instead of $4,000 — a $70 tax reduction for each year of owner-occupancy. Small money, but sufficient to supply beer, not wine, for a small party.

The $7,000 exemption is a fixed recurring amount. It does not vary annually like the assessed taxable value which is inflation adjusted each year. For example, when the $400,000 assessed taxable value of a homeowner's residence is increased by the annual upward adjustment of the 2% maximum inflation rate to $408,000, the exemption remains at $7,000. Thus, the assessed taxable value for property taxes lowered to $401,000. The owner's resulting property taxes are $4,010, again representing an annual savings of $70 for the owner-occupant of the single-family residential property.

Properties qualifying as a "dwelling" for the owner-occupant's exemption include:

- a condominium or planned-unit development;
- a multiple unit property occupied by the owner;

- a single-family dwelling;
- shares in a co-op housing corporation; and
- a mobilehome and any ownership interest in the space occupied by the mobilehome. [Revenue & Taxation Code §218(c)(2)(B)]

A single-family residence which is rented or vacant does not qualify for the exemption. Neither does a residence still under construction on March 1st, with exceptions for reconstruction due to some disasters. Also, second homes and residences with a disabled veteran's $100,000 exemption do not qualify for the $7,000 exemption from property assessment.[3]

The homeowner's exemption applies to a homeowner's residence whether or not it is encumbered by a mortgage. Thus, a residence qualifies that is purchased and financed by the buyer entering into a land sales contract or lease-option sales agreement to finance their acquisition and possession as an equity owner of the property.

Aged 55, assessment transfers to replacement home

Editor's Note – Prop 19 legislation is now law. But this copy was posted prior to the legislature enacting codes to implement Prop 19 procedures. When enacted the codes may alter some of the minor details presented below.

Consider a retired couple, one or both aged 55 or more. They have long owned and occupied a single-family residence (SFR) but it no longer accommodates their needs for desirable shelter and card games. They intend to buy a replacement SFR.

A real estate agent they know is contacted for advice and assistance on the sale of their residence. Their need to purchase a more commodious residence in an urban area with greater cultural and social amenities than they now have will be addressed.

While discussing listing arrangements for the sale and the separate costs incurred to sell their residence and buy another, the agent brings up the topic of annual property taxes they will pay on a replacement residence.

By considering the seller's relocation intensions, the relative values of the properties to be sold and purchased, and the contents of a title profile for the home to be sold, the agent determines:

- the couple is *vested* in ownership and *occupies* the property as their primary residence;
- the property qualifies for or has a homeowner's $7,000 assessment exemption;
- at least one spouse will be over 55 years of age on the closing date for the sale of their residence;
- the sales price and FMV of their current residence is $700,000;
- the current factored base year value of the residence is $250,000; and
- the couple is willing to pay up to $1,000,000 for a replacement residence.

3 RTC 218 (b)(1)

Thus, the purchase price of the replacement residence of the quality they seek may greatly exceed the current assessed taxable value of the residence they are selling.

The agent first advises the couple that the replacement residence may be located anywhere in California, not in another state. Also, that the base year value and assessed taxable value for setting property taxes on their replacement residence will be the sum of:

factored base year value
The base year value adjusted upward annually by the County Assessor to reflect consumer inflation limited to 2% annually, compounded.

- the **factored base year value** of $250,000 for their current home - the amount transferred to the replacement home to set the replacement property's base year value assessment for the portion of the price paid to acquire it up to the amount of the price received for the home they sold, **plus**
- the portion of the price they pay for their replacement home which exceeds the price they receive for the home they sold.

By simply claiming the exclusion, the buyer of a replacement residence pays property taxes on a new base year value assessment set entirely or in large part on the assessment on their current residence. Critically as a sort of conditional reassessment, when the price paid for the replacement residence exceeds the price received for their current residence, that price difference is added to the factored base year value assessment transferred from the home sold to the replacement home. The assessed taxable value for property taxes on the replacement residence will be its new base year value assessment, less a homeowner's exemption of $7,000 they may also claim.

For example, a retired couple's primary residence has a factored base year value assessment of $300,000, and is sold for $600,000. On the other hand, the replacement residence they are buying has a market value of $700,000.

Since the market value of the replacement residence is $100,000 more than the price received for the primary residence they sold, the factored base year value transferred to the replacement residence is increased for the difference in value. Thus, the new base year value for the replacement home, and thus its first year assessed taxable value will be $400,000 ($300,000 + $100,000).

The transfer of assessment stabilizes housing expenses

The California housing policy transferring the amount of the factored base year value from the primary residence which is sold to a replacement residence is available to:

- homeowners aged 55 or more
- persons with severe disabilities;
- victims of natural disasters; and
- victims of wildfires.

Further, homeowners aged 55 or move and those with *severe disabilities* may during their lifetime sell and replace their primary residence and transfer the factored base year value from the home sold to the replacement home three times. However, only one assessment transfer is permitted per *natural* *disaster* or *wildfire* and then only when the value of the improvements is diminished more than 50% by the wildfire or a natural disaster declared by the governor.

As California's housing policy, a factored base year value which is below market value for a primary residence that is sold may be transferred to a replacement residence. This tax code result is designed to encourage retirees to own the residence they occupy, not rent it, by keeping their property tax payments low. Also, the taxing policy tends to keep them as California taxpayers rather than their moving to another state for personal financial reasons.

As a direct result, turnover of long-standing ownership by retirees, and the disabled, is increased. Turnover allows for a home larger than the owner needs to be sold and more efficiently used by another household. An example of such a relocation is empty-nest retirees aged 55 or more who move into a more compact home of any price, anywhere in the state.

