5 Home Ownership and Real Estate

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Planning for Tax Law Changes

- The provision allowing a deduction for mortgage insurance premiums has expired for tax years beginning after December 31, 2014. At the time this publication went to print, the provision had not been extended. See *TheTaxBook* Update Service at www.thetaxbook.com for late-breaking news.

Home Ownership and Real Estate Planning Strategies

Following is a summary of planning strategies used in this Tab.

- In making the decision to buy or rent a home, compare the cost of renting versus buying a home. Compare similar properties. Comparing a single-family home with an apartment is not useful. Include all costs, such as property taxes, insurance, utilities, maintenance, the tax savings that owning a home will generate, and also consider the appreciation in the value of the home over time. See *First-Time Homebuyer—Buy or Rent,* page 5-3.
- Buying a home late in the year may not generate enough tax deductions in year one to itemize. Thus, the value of deducting points in one year would be lost. Instead, if the taxpayer does not have enough to itemize in year one, choose to amortize the points on the purchase of the home over the life of the loan. See *First-Time Homebuyer—Deducting Points,* page 5-4.
- Online mortgage calculators are designed to calculate the effect of refinancing a mortgage. The calculators show the amount that will be saved compared with the costs incurred to help the borrower determine whether the refinancing offer is right for him or her. See *Does It Make Sense to Refinance a Mortgage,* page 5-5.

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Home Ownership and Real Estate Planning Strategies continued

- Taxpayers can use a reverse mortgage to generate tax-free income by converting equity built up inside their home into cash. Taxpayers can also use a reverse mortgage to pay off an existing home, thereby creating a need for less income each month. See *Reverse Mortgages,* page 5-8.
- If a child purchases a home from a parent, and then rents it back to the parent at fair rental value, the child may benefit from tax breaks that the parent might no longer benefit from. The parent also benefits by converting equity locked up in the house into cash. See *Parents' Home—Tax Benefits for Children,* page 5-10.
- A construction contractor should build and live in his or her home for two years, then sell it and build another to live in for two years, then sell it and build another to live in for two years, etc. If the construction contractor has the knowledge and skills to personally perform several jobs, up to $250,000 ($500,000 MFJ) of profits from the sale of the homes over a two-year period can be excluded from income. See *Sale of Principal Residence—Construction Contractors,* page 5-13.
- Homeowners living next to major sporting venues, conventions, and other one-time attractions should take advantage of the short-term rental rules. If a residence or second home is rented for no more than 14 days during the year, the rental income is tax free. See *Short-Term Rentals,* page 5-17.
- A taxpayer who wants to dispose of business or investment property and reinvest the money in a similar property should utilize the tax advantages of a like-kind exchange. Careful planning is required to avoid the constructive receipt of money prohibition. See *Like-Kind Exchanges—Deferred Exchanges,* page 5-20.
- Taxpayers with vacation homes should maximize deductions by taking advantage of the *Bolton method* for allocating mortgage interest and real estate taxes. This method allocates these two expenses based on the number of days in the year instead of the number of days the unit is actually used. All other expenses are allocated based on the number of days the unit is actually used. See *Vacation Homes—Maximizing Deductions,* page 5-23.
- Instead of contributing real estate to a corporation, the shareholder should keep the real estate in his or her name and rent it to the corporation. There are several tax benefits for keeping real estate outside the corporation. See *Holding Real Estate Outside the Corporation,* page 5-25.
- If a taxpayer owns investment real estate and does not have enough other expenses to itemize, consider the election to capitalize interest and taxes on real property instead of claiming a current tax deduction. See *Election to Capitalize Interest and Taxes on Real Property,* page 5-27.

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Home Ownership and Real Estate Planning Strategies continued

- Homeowners' associations have a unique ability to choose how to file and pay taxes each year. Compare the different rules that apply to each form and determine which method to choose on a year-to-year basis. A reason to file Form 1120-H is certain income (dues, fees, or assessments paid by property owners) is exempt from income tax. A reason to file Form 1120 is a net loss can be carried over to the following tax year to offset future income. See *Homeowners' Association—How to Save Tax,* page 5-29.

Buy or Rent Online Calculators

Several free online calculators are available to help taxpayers weigh the option of whether it is better to purchase or rent a home. Most require the user to enter the following:

- Monthly rent.
- Home purchase price including down payment, length of loan, and interest rate.
- Yearly appreciation in home values and rent prices.
- Expected property taxes.

Some calculators also allow the user to input closing costs, insurance, expected maintenance costs, percentage return on investment, rate of inflation, and tax bracket. Others have these costs included as a non-variable amount programmed within the calculator. Most also assume the house will be sold at the end of the time period being analyzed.

New York Times

www.nytimes.com/interactive/business/buy-rent-calculator.html

The New York Times website features an interactive graphic calculator which keeps a running tally of the most common expenses of owning and renting. It also takes into account opportunity costs. For example, the return that could have been earned by investing the money instead of spending it on a down payment. The effect of changes to variable assumptions can be instantly seen on the interactive graph portraying the breakeven point between renting and purchasing.

Realtor.com

www.realtor.com/mortgage/tools/rent-or-buy-calculator

This calculator provides a side-by-side comparison of the costs of renting versus buying in an easy-to-read chart. It allows the user to change assumptions and quickly recalculates the results. It also takes into account opportunity costs of tied-up equity and present-dollar values based on a variable inflation rate.

"We forgot to read the fine print."

Pay Off Mortgage Early By Paying Once Every Four Weeks Rather Than Once Per Month

Loan Amount: $200,000	With no extra payments:	With one extra payment per year:
Loan Term: 30 Years	Number of Payments Per Year: 12	Number of Payments Per Year: 13
Annual Interest Rate: 5%	Pay-Off Time: 30 Years	Pay-Off Time: 25 Years, 4 months
Monthly Payment: $1,073.64	Total Interest Paid: $186,511.57	Total Interest Paid: $152,998.52
Savings: $33,513.05 of interest over life of loan—paid off 4 years and 8 months early.		

Loan Amount: $100,000	With no extra payments:	With one extra payment per year:
Loan Term: 30 Years	Number of Payments Per Year: 12	Number of Payments Per Year: 13
Annual Interest Rate: 4%	Pay-Off Time: 30 Years	Pay-Off Time: 25 Years, 11 months
Monthly Payment: $477.42	Total Interest Paid: $71,869.51	Total Interest Paid: $60,867.98
Savings: $11,001.53 of interest over life of loan—paid off 4 years and 1 month early.		

Loan Amount: $150,000	With no extra payments:	With one extra payment per year:
Loan Term: 15 Years	Number of Payments Per Year: 12	Number of Payments Per Year: 13
Annual Interest Rate: 5%	Pay-Off Time: 15 Years	Pay-Off Time: 13 Years, 5 months
Monthly Payment: $1,186.19	Total Interest Paid: $63,514.28	Total Interest Paid: $56,094.54
Savings: $7,419.74 of interest over life of loan—paid off 1 year and 7 months early.		

For someone who is paid once every two weeks (26 times per year), the mortgage payment is paid with every other paycheck for 10 months during the year, and with every third paycheck for the other two months of the year. The above examples illustrate how much can be saved by simply making a mortgage payment with every other paycheck for all 12 months during the year.

Source: www.mortgagecalculators.info/calc-additionalpayment.php

Online Refinancing Calculators

Several free online calculators are available to help taxpayers calculate the effect of refinancing a mortgage. The calculators show the amount that will be saved compared with the costs incurred so that the borrower can determine whether the refinancing offer is right for him or her.

Bankrate.com
www.bankrate.com/calculators/mortgages/refinance-calculator.aspx

Calculators 4Mortgages
www.calculators4mortgages.com/mortgage-calculator/refinance

Mortgage-calc.com
www.mortgage-calc.com/mortgagerefinancing/mortgage_refinancing.html

Mortgage101
www.mortgage101.com/refinance-calculator

HSH.com
www.hsh.com/refinance-calculator

First-Time Homebuyer — Buy or Rent?

Cross References

- Form 1098, *Mortgage Interest Statement*
- IRS Pub. 523, *Selling Your Home*
- IRS Pub. 530, *Tax Information for Homeowners*
- IRS Pub. 936, *Home Mortgage Interest Deduction*
- IRC §121, *Exclusion of gain from sale of principal residence*

Tax Issue

Homeownership is a dream of many Americans. Whether it is economically more beneficial to rent or buy depends on many variables, including whether home values are rising or falling, how long the individual plans to stay in one location, and whether or not the individual is willing to take on the responsibility of maintaining the upkeep on a home. The advantages of owning or renting are different for everyone, however, the tax benefits available to homeowners can provide significant savings.

Applicable Tax Law

- Real estate taxes are deductible as itemized deductions if the taxpayer owns the real estate and the taxes are based on the assessed value of the property.
- Mortgage insurance premiums paid for acquisition indebtedness after December 31, 2006, and before January 1, 2015, may be treated as deductible mortgage insurance. See *Planning forTax Law Changes,* page 5-1.
- Home mortgage interest paid, including acquisition debt and home equity debt, may be deductible as an itemized deduction.
- Deductible points paid at closing to purchase a home are generally deductible as mortgage interest.
- If the seller pays points, the buyer is treated as having paid the points for purposes of an itemized deduction.
- Individuals can exclude up to $250,000 ($500,000 MFJ) of gain on the sale of a qualifying principal residence.

Tax Planning Strategies

One way to help a taxpayer decide whether they should buy or rent is to calculate how much he or she will have to pay each month if they purchase a home and compare it with how much they would have to pay to rent the same home. It is important to compare similar types of properties. Comparing a single-family home with an apartment will not be useful. It is also important to remember that homeownership entails additional housing expenses that a renter would normally expect the landlord to cover. These expenses include property taxes, homeowner's insurance, utilities, and home maintenance. Do not neglect to factor in the tax savings that owning a home will generate in the form of possible itemized deductions for mortgage interest and property taxes paid. Also, a home may appreciate over the time the taxpayer holds it, generating a possible gain on its sale which may qualify for a tax exclusion if the taxpayer otherwise qualifies.

Examples

Example #1: Sheryl is a renter currently paying $800 per month in rent. She anticipates an average annual increase in her rent of about 5% each year. She is thinking of purchasing a home for $110,000. Her monthly mortgage payment would be fixed at $1,000. According to the following chart, after six years, her monthly mortgage payment would be less than her monthly rent payment. When factoring in the approximate tax savings of home ownership ($1,800), her monthly homeowner's payment is less than the rental payment after only three years.

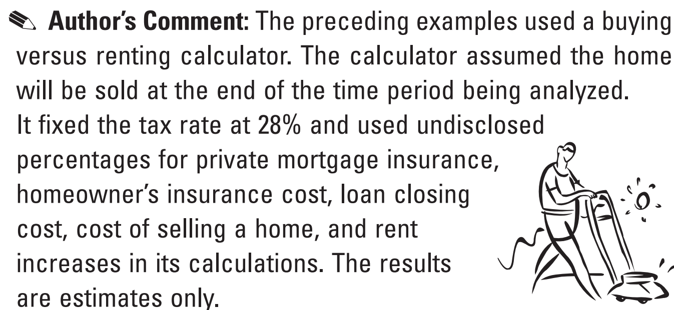
Years	*Rent Payment*	*Mortgage Payment*	*Monthly Difference*	*Yearly Difference*	*After-Tax Savings*
1	800	1000	-200	-2400	-600
2	840	1000	-160	-1920	-120
3	882	1000	-118	-1416	+384
4	926	1000	-74	-888	+912
5	972	1000	-28	-336	+1464
6	1021	1000	+21	+252	+2052
7	1072	1000	+72	+864	+2664
8 – 30				*Savings increase every year*	

Note: Negative numbers mean mortgage is more expensive than rent. Positive numbers mean mortgage saves money by the positive amount.

Example #2: Nick is currently paying $900 per month in rent. He has found a home he would like to buy for $200,000. He will put 10% down on a 30-year mortgage at 5% fixed interest rate. His yearly property taxes will be 1% of the property's value annually. Home values have been increasing in the neighborhood at a rate of about 2% per year. Nick is currently in the 28% tax bracket. If Nick spends only two years in the area, he would be better off economically to continue renting. However, with these assumptions, he would be better off buying the home if he stays in it for only one more year. After three years, the tax savings will have made buying the home the better economic decision.

Example #3: Assume the same facts as Example #2, with the exception that home values are stagnant. In this case, Nick would have to stay in the home for six years before the tax savings from buying the home will make it a better economic choice than renting.

✎ **Author's Comment:** The preceding examples used a buying versus renting calculator. The calculator assumed the home will be sold at the end of the time period being analyzed. It fixed the tax rate at 28% and used undisclosed percentages for private mortgage insurance, homeowner's insurance cost, loan closing cost, cost of selling a home, and rent increases in its calculations. The results are estimates only.



There are several "Buy vs. Rent" calculators available online. See *Buy or Rent Online Calculators,* page 5-2. By factoring in several other variables, such as anticipated maintenance costs, property appreciation, and the lost opportunity cost of investing the down payment in another savings vehicle, these online tools help analyze the costs/benefits over a number of years. Results will vary depending on the complexity of the calculator and the number of variables allowed.

Possible Risks

- If circumstances change, such as a job change or the neighborhood becomes undesirable for some reason, it's easier for a renter to move on short notice.
- A homeowner is responsible for the time and money required for the home's maintenance. Maintenance on a rental property is usually covered by the landlord.
- If it becomes necessary for a homeowner to sell the house at a time when the housing market is depressed, he or she could lose money on the investment. A loss on the sale of a principal residence is not tax deductible.
- Potential tax benefits, such as deductions on mortgage interest and property taxes, may not be significant if the taxpayer does not have enough other deductions to itemize on his or her individual income tax return.

First-Time Homebuyer—Deducting Points

Cross References

- Form 1040 (Schedule A), *Itemized Deductions*
- Form 1098, *Mortgage Interest Statement*
- IRS Pub. 936, *Home Mortgage Interest Deduction*
- Rev. Proc. 94-27

Tax Issue

Points paid to purchase a home are fully deductible in the year paid if the loan meets certain criteria. However, first-time homebuyers who purchase a residence late in the year often find they do not have enough mortgage interest or property taxes accumulated to benefit from itemizing deductions. The deduction for points paid on the purchase of their home may be lost.

Applicable Tax Law

- Points are fully deductible in the year paid if all of the following provisions are true.
  - The loan is secured by the taxpayer's main home,
  - Paying points is an established business practice in the area where the loan was made,
  - The points paid were not more than the points generally charged in that area,
  - The taxpayer uses the cash method of accounting,
  - The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes,
  - The funds the taxpayer paid at closing, plus any seller paid points, were at least as much as the points charged. The funds paid do not have to have been applied to the points. The funds paid can include a down payment, an escrow deposit, earnest money, etc. The funds cannot have been borrowed from the lender or mortgage broker,
  - The loan is used to buy or build the taxpayer's main home (not a second home),
  - The points were computed as a percentage of the principal amount of the mortgage, and
  - The points are clearly shown on the settlement statement as points charged for the mortgage.

- Deductible points paid at closing to purchase a home are generally included as mortgage interest on Schedule A (Form 1040).
- Deductible points paid may be deducted in full in the year paid or amortized over the life of the mortgage.
- If points are being deducted over the life of the mortgage, and the mortgage is paid off early (such as another refinance or sale of the house), then any remaining

balance is deductible in full in the year the mortgage ends unless the mortgage is refinanced with the same lender.
- Points paid on obtaining a permanent mortgage to refinance short-term debt are deductible in full in the year paid if the points are paid in connection with the purchase of the main home.
- If the seller pays the points, the buyer is treated as having paid the points. The buyer deducts the points as an itemized deduction and then reduces the home's basis by the amount of seller-paid points.

Tax Planning Strategies

A taxpayer, in the situation of incurring deductible points in a year in which he or she does not have enough deductions to itemize, may choose to amortize the points over the life of the mortgage rather than allowing the current deduction. Electing to amortize the points paid for the purchase of the home preserves the tax benefits by extending the deduction into future years. Although the yearly deduction may be small when amortized over 15 or 30 years, a large deduction can be waiting for the taxpayer if the mortgage is paid off early.