This result helps reverse part of the adverse effect on low homeownership turnover experienced in California before the 2020 recession in order to keep homeownership taxes low, and the disruption of a proper allocation of national wealth by the unused excess housing space brought about by reverse mortgage originations, advanced surveillance installations, and shelter-in-place requirements in 2020-2021 during the COVID-19 pandemic. A further point: use of the tax code to achieve public policy objectives constitutes a subsidy, an investment in keeping elderly Californians efficiently housed in California.

Qualification requirements

To qualify, homeowners need to:

- *own and occupy* a primary residence so they qualify for a $7,000 homeowner's exemption from assessed taxable value;[4]
- be at least *55 years aged* or severely and permanently disabled on closing the sale of the residence sold or the residence significantly damaged in value by wildfire or natural disaster;[5]
- close the purchase of a replacement principal residence or complete construction during the period beginning *two years* before and ending two years after closing the sale of the residence sold.[6]

While the owner's original and replacement residences need to *qualify* for the $7,000 exemption, the owner does not need to actually *take* the exemption to qualify on their claim for transfer of the current assessment.[7]

To qualify for the age requirement, only one of the sellers needs to be aged 55 or more on the date they close the sale of the residence sold. The replacement

4 Rev & T C §69.5(b)(4)
5 Rev & T C §69.5(b)(3)
6 Rev & T C §69.5(b)(5)
7 Rev & T C §69.5(g)(10)

property can be acquired before age 55 during the two-year period before turning age 55 and then on turning age 55 close escrow on the sale of the primary residence.

To qualify as "bought" or "sold," the properties need to close escrow and the conveyances recorded with titles vested in the owners as sole owner, community property, joint tenants, tenants-in-common or as individuals, or in their intervivos "living" trust, but not vested in the name of an entity such as an LLC, partnership, or corporation.

Further, simply entering into a purchase agreement without closing documentation does not qualify the homeowner to carry forward the factored base year value from the residence sold to the replacement residence.

Occasionally, a homeowner retains their residence by converting it to a rental when the move to their replacement residence. When they retain their prior primary residence and rent it and do not sell it within two years after taking title to the replacement residence, they are unable to transfer its assessment to the replacement residence.[8]

8 Rev & T C §69.5 (e)

Chapter 32 Summary

Since 1978, the dollar amount of annual property taxes an owner pays have been limited to 1% of a property's assessed taxable value. As a result, each time a property has a change of ownership, the County Assessor determines the fair market value (FMV) of a property.

This assessment is referred to as a property's base year value. This base year value amount is factored annually and adjusted for consumer inflation, minus any qualified exemptions or exclusions claimed by the owner.

The inflation adjustment rate is the lesser of California's consumer price index (CPI) figure for the prior year or 2%. Exemptions are a type of tax-avoidance claim made by an owner to either subtract a fixed dollar amount from the property's base year value or set its annual taxable value to zero.

Similarly, yet different, exclusions are a type of tax-avoidance claim arising out of exceptional circumstances, such as the replacement of a primary residence with a base year value assessment lesser than its FMV or intergenerational transfers of a family home or farm. The distortions between assessment figures and current FMV are partially the result of the annual base year value adjustment being restricted to consumer inflation rather than asset inflation.

As interest rates rise, annual market value increases will align more closely with the 2% consumer inflation maximum and be reflected in assessed taxable values.

Chapter 32 Key Terms

Chapter 33

Parent-to-child transfers of family home and farm cap property taxes

Learning Objectives

After reading this chapter, you will be able to:

- explain the reassessment limitations on the transfer of a parents' principal residence and farm to their children or parentless grandchildren;
- analyze the financial benefits of the taxable value exclusion on transfers of the parents' family residence and farm to children or parentless grandchildren; and
- identify recordings which indicate a change in property ownership triggering base year value reassessment to fair market value (FMV) under Proposition 13.

Key Terms

apportionment	**Proposition 19**

Base year value reset on change of ownership under Prop 13

Before discussing the parent-to-child limited reduction of assessed **taxable value** on a *change of ownership* of family home and farm, one needs to consider the transfers of property interests which constitute a change of ownership and trigger a **base year value** reassessment at current market value.

On parent-to-child transfers of a parcel of real estate, its assessed *base year value* is reset at fair market value (FMV) by Proposition 13 (Prop 13). In turn, the **Proposition 19 (Prop 19)** $1,000,000 intra-family exclusion is claimed

Proposition 19
Constitutional amendment excluding up to $1,000,000 property value from assessments which apply only to the replacement of a primary residence by those aged 55 or more and to transfers from parent to children of their family home and farms when occupied and operated by the children.

to set the assessed *taxable value* on which property taxes are calculated. Both the base year value and the taxable value are adjusted annually as factored for up to 2% consumer inflation.

A **change of ownership** triggering reassessment occurs when a property owner transfers an ownership interest in real estate which includes:

- the *beneficial use* of the real estate; and
- a value *substantially equal* to a fee interest. [1]

Each person on acquiring an ownership interest in real estate files a *change of ownership* report with the County Assessor to claim any exemption from property taxes or exclusion to limit assessed taxable value and thus property taxes.

When the real estate interest conveyed constitutes a change of ownership, the County Assessor resets the base year value for the parcel at its FMV on the date of transfer, called reassessment. Typically, the purchase price the new owner paid for the property in a conventionally negotiated open market transaction establishes the property's FMV the County Assessor uses to set the base year value.

Most *assessment exemptions* indicate the ownership of the property is not taxed at all, such as real estate owned by:

- the local, state, or federal government;
- churches and religious organizations;
- universities and colleges; and
- charities and nonprofit hospitals.[2]

The exclusion claimed for the replacement of a primary home by an individual aged 55 or more avoids the reassessment of the base year value at FMV. On qualifying for the primary home exclusion, the base year value assessed is the sum of:

- the inflation-adjusted base year value carried forward from the home sold;
- **plus**;
- any excess in the price paid for the replacement home over the price received for the home they sold. [See Chapter 32]

Unlike the replacement home exclusion limiting the base year value, the parent-to-child exclusion does not reduce the base year value assessment below FMV. Instead, the amount of the parent-to-child exclusion allowed is subtracted from the base year value reassessment – as is the homeowner's or disabled veteran's exemption - to set the property's taxable value. The result is lower property taxes, as discussed later in this chapter.

1 stantially equal to a fee interest.

2 Rev & T C §§202, 203, 214

Revesting and transactions not classified as a change of ownership

A mere *change in the vesting* of title by an owner or owners does not constitute a change in ownership, an excluded activity that does not trigger reassessment.

To qualify as a change in vesting, not ownership, the proportional interests held in the property by the co-owners before revesting needs to remain in the same percentages under the new vesting.

Examples of a change in vesting by the current owners of a property include changes in joint tenants, tenants in common, community property, living trust, or these changes among co-owners' of a partnership, LLC or corporation.

A further exclusion addresses the syndicated ownership of a property vested in a partnership or LLC. Here, the transfer is not about title to ownership of the property but is a transfer by assignment of a co-owner's percentage share of ownership as a member of a partnership or LLC which is the vested owner of the property. When the partner's assignment does not alter control of the partnership, reassessment of the real estate owned by the partnership is not triggered.[3]

However, a *change in control* by assignment of interests held by partners or members in a partnership or LLC which is the vested owner of real estate does trigger reassessment of the property.

When more than 50% of the ownership interests in the entity are assigned, a change in control has occurred which constitutes a change in ownership and triggers reassessment of the property at current FMV. This threshold percentage of transfers by partners before reassessment is one reason several persons who join together hold title in a limited partnership or LLC rather than as tenants in common (TIC).[4]

Conversely, the transfer of a fractional interest in the vested ownership of the real estate, such as the transfer of a person's TIC interest in title, triggers reassessment of only the percentage of ownership transferred. The entire property is not reassessed, just the percentage transferred is reassessed.

For a TIC vesting, an exclusion exists for the transfer of fractional TIC ownership interests which are less than 5% of ownership and have a FMV less than $10,000.[5]

Also, the double-up claim of two exclusions in the same transfer or series of related transfers denies both exclusions. When attempted, the property is reassessed. These multiple transfers of an ownership interest in a property, though staged as separate steps, are collapsed and viewed as a one-step transaction. Again, the property interest transferred is reassessed.[6]

3 Rev & T C §64(a)
4 Rev & T C §§64(c), 25105
5 Rev & T C §65.1(a)
6 **Crow Winthrop Operating Partnership** v. **County of Orange** (1992) 10 CA4th 1848

Family transfers not reassessed to share the wealth

Editor's Note – Prop 19 legislation is now law. However, this material was published prior to the legislature enacting codes to implement Prop 19 procedures. When enacted, the codes may alter some of the minor details presented below.

Transfers between spouses, called **inter-spousal transfers**, are also excluded from reassessment. *Inter-spousal transfers* are not considered a change in ownership triggering reassessment when the transfer:

- adds a spouse to title;
- reports the death of a spouse; or
- settles a divorce.[7]

The exclusions from assessed **taxable value** on a parent-to-child transfer of a principal residence and a family farm while limited in amount are also available, as discussed below.

The replacement home exclusion from **base year value** assessment for a primary residence by an individual aged 55 or more, acquired within two years before or after the sale of their prior primary residence, is fully addressed in Chapter 32.

For the family farm exclusion, the rules applied when the conveyance is of a family farm to a child are the same as the rules for the family home from parent to child. Thus, in all discussions below about the family home exclusions, the reader can substitute the family farm for the family home and get the same result. In the context of a family farm, occupancy of the property is replaced with the need for the child to be the *operator* of the family farm.

A parent's dwelling of average FMV, sold to an adult child

Consider a couple who occupies a single family home as their principal residence, a property they have owned for decades. They want to sell it and move into housing accommodations they will not own. The home has a FMV of $600,000 and an inflation-adjusted base year value of $120,000.

Their son, who lives locally in a rental property, intends to move into the family home as his principal residence. The parents and the son agree on a below FMV price and terms for payment that is satisfactory to all family members - no down payment and payments including interest. The interest rate will be the lowest permitted by the applicable federal rates (AFRs) for loans to family members. Thus, the parents avoid annual imputing of principal as interest.

Here, the sale (or gift) of the parent's principal residence to a child will, on recording the conveyance of title, disclose the change of ownership and trigger reassessment of the property. The County Assessor will set the property's new **base year value** at $600,000, the property's FMV, not the pricing agreed to by the family.

7 Rev & T C §63

Along with the recording of the conveyance to the son, the son files a claim for a homeowner's exemption and a claim for the family home exclusion (then or within one year) as occupant of the property as their principal residence.

Accordingly, the County Assessor determines the amount of family home exclusion the son qualifies for by subtracting the parent's inflation-adjusted base year value of $120,000 from the FMV of the property.

Here, the son qualifies for a $480,000 amount of exclusion as a subtraction from the new base year value of $600,000 to set the *taxable value* assessment at $120,000, which is further reduced by the $7,000 homeowner's exemption.

Here, the result for the son's assessed taxable value is the same amount as the property's assessed taxable value set for the parent's ownership. What the Assessor changed on the change in ownership is the *base year value* assessment for the property – it was reset at the property's FMV. However, the son did not retain the parents' inflation-adjusted base year value which is set by the price the parents paid for the property decades ago.