Examples

Example #1: Matt bought his first home in November 2015. Matt is single. He paid $2,400 in points to get a 30-year $80,000 mortgage. He made his first mortgage payment in December 2015. For 2015, his itemized deductions, including the points paid, total $4,750. His standard deduction is $6,300. Since his standard deduction for 2015 is greater than his itemized deductions, Matt should amortize the points paid over the 30-year life of the mortgage. His calculation would be as follows:
- $2,400 (points paid) ÷ 360 (monthly payments) = $6.67 (monthly deduction)

Since he made one mortgage payment in 2015, he must allocate one month's amortization, or $6.67 to 2015.

For 2016 through 2043, he will deduct $80 each year.
- $2,400 (points paid) ÷ 360 (monthly payments) × 12 (payments per year) = $80

In 2044, Matt will only deduct 11 months worth, or $73.33

Example #2: Dan paid $3,000 in points when he purchased his house in October 2004. He amortized those points over the 30-year life of the mortgage. Through 2014, Dan has deducted $1,025 of the points as follows:

2004 (3 months)	$ 25	($3,000 ÷ 360 × 3)
2005 – 2014	$1,000	($3,000 ÷ 360 × 120)
	$1,025	

Dan prepaid his mortgage in full in January 2015. He can deduct the remaining $1,975 of points ($3,000 – $1,025) in full in 2015.

Example #3: Assume the same facts as Example #2, except that instead of paying off the mortgage in full, Dan refinances his mortgage with a different lender. Dan can still deduct the remaining $1,975 of points in full in 2015. If, in addition, he pays deductible points to obtain the refinance, Dan will amortize those points over the life of the new mortgage. He does not have the option of deducting points in the year paid for a refinanced mortgage.

Example #4: Assume the same facts as Example #3, except that instead of refinancing with a different lender, Dan refinances his mortgage with the same lender. The refinanced mortgage is a 15-year mortgage. In this case, Dan will amortize the $1,975 remaining points over the 15-year life of the loan. His annual deduction will be $10.97 per month ($1,975 ÷ 180).

Possible Risks

- If the taxpayer continues to be in a situation where the standard deduction is greater than his or her itemized deductions, the deduction will still be lost.
- If the taxpayer refinances the loan with the same lender, any remaining points balance is deducted over the life of the new mortgage.

Does It Make Sense to Refinance a Mortgage?

Cross References

- Form 1098, *Mortgage Interest Statement*
- IRS Pub. 936, *Home Mortgage Interest Deduction*
- IRC §163, *Interest*

Tax Issue

The chance to refinance a mortgage and get a lower interest rate is sure to get a homeowner's attention. Most people assume that refinancing will put them ahead economically, but that may not always be the case. Any number of situations can arise which will make the decision to refinance unwise. Also, a lower interest may reduce tax deductible interest, but the homeowner may benefit from a substantially lower total interest payment over the life of the loan.

Applicable Tax Law

- Home mortgage debt, including acquisition debt, home equity debt, and points or loan origination fees paid to refinance a mortgage, generate interest which may be deductible as an itemized deduction on Schedule A (Form 1040).
- Total acquisition debt on main and second home combined is limited to $1 million ($500,000 MFS) at any time.

- Debt secured by the home and used to refinance acquisition debt is treated as acquisition debt up to the balance of the old mortgage principal just prior to refinancing.
- Debt used to substantially improve the home is acquisition debt.

- Refinanced debt in excess of the old acquisition debt principal may qualify as home equity debt.
- Total home equity debt on a main and second home combined is limited to the smaller of $100,000 ($50,000 MFS), or the total of each home's FMV reduced (but not below zero) by acquisition and grandfathered debt for each home on the date the last debt was secured by the home.

Tax Planning Strategies

Homeowners may consider refinancing their mortgages for a number of reasons.

- The interest rate on a mortgage is directly tied to how much the monthly payment is. Lower rates usually mean lower payments. If a borrower's credit score has improved since the current mortgage was obtained, or market conditions have changed to make lower interest rates available, refinancing to obtain a lower interest rate will allow the borrower to build up equity in the home more quickly.
- A homeowner may want to adjust the length of his or her mortgage. A mortgage with a longer term will reduce the amount paid each month. However, this will also increase the total amount he or she ends up paying in interest over the life of the mortgage. Shorter-term mortgages generally have lower interest rates. Plus, they are paid off sooner, further reducing total interest cost. The trade-off is generally higher monthly payments because more principal is being paid each month.
- A homeowner with an adjustable-rate-mortgage (ARM) must adjust to monthly payment increases or decreases as interest rates change. He or she may want to switch to a fixed-rate mortgage to obtain some peace of mind by having a steady interest rate and monthly payment. This is especially true if he or she believes interest rates may rise in the future.
- A homeowner may choose to refinance a mortgage if the home's value is greater than the balance owed on the current mortgage. He or she may do this to receive the difference as a cash source for such things as making home improvements or paying for a child's education.

When deciding whether or not to refinance, the homeowner should calculate the financial benefit of refinancing over a number of years. If the taxpayer plans to stay in the house until the mortgage is paid off, it may also help to look at the total interest that will be paid under both the old and new loans. Another good thing to compare is the equity build-up in both loans. If the borrower has had the original loan for a while, more of the payment is going to principal, building up equity. If the new loan has a term longer than the remaining term on the existing mortgage, less of the early payments will go to principal, slowing down the equity build-up in the home.

Refinancing calculators. Many online mortgage calculators are designed to calculate the effect of refinancing a mortgage. These calculators usually require information about the current mortgage (such as the remaining principal, interest rate, and years remaining on the mortgage), the new loan being considered (such as principal, interest rate, and term), and the upfront or closing costs for the loan. Some may ask for the borrower's tax rate and the rate of interest on investments (assuming the savings will be invested). Refinance calculators will show the amount that will be saved compared with the costs incurred so that the borrower can determine whether the refinancing offer is right for him or her. See *Online Refinancing Calculators,* page 5-3.

Examples

Example #1: Kim currently has a $200,000 30-year mortgage on her home at a fixed interest rate of 6%. Her monthly payments are $1,199. She can refinance her loan at a 5% interest rate, reducing her monthly payments to $1,074. This is a monthly savings of $125. Over one year's time, the savings is $1,500 and over 10 years the savings adds up to $15,000.

Monthly payment at 6%	$ 1,199
Monthly payment at 5%	$ 1,074
Savings per month	$ 125
Savings per year ($125 × 12)	$ 1,500
Savings over 10 years ($1,500 × 10)	$15,000

Example #2: Assume the same facts as Example #1. If Kim keeps her current mortgage, she will pay $431,640 ($1,199 × 360) over the life of the mortgage. Of this amount, $231,640 will be interest ($431,640 – $200,000). By contrast, a 15-year mortgage at 6% requires higher monthly payments of $1,688 resulting in a total outlay of $303,840 of which only $103,840 ($303,840 – $200,000) will be interest.

$200,000 Mortgage	*Monthly Payment*	*Total Payments*	*Total Interest*
30-year loan at 6%	$1,199	$431,640	$231,640
15-year loan at 6%	$1,688	$303,840	$103,840

Example #3: Assume the same facts as Example #1. Kim wishes to estimate the amount of time it will take her to recover her refinancing costs before she will benefit from a lower mortgage rate. She can get a new $200,000, 30-year fixed-rate mortgage at 5%. The fees for her new loan are $2,500, paid in cash at closing. Kim's tax rate is 28%. She uses the following worksheet to guide her.

1) Current monthly mortgage payment $1,199
2) Subtract the new monthly payment $1,074
3) Monthly savings .... $ 125
4) Subtract borrower's tax rate from 1.00 (e.g. 1.00 – 0.28 = 0.72) 0.72
5) Multiply monthly savings (#3) by borrower's after-tax rate (#4) .... $125 × 0.72
6) Borrower's after-tax savings $90
7) New loan's total fees and closing costs $2,500
8) Divide total costs by monthly after-tax savings (from #6) $2,500/90
9) This is the number of months it will take to recover the refinancing costs .... 28 months

Example #4: Assume the same facts as Example #1, except that Kim has already made payments on her existing mortgage for five years. She will be refinancing the remaining balance on the loan of $186,109 at 5% interest for 30 years. Closing costs are $2,500 to be paid at closing.