In the future, the son might vacate the property with no intent to return to use it as his principal residence. Then the son no longer qualifies for the homeowner's exemption or the family home exclusion. As a result, the County Assessor will reset the assessed taxable value at the amount of the inflation-adjusted base year value assessment of $600,000 plus the inflation factor for the Tax Collector to calculate property taxes of 1%. Thus, the amount of the exclusion lost – $480,000 – is now taxed annually.

A high-tier priced principal residence and the exclusion

Consider parents who own a single family residence (SFR) near the coast that for previous decades was their second home. For the past few years, the parents occupy the home as their principal residence. They qualify for a homeowner's exemption due to their occupancy though they have not claimed one.

The SFR has a fair market value (FMV) of $2,500,000, currently assessed at a *factored base year value* of $600,000, which is also the assessed taxable value. The parents convey the property to a child who intends to occupy the home as their principal residence.

Upon the transfer or within one year of transfer, the child files a claim with the County Assessor for the homeowner's exemption and the family home exclusion. The County Assessor notes a change of ownership has occurred with the recording of the deed transferring title to the child, triggering reassessment. The County Assessor determines the FMV is $2,500,000 and sets the new base year value assessment at $2,500,000.

Upon receiving the child's claim for exclusion (and the claim for a homeowner's exemption), the County Assessor now sets the assessed **taxable value** of the home for use by the County Tax Collector.

Here, the FMV of the home ($2,500,000) exceeds the parent's inflation-adjusted base year value ($600,000) by more than the $1,000,000 family home exclusion ceiling. Thus, the County Assessor sets the **taxable value** of the home as the sum of:

- the home's new base year value assessment (FMV) of $2,500,000;
- *minus* the full $1,000,000 exclusion;
- resulting in $1,500,000 as the assessed taxable value for the child's first year of ownership.

The Tax Collector calculates the taxes due for the fiscal year at 1% of the assessed taxable value, a property tax bill of $15,000, plus any voter approved bond payments. Thus, the child effectively garners a $10,000 annual savings on property taxes that a conventional buyer of the property would otherwise pay into the city's coffers.

A wealthier family's use of exclusions

Consider the parents of a son and daughter. Both children are married and have children of their own. The daughter later dies and her husband does not remarry. The parents own the following real estate:

- an apartment building, one unit of which they occupy as their principal residence;
- two farms they operate, one that grows and markets ornamental trees and another that produces citrus; and
- other properties consisting of single family rentals and a strip mall.

All these properties are vested in the parent's **inter vivos trust**. On the death of the parents, the transfer of these properties as directed by the trust agreement will be distributed as follows:

- the apartment building in which a unit is their principal residence is to be transferred to the husband of the deceased daughter, and if the husband has remarried, the transfer is to the parents' grandchildren;
- both farms are transferred to their son;
- the remaining single family rentals and strip mall are transferred to the son and deceased daughter's unremarried husband, in equal undivided interests (50:50) as tenants in common.

The parents qualify for a homeowner's or veteran's exemption on their rental property which contains their principal residence, though they have not claimed the exemption. The family-owned and operated farms qualify as property which produces an **agricultural commodity**.

On transfer of the principal residence, to qualify for the family home exclusion, the daughter's husband (or grandchildren if the husband is remarried) needs to:

- occupy the property as their principal residence; and
- file a homeowner's exemption claim within one year of transfer.

The apartment building is a single appraisal unit with one parcel number. On the date of the transfer, the building has a FMV of $3,500,000. The apartment unit used as their primary residence within the building has a FMV of $350,000, 10% of the FMV of the entire building.

The inflation-adjusted – *factored – base year value* on the building is $2,100,000. This amount is also the assessed taxable value used to calculate property taxes owed since the parents have claimed no exemptions or exclusions. The portion of the factored base year value assessment attributable to the unit which is the family home is $210,000.

Here, the transfer of the apartment building to the deceased daughter's husband is a change of ownership triggering a new base year value assessment at its FMV of $3,500,000.

The intra-family family home exclusion reduces the assessed taxable value, not the new base year value assessment. If in the future the daughter's husband no longer qualifies for homeowner's exemption by ending occupancy of the unit as his principal residence, the exclusion is lost and the inflation-adjusted base year value becomes the assessed taxable value.

When the daughter's husband takes possession of the family home unit as his principal residence, he will file a claim for homeowner's exemption with the County Assessor at the time of the transfer of ownership or within one year of transfer. Here, the $1,000,000 family home exclusion kicks in to set the property's assessed taxable value as the sum of the unit's base year value minus the amount of exclusion allowed.

Again, the unit occupied as the principal residence has a FMV of $350,000 and as 10% of the building's FMV the parents have an inflation-adjusted base year value of $210,000. The family exclusion allowed is based on the difference between the FMV and assessed value.

Thus, $140,000 is the amount of the family exclusion allowed to set the building's **taxable value**. Thus, the $140,000 value excluded from property taxes is subtracted from the building base year value ($3,500,000 FMV) to set the building's reduced taxable value used by the Tax Collector to calculate property taxes due on the building.

No exemption or exclusion from reassessment exists for the remaining 90% of the building's FMV.

Thus, the *base-year assessed value* is $3,500,000 while the assessed *taxable value* is 3,360,000. The reduced amount reflects the portion of the $1,000,000 family home exclusion available, so long as the daughter's husband occupies the unit as his principal residence.

In other cases where the FMV of the family home or family farm involved in the transfer exceeds the sum of the parent's factored base year value assessment figure and the $1,000,000 exclusion, the entire $1,000,000 is subtracted from the new base year value FMV assessment to set the taxable value.

Who qualifies?

The *parent-child exclusion* only applies to transfers between parents and children, or grandparents and grandchildren when the grandchildren are the only direct line of descent remaining due to deaths.

A "child" includes a parent's:

- natural child, unless that child has been adopted by another parent;
- stepchild or the stepchild's spouse;
- son-in-law or daughter-in-law; and
- foster child or adopted child unless the child was adopted after turning 18.

Further, the family home exclusion only includes the portion of land surrounding the improvements used as the principal residence, also called a **dwelling**. The exclusion separates the portion of land and improvements used for other purposes, such as the apartment example above, from the portion of the land or building containing the residence, called **apportionment**.

> **apportionment**
> The separation of land into the portion used as a principal residence and the portion used for other purposes.

Thus, a principal residence on a large parcel or one of several adjacent properties owned by the parents and held for other uses, such as an agribusiness, rental, or sub-divisible acreage — with the exception of family farms — is subject to *apportionment* of FMV on a transfer.

Filing the claim for exclusion

To qualify for an intra-family taxable value reduction, the child receiving ownership of a property needs to file a claim with the County Assessor when the deed transferring the property is recorded, or within one year. The assessor notes this on the change of ownership report form used for tracking the parents' and children's limitation or exclusion amounts through the *California Franchise Tax Board (FTB).*

The FTB acts as a clearing house to monitor the total exclusion amounts claimed by property owners.

An asset inflation adjustment resetting the $1,000,000, whether up or down, will be calculated and published by the State Board of Equalization (SBOE) on February 16 every odd numbered year after 2021.

The asset inflation figure used is the **FHFA Home Price Index** for California figure for the prior even numbered year.

Chapter 33 Summary

Proposition (Prop) 13 triggers reassessment of a home's base year value to be reset at FMV upon parent-to-child transfers of a family home or farm they occupy or operate. Subsequently, Prop 19 excludes $1,000,000 from an intra-family transferred home or farm's assessed taxable value at which property taxes are calculated.

The base year value and assessed taxable value of a home are both factored and adjusted annually for up to 2% consumer inflation. A new owner's purchase price paid for the property in a conventionally negotiated open market transaction typically establishes the property's FMV used by the County Assessor.

Replacement of a primary home by an individual aged 55 or over avoids a base year value reassessment at FMV. Upon qualifying for the 55 and over primary home exclusion, the base year value is reassessed as the sum of the inflation-adjusted base year value of the home sold plus any excess in the price paid for the replacement home over the price received for the home sold.

Contrastingly, the parent-to-child exclusion doesn't reduce the base year value below FMV, but rather the $1,000,000 exclusion is subtracted from reassessed base year value to set the property's assessed taxable value, resulting in lowered property taxes. A change in vesting or change in control between vested owners of real estate in scenarios such as joints tenants, tenants in common, community property and LLCs or corporations does not trigger reassessment.

Chapter 33 Key Terms


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Glossary

#

§1031 cooperation provision 174
A condition in purchase agreements advising participants about §1031 reinvestment planning and providing for mutual cooperation prior to closing for the disbursement of net sales proceeds when a participant decides to purchase or sell other property in §1031 reinvestment plan. [See **RPI** form 159 sec 11.6]

§1031 investment property 56
Business-use and investment real estate which qualifies the owner to exempt profit realized on its sale from income taxes by acquiring like-kind property in a §1031 reinvestment plan.

§1031 reinvestment plan 21
A sales transaction of like-kind property which generates net sales proceeds, some or all of which the seller will use to purchase like-kind replacement property under Internal Revenue Code §1031. The cost basis and unrecaptured gains are carried forward to the property purchased and the seller avoids reporting some or all of the capital gains realized on the sale.

§1031 trustee 204
A third party who, in lieu of the seller in a §1031 reinvestment plan, receives and holds the net sales proceeds from the sale of property, and on demand from the seller deposits the funds in a purchase escrow the seller opens to acquire replacement property.

A

active management 51
The responsibility of a rental property owner under a rental or gross lease to care for and maintain their rental real estate, needed to qualify a property's income and expenses to be classified as passive category income.

active participant 92
An owner-operator of rental property who owes a duty to tenants under rental and gross lease agreements for the care and maintenance of the property and retains ultimate authority over key landlord decisions.

adjusted gross income 10
Gross income remaining from the three income categories after taking expenses and deductions.

agency duty 179
The fiduciary duty a broker and their agents owe a client to use diligence in attaining the client's real estate objectives. [See **RPI** Form 305]

Agency Law Disclosure 180
Restatement of agency codes and cases summarizing the agency conduct of real estate licensees. It is delivered to all parties in consumer sales and leasing transactions.

aggregating 70
Combining the reportable operating income and losses from all sources within the passive income category.

all-inclusive trust deed note (AITD) 113
A note entered into by a buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment. This amount includes mortgage debts remaining of record which the seller remains responsible for paying. Also called a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

alter ego **65**
A corporation or LLC whose earnings and assets are used directly for the personal advantage of its owner, resulting in insufficient separation between the owner and the corporation or LLC to shield the owner from personal liability for the entity's debts.

alternative minimum tax (AMT) **11**
A supplemental income tax paid by taxpayers in higher income tax brackets.

annual property operating data sheet (APOD) **76**
A worksheet used to gather income and expenses on the operation of an income producing property for an analysis of the property's suitability for investment.

Applicable Federal Rate (AFR) **162**
Rates set by the Internal Revenue Service and used by carryback sellers to impute and report minimum interest income when the note rate on their carryback debt is a lesser rate.

apportionment **298**
The separation of land into the portion used as a principal residence and the portion used for other purposes.

appreciable asset **75**
A tangible collectible, such as property held for investment or productive use in a business, the value of which increases over time at a rate greater than the rate of consumer inflation.

assessed taxable value **283**
The annual valuation of property set by the County Assessor as the sum of the base year value, factored for inflation, minus exemptions and exclusions, for use by the County Tax Collector to levy annual property taxes, commonly referred to as the assessed taxable value or current taxable value for a property.

asset price inflation **117**
A rise in the value of assets, such as stocks, bonds, and real estate. Contrast with *consumer price inflation*.