	Total Paid	Interest
Current mortgage cash outlay – 30 years		
Total payments ($1,199 × 360)	$431,640	
Total interest paid – 6% ($431,640 – $200,000)		$231,640
Refinance mortgage cash outlay – 35 years		
5 years current mortgage ($1,199 × 60)	$71,940	
5 years interest on current mortgage – 6%		$58,049
Cash paid at closing	$2,500	
Total payments new mortgage ($999 × 360)	$359,640	
Total interest on new mortgage – 5%		$173,531
Total payments	$434,080	$231,580

In this case, Kim will be able to reduce her monthly payments by $200 each month. Although she has an additional five years of payments to make and will be paying $2,440 ($434,080 – $431,640) more over the life of the loans, by reducing her interest rate from 6% to 5%, she is actually reducing her total interest expense by $60 ($231,640 – $231,580). Using the worksheet from Example #3, she calculates that it will take her a little more than 17 months to recover the costs of refinancing [total costs divided by monthly after-tax savings = $2,500/($200 × 0.72)].

Example #5: Assume the same facts as Example #4, except that Kim will be refinancing the remaining balance of $186,109 at 5% interest for 15 years.

	Total Paid	Interest
Current mortgage cash outlay – 30 years		
Total payments ($1,199 × 360)	$431,640	
Total interest paid – 6% ($431,640 – $200,000)		$231,640
Refinance mortgage cash outlay – 20 years		
5 years current mortgage ($1,199 × 60)	$71,940	
5 years interest on current mortgage – 6%		$58,049
Cash paid at closing	$2,500	
Total payments new mortgage ($1,472 × 180)	$264,960	
Total interest on new mortgage – 5%		$78,851
Total payments	$ 339,400	$136,900

Kim is increasing her monthly payments by $273 ($1,472 – $1,199) but reducing the duration of her mortgage by 10 years. By doing this, she has reduced her cash outlay over the life of the loans from $431,640 to $339,400, a savings of $92,240. By reducing her interest rate, as well as the number of payments, the total interest she will pay is reduced from $231,640 to $136,900, nearly $95,000.

Example #6: Assume the same facts as Example #5, except that Kim sells the home after three years.

	Total Paid	Interest
Current mortgage cash outlay – 8 years		
Total payments ($1,199 × 96)	$115,104	
Total interest paid – 6%		$90,969
Refinance mortgage cash outlay – 8 years		
5 years current mortgage ($1,199 × 60)	$71,940	
5 years interest on current mortgage – 6%		$58,059
Cash paid at closing	$2,500	
Total payments new mortgage ($1,472 × 36)	$52,992	
Total interest on new mortgage – 5%		$26,814
Total payments	$127,432	$84,873

Kim has reduced the amount of interest she is paying over the total eight years from $90,969 to $84,873, and therefore has paid $6,096 more on the principal of the loan. However, she has spent a total of $12,328 ($127,432 – $115,104) more than if she had stayed with the original mortgage.

Possible Risks

- The proportion of a monthly mortgage payment that is credited to the principal of the loan increases each year, while the proportion credited to the interest decreases each year. In the later years of a mortgage, more of the monthly payment applies to the principal and helps build equity. By refinancing late in the mortgage, the amortization process is restarted and most of the monthly payment will be credited to paying interest again and not to building equity.

continued on next page

- The current mortgage may have a prepayment penalty. Carefully consider the costs of any prepayment penalty against the savings expected to be gained by the refinancing. Paying a prepayment penalty will increase the time it will take to break even when balancing the costs against the expected savings. If refinancing with the same lender, ask whether the prepayment penalty can be waived.

- The total monthly savings gained from lower monthly payments may not exceed the costs of refinancing if the homeowner is planning to move in the near future.
- If the borrower's credit score has fallen since the current mortgage was obtained, the new loan may require a higher interest rate.
- If housing prices have fallen, the house may not be worth as much as what is owed on the current mortgage. Even if home prices have stayed the same, a loan which includes negative amortization (the monthly payment is less than the interest and the difference is added to the principal) may result in more being owed on the mortgage than was initially borrowed. Such a situation would make it difficult to refinance.
- When refinancing to get cash for something such as home improvements or higher education, equity is being taken out and it will take time to build the equity back up. This means that if the borrower needs to sell his or her home, they will not pocket as much money after the sale.
- Refinancing is not the only way to decrease the term of a mortgage. By paying a little extra on principal each month, the borrower will pay off the loan sooner and reduce the term of the loan. For example, adding $50 each month to the principal payment on the mortgage in Example #1 reduces the term by three years and saves the borrower more than $27,000 in interest costs.

Reverse Mortgages

Cross References

- Form 1040 (Schedule A), *Itemized Deductions*
- Form 1098, *Mortgage Interest Statement*
- IRS Pub. 936, *Home Mortgage Interest Deduction*

Tax Issue

Equity in a taxpayer's home is often considered one of the most important assets. As the taxpayer gets older and is ready to downsize to a condominium or townhouse, the taxpayer can sell the home, exclude up to $250,000 of gain ($500,000 MFJ) if the ownership/use tests are met, take the equity and pay cash for the purchase of a new condominium or townhouse, and possibly have some leftover cash to invest for retirement.

The problem with this approach for some is they are not yet emotionally ready to move because their home is where their family was raised. Another problem might be that although they are getting too old to take care of a big house, there might not be enough cash left over from the home sale and purchase of a new home to live on during retirement. Home equity loans from previous purchases may eat up too much of the equity for there to be anything left. The taxpayer may not be able to afford to sell the home and downsize to a more convenient condominium or townhouse.

Under these circumstances and others, the equity in a taxpayer's home may be meaningless if it is locked up inside a home the taxpayer is unwilling or unable to sell.

Applicable Tax Law

- Interest on a reverse mortgage is deductible only when a payment is made on the mortgage.
- Payments received by the taxpayer from the reverse mortgage are not taxable.
- A reverse mortgage gives a taxpayer a monthly income, lump-sum payout, or a line of credit. No payment is due on the reverse mortgage until the home is sold, the owner dies, or the owner ceases to live in the property for a specified period of time.
- To qualify for a reverse mortgage, a homeowner must:
  - Be 62 years of age or older,
  - Own the property outright or have a small mortgage balance,
  - Occupy the property as his or her principal residence, and
  - Not be delinquent on any federal debt if it is a federally insured reverse mortgage.
- The amount loaned on a reverse mortgage is determined by the age of the youngest borrower, the current interest rate, the lesser of the appraised value or FHA mortgage limit, and the initial mortgage insurance premium. The loan is a non-recourse debt. The homeowner retains title to the home.
- To qualify, a property must meet all FHA property standards and flood requirements. The following eligible property types are eligible.
  - Single-family homes.
  - Multiple-unit home of 1–4 units with the eligible unit being occupied by the borrower.
  - HUD-approved condominium.
  - Manufactured home that meets FHA requirements.
- The income, lump-sum payout, or line of credit available to the borrower is not taxable to the borrower.
- No income or employment qualifications are required of the borrower.
- No repayment of the reverse mortgage is needed as long as the property is the borrower's principal residence and the obligations of the mortgage are met.
- Closing costs may be financed in the mortgage.

Tax Planning Strategies

Taxpayers who are unwilling or unable to sell their home, and need additional income during retirement, may benefit from a reverse mortgage. The payments received by the taxpayer on a reverse mortgage are not taxable to the taxpayer.

Tax-free income. Taxpayers can use a reverse mortgage to generate tax-free income. The taxpayer converts equity built up inside the home into cash without having to sell the home and move. See *Example #1,* below.

Eliminate mortgage payments. Taxpayers can use a reverse mortgage to pay off an existing mortgage, thereby creating a need for less income. See *Example #2,* below. This can sometimes benefit a taxpayer who is considering retirement but does not currently have enough money to retire on. See *Example #3,* below.

Home modifications. Taxpayers can use a reverse mortgage to modify an existing home. By making changes to the home, the taxpayer can continue to live in the home rather than sell and move to a different location. This can be especially important to taxpayers who wish to keep the home in the family or have an emotional attachment to the home. See *Example #4,* next column.

Examples

Example #1: Louise, a single taxpayer age 64, owns her home. Her home is worth $175,000 and she owns it outright. Her monthly sources of income include Social Security of $1,250 and a pension of $1,400. She needs $3,000 per month to live on and has no other assets to generate income. Louise takes a reverse mortgage and receives a monthly payment of $505. The annual income from the reverse mortgage of $6,060 is not taxable. In addition, the reverse mortgage payment does not cause any of her Social Security benefits to be taxable.

Example #2: Jack, age 75, and Margaret, age 72, owe $20,000 on their current mortgage. Their home is worth $100,000 and their current payment on their mortgage is $700 per month. Jack and Margaret take out a lump-sum reverse mortgage of $20,000 and use it to pay off the $20,000 mortgage. They no longer have a house payment which frees up $700 per month. The amount used to pay off the original mortgage is not taxable for Jack and Margaret.

Example #3: William, age 65, is looking to retire. He is concerned that he needs to wait seven more years because his mortgage will not be paid off until then. He currently owes $65,000 on his current mortgage and his monthly payment is $900. His home is worth $225,000. In reviewing his anticipated retirement income and expenses, if he were to retire today, he would have a shortage each month of $400.

William decides to do a reverse mortgage to pay off his $65,000 mortgage. In addition, the reverse mortgage generates an income of $288. Instead of waiting seven years to retire, William has the choice to be able to retire immediately.

	With Current Mortgage	*With Reverse Mortgage*
Income:		
Pension	$ 500	$ 500
Social Security	$1,400	$1,400
Reverse mortgage	$ 0	$ 288
Total Income	$1,900	$2,188
Expenses:		
Mortgage	$ 900	$ 0
Other expenses	$1,400	$1,400
Total expenses	$2,300	$1,400
Shortage/surplus	($ 400)	$ 788

Neither the lump sum nor the monthly income generated by the reverse mortgage is taxable to William.

Example #4: Hazel, a widow age 85, owns her home outright. She has lived in the two-story home for her entire adult life. The only bathroom in her house is on the second floor and she is having difficulty climbing the steps. She wants her daughter to eventually have the house, but is considering selling it to make her own living arrangements easier. Instead, Hazel takes a reverse mortgage, either a lump sum or line of credit.

She uses the funds to remodel the first floor of her home by turning the den into a bedroom and adding a bathroom. The money Hazel receives from the reverse mortgage is not taxable to her.

✎ **Author's Comment:** A reverse mortgage can be a good source of funds for a taxpayer who is in or near retirement. The payout from the reverse mortgage to the borrower is tax free to the borrower. By using a reverse mortgage, a taxpayer can use the funds to generate income, pay off debts, remodel his or her home, and make critical financial decisions.

Possible Risks

- The deduction of interest on a reverse mortgage, whether by the taxpayer while alive or by the estate after the borrower's death, may be limited because of the limits on home equity debt.
- The examples in this strategy are for illustration purposes only. The actual amount of payment, line of credit, or lump sum depends on the location, appraisal value, age of the borrower and current interest rate. Only a mortgage contract can guarantee a payment, term, or interest rate.
- The cost of financing the reverse mortgage can be very similar to the cost of purchasing a home. Appraisals, loan origination fees, and closing costs are often added to the loan.
- The reverse mortgage is generally required to be repaid within six months of the death of the last owner. Heirs

need to have a plan to finance the balance of the reverse mortgage if they wish to keep the house in the family. If heirs are looking to sell the property, the six-month timeframe may not be enough to sell the house at the price desired.
- The monthly payment option and line of credit option are available as variable rate loans. When interest rates increase, the cost of the loan increases.
- Taxpayers seeking to qualify for public assistance may need to include income or assets generated from reverse mortgages. For example, a lump sum paid from a reverse mortgage may be deposited into the borrower's savings account or other asset.
- Taxpayers with existing mortgages may have property tax and insurance being paid through escrow. When calculating the monthly costs in paying off a mortgage with a reverse mortgage, the property tax and insurance payments need to be taken into consideration as the taxpayers will need to pay those costs out-of-pocket after the reverse mortgage is in effect.
- Reverse mortgages can be very complex instruments especially for couples who are not both named on the reverse mortgage and/or title of the home. The death of one of the owners or borrowers can cause the reverse mortgage to become due, even though the surviving spouse wishes to continue to live in the home.
- If the intent is to leave the house to the children, the parent may use up all the equity in the home by living too long and collecting too much from the reverse mortgage. The children may not be able to afford to buy back the house from the mortgage company after the death of the parent.

Parents' Home — Tax Benefits for Children

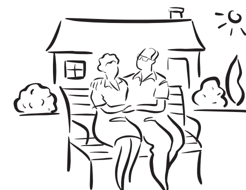
Cross References
- IRS Pub. 523, *Selling Your Home*
- IRS Pub. 527, *Residential Rental Property*
- IRC §121, *Exclusion of gain from sale of principal residence*

Tax Issue
Aging parents may live in a home that has appreciated in value. They no longer receive a tax benefit for home mortgage interest and property taxes because they have either paid off their mortgage or are close to the end of the mortgage where most of the payment is going toward principal and not interest.

For a number of reasons, parents may want to transfer ownership of their home to their children:

- To keep the home in the family for sentimental reasons.
- To shield the home from being lost should one or both have to go into a nursing home for an extended period of time.
- To take the appreciating home out of the parents' estate.
- To convert the home into investment property for their children.

There may also be a number of reasons why the parents want to remain living in their home.
- They are still healthy enough to take care of it.
- They have no desire to move into a condominium or townhouse where space is limited.
- The home has sentimental value.
- They like the location.



Applicable Tax Law
- Individuals can exclude up to $250,000 of gain on the sale of a home if all of the following three conditions are satisfied.
  1) ***Ownership test.*** The individual owned the home for at least two years during the 5-year period ending on the date of sale,
  2) ***Use test.*** The individual used the home as a principal residence for at least two years during the 5-year period ending on the date of sale, and
  3) The individual did not exclude gain from the sale of another home during the 2-year period ending on the date of sale.
- Married couples can exclude up to $500,000 of gain on the sale of a home if all of the following four conditions are satisfied.
  1) The married couple files a joint return for the year,
  2) ***Ownership test.*** Either spouse (or both spouses) owned the home for at least two years during the 5-year period ending on the date of sale,
  3) ***Use test.*** Both spouses used the home as a principal residence for at least two years during the 5-year period ending on the date of sale, and
  4) Neither spouse excluded gain from the sale of another home during the 2-year period ending on the date of sale.
- Taxpayers who do not meet the above ownership and use tests may qualify for a reduced exclusion.
- A surviving spouse who does not remarry before the sale of a home is considered to have owned and used the home as a primary residence during any period of time the deceased spouse owned and used it as a primary residence.
- The $500,000 exclusion for married couples will apply to unmarried individuals whose spouse is deceased on the date of sale provided that the sale occurs not later than two years after the date of death of the deceased spouse, and the couple would have qualified for the

$500,000 exclusion if the sale had occurred immediately before the date of death.

- No deduction is allowed for the personal use of a home by the taxpayer. A taxpayer is deemed to have used a home for personal purposes if the home is used by a family member and the home is not rented to the family member at fair rental value. Rents collected would be taxable but no deductions would be allowed (other than allowable mortgage interest and real estate taxes).
- Estate tax is due if the net estate is more than the estate tax exclusion for the year of death ($5.43 million for 2015).
- The value of the home owned by a decedent on the date of death must be included in the decedent's gross estate for estate tax purposes.
- The value of the home on the date of a gift is included on the donor's estate tax return at death.

Tax Planning Strategies

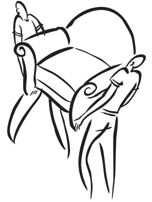
Have parent sell home to his/her child and then pay rent to live in it. If the child purchases the home from a parent and then rents it back to the parent at fair rental value, the child may benefit from tax breaks that the parent might no longer benefit from, such as deducting mortgage interest and property taxes. Even if the parent is still deducting these expenses as itemized deductions, the parent may be in a lower tax bracket than the child and thus receive less of a tax benefit than if the same expense were incurred by the child. Thus, overall family taxes might be reduced.

The parent receives the following possible tax benefits.