B

balloon payment **138**
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final payment. [See **RPI** Form 418-3 and 419]

base year value **282**
A conveyance of title to real estate resulting in transfer of the beneficial use of the property which triggers reassessment of the property by the County Assessor to set the property's new base year value.

bid-equals-value presumption **167**
The IRS's presumption a mortgage holder's successful bid at a foreclosure sale, limited in amount to the remaining principal, costs and advances, is equal to the FMV of the interest acquired in the property leaving no reportable income in the exchange.

book value **43**
The value of an asset expressed for accounting purposes as the original cost of acquisition and capital improvements, minus accumulated depreciation and destruction, also known as cost basis. Contrast with current market value.

C

capital asset **55**
Real estate held by an owner as their principal residence or for investment, excluding properties held as inventory for sale to customers or for productive use in a trade or business.

capital expenditure **68**
An expenditure incurred to fund the purchase, improvement, or carrying costs of real estate.

capital gain **135**
Profits from the sale of a capital or business-use asset at a price exceeding the cost of acquisition and further improvements. Contrast with unrecaptured gain.

capital investment **43**
The capital invested in a property, comprising cash and mortgage proceeds used to purchase, improve or carry the property, as well as any adjusted cost basis carried forward in the disposition of other property in a §1031 reinvestment plan.

carryback sale **98**
Financing provided by a seller of real estate by extending credit to a buyer for the deferred payment of a portion of the sales price, typically repaid monthly with accrued interest — also known as an installment sale.

cash boot **251**
Items of value received on a sale of property or contributed to purchase replacement property in a §1031 reinvestment plan which include money, carryback notes, purchase-assist financing for the replacement property, and equity in property not qualified as §1031 like kind property. Also called money and other properties.

cash-out transaction **57**
Selling a like-kind §1031 property without a concurrent reinvestment plan for acquiring a like-kind §1031 replacement property to exempt profit realized on the sale from taxes.

common interest development (CID) **160**
Condominium projects, cooperatives, or single-family residences in a planned unit development. [See **RPI** Form 135]

Consumer Price Index (CPI) **116**
An index of fluctuations in the general price of a wide selection of consumable items consisting of goods and services to measure and track the rate of consumer inflation.

consumer price inflation **117**
An increase in the general price level of all goods and services consumed in the economy. Contrast with *asset price inflation*.

cost basis **20**
The cost incurred to acquire and improve an asset subject to adjustments for destruction and depreciation, a term used primarily for tax reporting.

D

dealer property **195**
Real estate held for sale to customers in the ordinary course of an owner's trade or business, where the earnings on the sales of the properties are taxed as business inventory at ordinary income rates.

deduction **10**
An expenditure or allowance offsetting net operating income (NOI) or subtracted from adjusted gross income, both lowering the amount of taxable income.

deed-in-lieu of foreclosure **168**
A grant deed from the owner of mortgaged real estate conveying it to the mortgage holder in exchange for cancelling the mortgage debt and avoiding foreclosure.

deferred exchange corporation **241**
A corporate facilitator retained to act as a trustee in a delayed §1031 transaction to receive, hold and disburse proceeds from the sale of a property under safe harbor rules for the seller to avoid receipt of their sales proceeds.

deficiency judgment **128**
A money award obtained by the holder of a recourse mortgage debt to recover money losses experienced when the value of the mortgaged property is less than the mortgage debt at the time of their judicial foreclosure sale.

depreciation **74**
Loss of property value brought on by age, physical deterioration, or the functional or economic obsolescence.

depreciation deduction **74**
The annual before-tax withdrawal from income, deducted from the NOI of a rental property, expensed from trade of business income, or deducted from the NII for portfolio investments, to provide a return of invested capital allocated to property improvements which reduces the owner's cost basis in the property. To be distinguished from a return on capital.

depreciation schedule **75**
The number of years over which an owner's capital investment in a trade or business, passive, or portfolio category property is recovered as an annual expense or deduction from income, limited to the portion of cost basis allocated to property improvements.

direct expense **32**
A deductible expense attributable to the home office area used exclusively for business.

discharge-of-indebtedness **126**
Reportable income resulting for an owner from a mortgage holder's discount on a payoff of a mortgage debt. Also called a short pay.

disposition **150**
The act of transferring or otherwise giving up an asset, such as property or a trust deed note, which triggers the reporting and taxing of profit.

disposition property **200**
Replacement property acquired in a §1031 reinvestment plan and immediately resold in a cash-out sale or conveyed to another individual or taxable entity, disqualifying it as like-kind property when received.

E

equitable ownership **159**
Held by a person who purchases a property and has possession but has not yet received legal ownership with title vested in their name, such as occurs under an unexecuted purchase agreement, land sales contract or lease-option sales agreement.

equity...188
The value of an owner's capital interest in real estate exceeding the mortgages encumbering it.

exchange... 187
A means of trading the equity in a property, owned for the equity in another, treated as a single transaction involving two properties conveyed through tandem escrows. Also called barter.

exclusive use 34
The use of a designated area in a residence only as an office, one of two conditions needed to qualify for a home office deduction.

exclusions...282
Types of property-tax avoidance claims arising when a primary residence is replaced resulting in a base year value reassessment less than FMV and on transfers of the family home or family farm between parents and children eliminating up to $1,000,000 from assessed taxable value.

exemptions..284
Types of property-tax avoidance claims made by the owner for setting the annual taxable value at zero or by subtracting a fixed dollar amount from the property's base year value.

F

factored base year value..286
The base year value adjusted upward annually by the County Assessor to reflect consumer inflation limited to 2% annually, compounded.

fair market value (FMV) 166
The price a reasonable, unpressured buyer and seller would agree to for property on the open market, both possessing symmetric knowledge of material facts.

G

gross equity...43
The portion of the market value of a property calculated by subtracting the amount of mortgage debt, unpaid property taxes and any bonded indebtedness secured by the property from the property's market value.

H

home office deduction 32
A deductible expense resulting from business use of a taxpayer's home.

homeowners' association (HOA) 159
An organization made up of owners of units within a common interest development (CID) which manages and operates the project through enforcement of conditions, covenants, and restrictions (CC&Rs).

I

imputed owner...23
Someone who for tax purposes is deemed to be a co-owner of a principal residence but does not have a vested interest in the property.

incidental property 232
Personal property used in the operation and management of real estate.

indirect expense **32**
An expense incurred in the upkeep and operation of a taxpayer's entire residence, a part of which is deducted as a business expense, the amount deductible based on the percentage of the area in the residence exclusively used as a home office.

Individual Tax Analysis (INTAX) **99**
An estimate of a seller's tax liability incurred due to unrecaptured and capital gains realized on a proposed sale of a property.

itemized deduction **2**
Deductions taken by a homeowner for allowable personal expenditures such as mortgage interest (MID) and state income and local property taxes (SALT) as itemized on Schedule A which reduce their taxable income and tax liability. Contrast with the standard personal deduction.

L

land sales contract **158**
A security device used for the sale of real estate when the seller retains title to the property as security until all or a prescribed part of the purchase price has been paid.

life-of-loan accrual **11**
The monthly accrual of mortgage origination fee over the life of a mortgage.

liquidation theory **63**
When, to facilitate the sale of investment property, the owner develops it only as necessary to cash out their capital interest in the property and still qualify the profit for capital gains treatment.

M

market value **42**
The highest price a property will bring in a competitive and open market between a buyer and seller given time to act prudently and knowledgeably.

material participant **86**
An owner of rental property in the passive income category who participates in its management or a real estate profession on a regular and substantial basis.

mortgage boot **255**
The amount by which the mortgage balances existing on the property sold, whether assumed or paid off by the buyer, exceeds the sum of the mortgage balances taken over on the replacement property purchased in a §1031 reinvestment plan and the net value of cash items contributed in the plan. Also called net debt relief. Contrast with *cash boot*.

mortgage interest deduction (MID) **1**
An itemized personal deduction permitted for interest accrued and paid on mortgages secured by a homeowner's principal and second residence.

mortgage origination fee **13**
A fee paid to a mortgage holder for originating a mortgage at a below-par interest rate, taxwise considered prepaid interest.

N

net cash items **265**
The sum of the amount of cash items from the sale of the property sold received prior to acquiring replacement property, plus the amount of cash

items received on or after the purchase of replacement property which exceed the contribution of cash items toward acquisition of the replacement property.

net debt relief **257**
The amount of the existing mortgage balance encumbering the property sold not offset by the assumption of mortgage balances or contribution of cash items on acquiring replacement property in a §1031 reinvestment plan. Also called *mortgage boot*.

net investment income (NII) **71**
Income less expenses related to portfolio category assets. For real estate investors, this includes income, profits and losses from the operations and sales of management-free, net-leased rental property, land held for profits on resale, and interest-bearing assets.

net investment income tax (NIIT)................................. **112**
A surtax on income from investment assets such as income, profits and losses from the operations and sales of rental property, interest income, stocks, bonds, and land held for profit on resale.

net operating income (NOI)... **10**
The net revenue generated by an income producing rental property before accounting for mortgage PI payments or the depreciation allowance. NOI is calculated as the sum of a rental property's total operating income less the property's operating expenses. [See **RPI** Form 352 §4]

net profit **101**
Gains on the sale of business-use and capital assets calculated as the sales price minus transactional costs minus the remaining cost basis.

net sales proceeds **109**
The amount of a seller's receipts on closing a sale of their property after deducting all costs of the sale and mortgage assumptions/payoffs from the gross price, but before payment of taxes on any profit on the sale.

nominal interest rate **11**
The interest rate agreed to between a homebuyer and a lender as stated on a promissory note, also called the note rate. To be contrasted with *par rate* of interest.

nonrecognition of gain...**175**
The exemption from taxes on profits or losses realized on disposition of investment or business-use property when the net equity in the property is replaced by acquiring other investment or business-use property in a continuing ownership of property.

nonrecourse debt.. **124**
A mortgage debt recoverable on default solely through the value of the security interest held by the lender in the mortgaged property. Contrast with *recourse debt.*

O

occupancy rule **89**
Rental properties are passive income category property when tenant occupancies average more than 30 days.

occupancy-to-ownership ratio **21**
A ratio of the years a homeowner has occupied a property as their principal residential to the years they have owned it. Used by the seller of a residential property to calculate the percentage of profit realized on the sale which qualifies for the principal residence profit exclusion.

offsets **255**
A reduction, typically reducing an amount received by an amount contributed by an individual in a §1031 reinvestment plan.

operating expenses **10**
The total annual costs incurred to maintain and operate a property for one year. [See **RPI** Form 352 §3.21]

option to buy **131**
A unilateral agreement entered into by a property owner granting a prospective buyer the right to buy property by exercising the option within a specified time period or on an event, at a determinable price and terms for payment. [See **RPI** Form 161]

ordinary income asset **56**
Real estate held by an owner primarily as inventory for sale to customers in the ordinary course of the owner's trade or business, called *dealer property*.

owner-operator **83**
An owner of rental property in the passive income category who renders professional real estate services, manages property, or invests in real estate for their own accounts and collectively spends a minimum amount of time on real estate-related activities.