- Receives cash (from the sale) without having to refinance or dip into the home with an equity loan.
- Is able to invest the sales proceeds in a safer investment than a possible stagnant or declining real estate market.
- Takes advantage of the $250,000 ($500,000 for MFJ) exclusion on the sale of a personal residence, thus converting the appreciation of the home into tax-free capital gains, while maintaining the ability to live in the home.
- Removes any future appreciation of the home from being included on the parent's estate tax return.
- Helps shield the home from being lost should one or both parents have to go into a nursing home for an extended period of time.

The child receives the following possible tax benefits.

- The child can offset the rental income by writing off rental expenses such as mortgage interest, taxes, depreciation, utilities, maintenance, insurance, repairs, and supplies as rental expenses. These same expenses (other than mortgage interest and property taxes), if paid by the parent as owner of the home (without converting the home into rental property), would be nondeductible personal expenses.
- The child may be able to write off occasional travel expenses when visiting his/her rental property (and visiting the parent).
- If the parent wants new furniture, the parent can gift money to the child up to the annual exclusion ($14,000 per parent per child in 2015) without having to file a gift return. The child can then use the gift to purchase furniture for the rental unit and deduct the cost through depreciation.



Have parents gift the home to their child with a life estate. If the parents and/or child do not like the idea of converting the home into rental property, the parents can gift the home to the child with a life estate and thus retain the legal right to live in the home for the rest of their lives. This will not remove any future appreciation of the home from being included on the parent's estate tax return, but it will help shield the home from being lost should one or both parents have to go into a nursing home for an extended period of time.

✎ **Author's Comment:** Real estate values have dropped significantly in recent years. However, the history of real estate values suggests the prices will rise again. If estate tax planning is the goal, it is best to gift the home to the children when the value is low rather than waiting until the value is high.

Examples

Example #1: Ray and Lois are retired and make less than the filing requirement each year. Their house is paid for. Their property taxes are $1,200 per year. Their house insurance is $800 per year. They sell their house to their daughter Linda for $160,000. The gain on the sale is excluded from their income. They use the $160,000 to invest in a nonqualified annuity that pays them $8,000 per year of income. The $8,000 per year causes their taxable income to be $5,000 above the filing requirement. Federal and state tax on the $5,000 is $750 per year, leaving them with $7,250 ($8,000 – $750) of after-tax income attributable to sales proceeds from the house each year.

They pay Linda $8,400 per year for rent, plus utilities, to remain living in the home. Linda pays the property taxes, plus insurance, as the owner of the rental property. Ray and Lois' cost to live in the home is increased by $6,400 ($8,400 – $1,200 – $800). Thus, Ray and Lois are able to increase their after-tax income minus housing expenses by $850 ($7,250 – $6,400) per year without having to move out of their home.

Example #2: Assume the same facts as Example #1. Linda puts down $16,000 to purchase her parent's house and takes out a mortgage for $144,000 at 4% annual interest. Assume the land value of the house is $40,000. She receives $8,400 rental income from her parents. The rental income is offset by the following rental deductions.

Mortgage interest	$ 5,760
Property taxes	1,200
Insurance	800
Depreciation	4,363
Total deductions	$12,123
Net deductible loss each year ($8,400 – $12,123)	$ 3,723

Assume Linda is in a 25% federal and state tax bracket. Linda saves $931 ($3,723 × 25%) in taxes each year by deducting the rental loss from other income. Linda's after-tax cash flow each year, not counting the principal portion of the mortgage payment, is a positive $1,571 ($8,400 + $931 – $5,760 – $1,200 – $800). Thus, the $1,571 represents the amount she receives each year from rent that may be applied toward increasing her equity interest in her rental property. The principal portion of her mortgage payments (which are not tax deductible) are also considered as being applied toward increasing her equity interest in the rental property.

✎ **Author's Comment:** There are two ways Linda could view the $1,571 amount. (1) She could consider the $1,571 as positive cash flow that helps pay for the cost of the principal portion of her mortgage payments. (2) She could consider the $1,571 as an extra amount available to apply toward the principal of her mortgage, thus reducing the time needed to pay off the mortgage. If Linda considers all payments applied toward the principal of her mortgage as an investment in her rental property, then the $1,571 represents her ability to increase her investment in the rental property without any additional cost to her.

Possible Risks

- If the child files for bankruptcy, the home could become part of the bankruptcy estate and sold to pay off creditors.
- Any deduction for travel expenses for the child to visit the rental property could be subject to IRS scrutiny if the child is also traveling to visit the parents.
- The look-back period for gifts is five years for purposes of long-term care under Medicaid (Public Law 109-171). Thus, if a nursing home patient runs out of assets, the government has the right to examine all financial transactions a person has made within the past five years (including gifts) for purposes of determining eligible Medicaid assistance status.
- Mixing gifts with rental transactions could cause the IRS to reclassify the transaction as a sham. For example, if the parent gifts money to the child and the child immediately uses the exact same amount to purchase furniture for the rental unit, the IRS might try to classify the gift as taxable rent or deny the depreciation deduction for the purchase of the furniture.

✎ **Author's Comment:** It may help if the amount of the gift was not identical to the purchase price of the furniture. It may also help if there is a period of time after the gift is given before the child purchases the furniture.

Court Cases

Court Case: The taxpayer rented a house to his parents for $250 per month. The parents paid for the utilities in addition to the rent. The parents also paid for materials used to make repairs and capital improvements to the property. During the year in question, the taxpayer paid $2,080.91 for mortgage interest, $222 for insurance, $415.37 for property taxes, and $1,927.07 for repairs. When the taxpayer first rented to his parents, he believed that they would take very good care of the house and would make improvements to it.

IRC section 280A(a) states that no deduction is allowable with respect to the use of a dwelling unit which is used as a residence by a taxpayer during the year. IRC section 280A(d)(2)(A) says that a taxpayer shall be deemed to have used a dwelling unit for personal purposes on any day that the unit is used by a member of the taxpayer's family. A parent is considered a member of the taxpayer's family under this rule. IRC section 280A(d)(3)(A) says a taxpayer shall not be treated as using a dwelling unit for personal purposes by reason of a rental arrangement if the dwelling unit is rented at fair rental value to any person for use as that person's principal residence.

The Internal Revenue Code does not define "fair rental value," but legislative history suggests the following factors should be used to determine fair rental value.

- Comparable rentals in the area, and
- Whether substantial gifts were made by the taxpayer to the family member at or about the time of the lease or periodically during the year.

An appraiser concluded that fair rental value for the house should have been $450 a month. The appraiser also said fair rental value might be lowered by 10% or, at most, 20% in the case of tenants who were expected to take unusually good care of the rented property. The appraiser also said that had the taxpayer negotiated a management agreement for the rental house with a realtor, the taxpayer would have had to pay a commission of 5% to 10%.

The court concluded that the taxpayer could have rented the house to a stranger for $450 per month. The court also concluded that fair rental value could be discounted 20% to $360 per month by avoiding a management fee and renting to trustworthy tenants. However, the court also said the taxpayer would have had no cause of action against his parents for their failure to make improvements to the property. Thus, the money spent by the parents to repair and improve the property could not be used to discount the fair rental value any further. Since the parents paid $250 per month for rent, the taxpayer failed to prove that he received a fair rental for renting the home to his parents. *(Bindseil,* T.C. Memo 1983-411)

Court Case: Taxpayer purchased a residence from the taxpayer's wife's parents and her maternal grandmother. The parents and grandmother continued to use the home as their residence after the sale and paid rent to the taxpayer. A local real estate agency determined that fair rental value was $600 per month. The taxpayer testified at court that he received $500 per month as rent, but that he reported $600 per month as rents received on his tax return on the advice of an IRS revenue agent, in order to satisfy the fair rental requirement of IRC section 280A.

The IRS limited the taxpayer's deductible expenses to the rents received on the grounds that the rental arrangement was not at fair rental value. The court ruled that the taxpayer only received $500 per month for rent. Since the $500 per month rent was below fair rental value, and the rental was to a family member, the taxpayer was deemed to have used the residence for personal purposes during the entire year. Thus, none of the claimed deductions were allowable under IRC section 280A(c)(3) and IRC section 280A(e)(1) by reason of being attributable to its rental.