P

paid and accrued rule **67**
Interest paid on a mortgage needs to accrue before it may be expensed or deducted from income.

par rate **12**
The lender's base interest rate without any positive or negative adjustments producing a variation set as the nominal interest rate in a promissory note.

partial §1031 reinvestment **213**
A sales transaction triggering reporting and taxes of a portion of the profit realized on the sale of property in an Internal Revenue Code (IRC) §1031 reinvestment plan when less than all the sales proceeds are reinvested in replacement property.

partial exclusion **21**
A prorated portion of the principal residence profit exclusion available to a homeowner who sells due to personal difficulties.

passive income category **48**
Income, profits and losses from rental real estate operations and sales, and from businesses not operated by the owner or co-owner.

passive ownership **51**
Ownership of a business without materially participating in its management.

personal-use mortgage **11**
A mortgage which funds a personal use such as the purchase or improvement of an owner's principal residence or second home, or the payoff of personal debt such as costs of education and healthcare or credit cards.

pledge **145**
To provide an asset, such as an existing carryback note, as collateral or security for repayment of a borrowing. Also known as hypothecation. [See **RPI** Form 242]

portfolio income category **52**
Unearned income from interest on investments in bonds, savings, stocks and mortgage notes, and income, profits, and losses from management-free net-leased income property and unimproved land held for profit on resale.

portfolio property **10**
Property held for investment that is management free, such as stocks, bonds, savings, notes, land not used in a trade or business, and rental properties under net leases.

prepaid interest **12**
Interest paid which has not yet accrued.

principal place of business **35**
The location where a broker or agent conducts the majority of, or the most significant activities related to their business.

principal residence **12**
The residential property where the homeowner resides a majority of the year.

principal residence profit exclusion **20**
A tax reporting exclusion of profit realized on the sale of the owner's principal residence limited to a maximum dollar amount and by an occupancy-to-ownership ratio.

property appreciation **74**
The portion of the increase over time in a property's market value exceeding the rate of inflation.

Proposition 19 .... **292**
Constitutional amendment excluding up to $1,000,000 property value from assessments which apply only to the replacement of a primary residence by those aged 55 or more and to transfers from parent to children of their family home and farms when occupied and operated by the children.

Q

qualified interest **5**
Mortgage interest accrued and paid on up to $750,000 of mortgage principal used to fund the acquisition or improvement of the homeowner's principal residence or second home. The interest is itemized on Schedule A as an itemized personal deduction which reduces the homeowner's taxable income and tax liability.

R

real profit **117**
The price received on the sale of property less the owner's capital investment in the property as adjusted for consumer inflation over the period of ownership.

real rate **118**
The nominal interest rate minus the rate of inflation.

recapitalization **258**
The restructuring of an owner's capital interest in a property between equity and mortgage debt or vice versa, often achieved by refinancing or further financing of the property.

recharacterization **162**
The depiction of a lease-option agreement as the economic equivalent of a sale and financing arrangement rather than by the function of a landlord/tenant transaction.

recourse debt **127**
A mortgage debt which exposes a borrower to personal liability when a judicial foreclosure sale of the secured property does not fully satisfy the debt. Contrast with *nonrecourse debt*.

regular use 35
The consistent repeated use of an area of a residence as a home office, one of two conditions needed to qualify for a home office deduction.

reportable operating loss 82
A passive category loss resulting from operating expenses, depreciation deductions and interest deductions for passive category properties, which exceeds income in the category is carried forward as a suspended loss unless the owner qualifies to offset income in trade or business and portfolio category income or reduce taxable income as a deduction.

reverse §1031 transaction 235
An Internal Revenue Code (IRC) §1031 transaction in which an investor controls title to replacement property before disposing of the property to be sold. Also called a parking transaction.

S

seller's net sheet 109
A document prepared and used by a seller's agent to itemize expenditures and charges incurred on a sale of a property, disclosing the financial consequences of a sales price set in a listing agreement or a buyer's offer to purchase.

short sale 124
A sale of mortgaged property by the owner when at closing the mortgage holder accepts the owner's net sales proceeds in full satisfaction of a greater amount of mortgage debt.

straight note 141
An instrument evidencing a debt on which the entire amount of principal together with accrued interest is paid in a single lump sum when the principal is due. [See **RPI** Form 423]

suspended loss 49
An operating loss incurred on passive income category rental property that is not recognized in the tax year incurred but is carried forward for use in future years to offset operating income or profit on a sale only from the property incurring the loss.

T

taxable income 99
The amount of an individual's income subject to tax, determined as adjusted gross income (income and profits less allowed losses from all income categories) minus deductions.

tenants in common (TIC) 225
Co-ownership of real estate by two or more persons, who each hold equal or unequal undivided interest, without the right of survivorship.

tracking 49
The separate accounting record of the operating income, expenses, and deductions for each assessor-identified parcel of real estate classified as passive category property.

trade or business asset 56
Real estate used to house or facilitate the ongoing operation of a trade or business.

trade or business income category 47
Income, profits and losses from the taxpayer's trade or owner-operated business, sales inventory, and real estate used to operate the trade or business.

trust account **205**
An account in the name of the trustee in which funds held for a client are deposited, separate and apart from the trustee's personal funds.

U

unforeseen circumstances **25**
Events not reasonably foreseeable by a homeowner which qualify the profit on the sale of a residential property for partial exclusion from taxation, such as a natural disaster, divorce or death.

unrecaptured gain **25**
The accumulated annual adjustments to a property's cost basis for depreciation deductions which on a sale of the property are reported and taxed at greater rates than the rates for capital gain.

V

vacation home **220**
Any dwelling unit, such as a house, apartment, condominium, mobile home, recreational vehicle, or boat, personally used by the owner or co-owners and their families or friends as a residence other than the owner's principal residence.