The only allowable expenses which were deductible were mortgage interest and property taxes, which are deductible on Schedule A as itemized deductions regardless of whether or not the residence is rented. *(Jackson,* T.C. Memo 1999-226, July 9, 1999)

✎ **Author's Comment:** The court in the *Jackson* case said the IRS erroneously determined that the taxpayer could deduct expenses attributable to the rental up to the amount of rent received. Under the mixed-use of property rules (the Vacation Home rules), deductions are limited to gross rental income. Unused deductions may be carried forward to future years. However, in this case, the residence was not mixed-use property. 100% of it was considered personal use. Since none of the use was considered rental (due to renting to a family member below fair rental value), then none of the expenses could be attributable to rental use. The gross rental income must be reported on line 21 as other income, and mortgage interest and property taxes must be reported on Schedule A as itemized deductions. No other expenses were allowed.

✎ **Author's Comment:** The court in the *Jackson* case also made no mention of being able to discount the rent 20% for trustworthy tenants such as family members. If the issue had been raised and the court agreed to allow such a discount, the $500 per month rent received would have been considered fair rental value. Other issues raised in the case indicate the taxpayer had overstated other deductions for charitable contributions and employee business expenses. This indicates that discounts for trustworthy tenants are not automatic. It also illustrates the importance of being able to substantiate all deductions claimed.

Court Case: A mother executed a Warranty Deed transferring her home to her son subject to a life estate allowing her to remain in the home. Years later, the son and his wife moved into the home to help take care of his aging mother. The son filed for bankruptcy and claimed that the home was exempt from the bankruptcy estate. The trustee of the bankruptcy estate filed an objection to the son's claim of exemption. The son's interest in the home was a remainder interest with no present right of possession. The bankruptcy court found that the home did qualify as exempt homestead. The son occupied the home as a permanent residence and made personal and financial contributions to the home. *(Williams,* U.S. Bankruptcy Court, March 31, 2010)

✎ **Author's Comment:** The above court decision was determined primarily due to the fact that the son and his wife were using the home as their residence. It is doubtful that the son would have been able to shield the home from the bankruptcy estate if the home was not used as his residence.

Sale of Principal Residence — Construction Contractors

Cross References

- Schedule SE (Form 1040), *Self-Employment Tax*
- IRS Pub. 523, *Selling Your Home*
- IRC §121, *Exclusion of gain from sale of principal residence*

Tax Issue

A taxpayer in the home construction business as a self-employed construction contractor is subject to income tax and self-employment tax on profits earned from the sale of residential homes. Individual tax rates can be as high as 39.6%. Self-employment tax is 15.3%. Add state income tax and the combined tax rate can be close to 50% on the profits from the sale of the last home sold during the tax year.

In recent years, construction contractors have been facing difficult times from a depressed real estate market. Construction contractors may have several model homes

built that are sitting vacant, with interest on debt used to construct the home accumulating to the point where there may be no profit left when the home is finally sold.

Home construction workers who subcontract their services to other construction contractors also risk losing payment for their services when they agree to wait for payment until the home sells. If the general contractor loses the home to the bank, the subcontractor risks not getting paid for work performed.

Applicable Tax Law

- Individuals can exclude up to $250,000 of gain on the sale of a home if all of the following three conditions are satisfied.
  1) ***Ownership test.*** The individual owned the home for at least two years during the 5-year period ending on the date of sale,
  2) ***Use test.*** The individual used the home as a principal residence for at least two years during the 5-year period ending on the date of sale, and
  3) The individual did not exclude gain from the sale of another home during the 2-year period ending on the date of sale.
- Married couples can exclude up to $500,000 of gain on the sale of a home if all of the following four conditions are satisfied.
  1) The married couple files a joint return for the year,
  2) ***Ownership test.*** Either spouse (or both spouses) owned the home for at least two years during the 5-year period ending on the date of sale,
  3) ***Use test.*** Both spouses used the home as a principal residence for at least two years during the 5-year period ending on the date of sale, and
  4) Neither spouse excluded gain from the sale of another home during the 2-year period ending on the date of sale.
- If either spouse does not meet all the requirements for the $500,000 exclusion, the couple can exclude the total of the exclusions that each spouse would qualify for if not married and the amounts were figured separately. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property.
- Taxpayers who do not meet the ownership and use tests may qualify for a reduced exclusion.
- The required two years of ownership and use during the 5-year period prior to the sale do not have to be continuous.
- The ownership test and the use test can be met at different times during the 5-year period.
- The sale of vacant land is treated as being included in the sale of a taxpayer's principal residence if:
  – The vacant land is adjacent to land containing the taxpayer's principal residence,
  – The taxpayer owned and used the vacant land as part of the taxpayer's principal residence,
  – The sale of the taxpayer's principal residence satisfies the requirements for exclusion and occurs within two years before or two years after the date of the sale of the vacant land, and
  – The ownership and use requirements for excluding gain from the sale of the vacant land have been satisfied.
- If the sale of vacant land qualifies for the exclusion, the sale of the principal residence and the sale of the vacant land are treated as one sale. Only one maximum limitation amount of $250,000 ($500,000 for eligible MFJ) applies to the combined sales.

Tax Planning Strategies

A construction contractor will pay zero tax on up to $500,000 of profits by building a new home (or remodeling an existing home), moving into it for two years, then selling it and excluding the gain under IRC section 121.

If the construction contractor has the knowledge and skill to perform several jobs, the construction contractor could also increase the potential profit on the home sold by doing all or most of the work himself or herself. This may also reduce the potential risk of not getting paid due to performing services for another construction company that goes bankrupt. This may also reduce the potential risk of having an over supply of housing inventory by spending more time doing all the work on one job versus hiring helpers to build several homes at once.

Examples

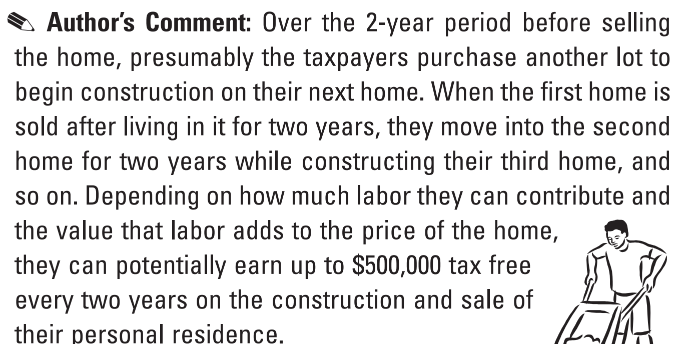
Example #1: Jim and Joy are married with no kids, live in Minnesota, file a joint return, take the standard deduction, and have no income other than their Schedule C construction business. They are both home construction workers with combined knowledge and skill to perform several jobs in the home construction trades. Over a 2-year period, they offer their services to other home construction companies and help build eight homes. Their combined profit for year one is $100,000. Their combined profit for year two is $80,000. Tax on their profits is calculated as follows (assume 2015 tax year rules):

Year 1 combined Schedule C profits	$100,000
Minus deductible portion of SE tax	(7,065)
Minus standard deduction	(12,600)
Minus personal exemption	(8,000)
Taxable income	$ 72,335
Federal income tax	$ 9,928
SE tax (15.3%)	$ 14,130
State income tax	$ 4,507
Combined tax	$ 28,565

Year 2 combined Schedule C profits	$ 80,000
Minus deductible portion of SE tax	(5,652)
Minus standard deduction	(12,600)
Minus personal exemption	8,000)
Taxable income	$ 53,748
Federal income tax	$ 7,140
SE tax (15.3%)	$ 11,304
State income tax	$ 3,197
Combined tax	$ 21,641

Over a 2-year period, total tax paid on their $180,000 profit from helping to build eight homes is $50,206 ($28,565 + $21,641).

Example #2: Assume the same facts as Example #1, except that instead of working for other contractors and helping to build eight homes over a 2-year period, they do all of the work building one home, move into it, and use it as their principal residence (after the home is able to be lived in but before the home is finished). Then, after owning and living in the home for two years and finishing the job, they sell the home for a gain of $180,000. There is no federal, state, or self-employment tax on the sale of their principal residence under IRC section 121. Thus, they save $50,206 in taxes by using all of their labor and skills to build their own principal residence rather than using those same skills to subcontract their labor for another construction contractor.



✎ **Author's Comment:** Over the 2-year period before selling the home, presumably the taxpayers purchase another lot to begin construction on their next home. When the first home is sold after living in it for two years, they move into the second home for two years while constructing their third home, and so on. Depending on how much labor they can contribute and the value that labor adds to the price of the home, they can potentially earn up to $500,000 tax free every two years on the construction and sale of their personal residence.

Possible Risks

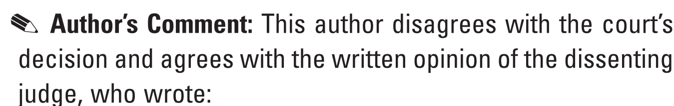
- The sale of a principal residence that qualifies for the IRC section 121 exclusion is not reported on the tax return. With little or no income reported by the taxpayer, there is a greater risk of being audited.
- If the construction contractor also builds and sells other homes for profit, accurate records and bookkeeping are required to keep the two activities separate. An IRS audit could reveal the taxpayer deducted expenses on the business return that were actually spent on building the personal residence of the taxpayer. It is common to purchase materials and supplies in bulk for more than one project at a time, which complicates bookkeeping.
- If the home was used for business, such as a home office, any gain attributable to depreciation deductions claimed after May 6, 1997, must be recaptured.
- For any period of time after 2008, if the home was used for any purpose other than as a principal residence (such as rental property) prior to moving into it and using it as a principal residence, gain from the sale or exchange is not excludable from the portion allocable to the period of time it was not used as a principal residence.
- If the real estate market is depressed, the number of foreclosed homes available for sale at reduced prices may make it difficult to turn a profit on constructing or remodeling a home.

Court Cases

Court Case: Taxpayers wanted to enlarge and remodel their home, but were advised by an architect that more stringent building and permit restrictions had been enacted since the original house was built. They decided to demolish the house and build a new one on the same property. After the new home was built, they decided to sell it before moving into it and realized a gain of $591,406. The taxpayers tried to exclude $500,000 of the gain under IRC section 121. The IRS said none of the gain was excludable because the new house was never used by the taxpayer's as their principal residence.

The court acknowledged that the Internal Revenue Code does not define the terms "property" and "principal residence." IRC section 121 simply provides that gross income does not include gain from the sale or exchange of property if "such property" has been owned and used by the taxpayer "as the taxpayer's principal residence" for the required statutory period. The taxpayers argued that since they used the original house and the land on which it was situated as their principal residence for the required period of time, then the sale of the land on which the original house had been situated should qualify for the IRC section 121 exclusion.

The court said that although a principal residence may include land surrounding the dwelling, the legislative history supports a conclusion that Congress intended the IRC section 121 exclusion to apply only if the dwelling the taxpayer sells was actually used as the taxpayer's principal residence for the required period of time. Since the taxpayers never used the dwelling that was sold as their principal residence, the court ruled that the IRC section 121 exclusion did not apply. *(Gates,* 135 T.C. No. 1, July 1, 2010)



✎ **Author's Comment:** This author disagrees with the court's decision and agrees with the written opinion of the dissenting judge, who wrote:

"I think that there is also adequate ground for concluding that [the taxpayers'] sale of the new house qualified for that exclusion...The majority focuses on the [property use condition] and interprets the condition as being satisfied only if the property sold constitutes, at least in part, a house or other structure used by the taxpayer as his principal place of abode…"

"Consider a taxpayer whose longtime home is demolished by a natural disaster (a hurricane). The taxpayer lacks insurance. Nevertheless, she rebuilds on the same land and lives in the rebuilt house for 18 months, and then she sells the house and land at a gain. Although the taxpayer satisfies the property use condition, I assume that, nevertheless, under the majority's analysis, she gets no exclusion because she fails the temporal condition; i.e., she has not lived in the rebuilt house for two or more of the last five years. I assume further that, if her house had been only damaged (and not demolished), and she repaired it, she would get an exclusion. That seems like an untenable distinction to me..."
"The majority's interpretation of the property use condition naturally suggests that there is some recognizable difference between remodeling a house and demolishing and rebuilding the house. I assume the majority does not mean to suggest that any remodeling of a home (1) terminates the use of that home as the taxpayer's principal residence and (2) resets the temporal clock to zero time elapsed. If not, then is there some level of remodeling that does (1) terminate the use of the home as the taxpayer's principal residence and (2) set the temporal clock to zero? What about a taxpayer who, wanting a bigger house, demolishes the old house (but not the foundation) and constructs a larger (taller) house using the old foundation? Is that remodeling or rebuilding?"

"...I would treat the demolition and reconstruction of [taxpayers'] house no differently from a renovation. As a second best solution (if I had adequate information), I would treat the original house as being sold for zero dollars upon its demolition and apply IRC section 121 to a subsequent sale of the land (and new house)."

Four other judges on the Tax Court agreed with the dissenting judge's opinion.

Principal Residence—Sale to Controlled Entity

Cross References

- Schedule C (Form 1040), *Profit or Loss From Business*
- Form 1120S, *U.S. Income Tax Return for an S Corporation*
- IRS Pub. 523, *Selling Your Home*
- IRC §121, *Exclusion of gain from sale of principal residence*

Tax Issue

A taxpayer who converts a principal residence into rental property may lose the sale of home gain exclusion under IRC section 121 and have a reduced deduction for depreciation due to lower basis.

Applicable Tax Law

Principal residence. A principal residence is the home where a taxpayer ordinarily lives most of the time. An individual can have only one principal residence at any one time. Houses, condominiums, cooperatives, mobile homes, house trailers, boats, or similar properties that have sleeping, cooking, and toilet facilities all qualify as a home.

- A taxpayer may exclude up to $250,000 ($500,000 if Married Filing Jointly) in gain from the sale of a principal residence if he or she satisfies the ownership and use tests.
  - ***Ownership test.*** The individual (at least one spouse) owned the home for at least two years during the 5-year period ending on the date of sale,
  - ***Use test.*** The individual (both spouses, if married) used the home as a principal residence for at least two years during the 5-year period ending on the date of sale, and
  - The individual (both spouses, if married) did not exclude gain from the sale of another home during the 2-year period ending on the date of sale.

- The required two years of ownership and use during the 5-year period prior to the sale do not have to be continuous.
- The ownership test and the use test can be met at different times during the 5-year period.
- If one spouse is ineligible, the other spouse generally remains eligible for a maximum exclusion of $250,000.
- Parcels of vacant land adjacent to a primary residence that have been used as part of the residence may also receive gain exclusion treatment if the sale of the vacant land occurs within two years before or after the sale of the principal residence.
- When a taxpayer converts a principal residence into rental property, the basis of the property is the lesser of:
  - The taxpayer's adjusted basis (original cost plus the costs of permanent additions or improvements), or
  - Fair market value (FMV) on the conversion date.
- Loss on the sale of a personal residence is never deductible.
- Loss on the sale of a rental property may be deductible as an ordinary loss.

Tax Planning Strategies

Homeowners that wish to rent out a former residence can maximize tax savings by first selling the residence to a controlled entity, such as a limited liability company (LLC) or an S corporation. The sale increases the tax basis for depreciation purposes and any gain on the sale may be excluded under IRC section 121.

Steps:

1) The taxpayer sells principal residence to a controlled entity (S corporation, LLC) in an arms-length transaction and excludes the gain from the sale under IRC section 121, if otherwise qualified.
2) The sale results in an increased basis (for depreciation purposes) to the FMV sales price.
3) The controlled entity then owns the home and rents it out, with rental income and expenses flowing through to the controlled entity's owner.

Examples

Example #1: Travis rents a home and lives in it as his primary residence starting in 2009. In October 2013, Travis buys the home he has been living in. He continues to live in it for a month and then moves to another home. In November 2015, Travis sells the home. Travis is eligible for the exclusion of gain because he used the home as his primary residence for at least two of the past five years (2009 until November 2013) and he has owned the home for at least two of the past five years (October 2013 until November 2015), even though the usage and ownership time frames did not occur at the same time.

Example #2: Bette's home has a value of $250,000 and a tax basis of $100,000. If Bette simply converts the property to a rental property, her basis for the depreciation deduction is $100,000, which results in an approximate depreciation deduction of $3,636 per year (27.5 year straight-line depreciation). However, if Bette establishes SEB, LLC to purchase the property for $250,000, the sales price becomes the depreciable basis, and depreciation deductions are approximately $9,091 per year. If rental income exceeds depreciation and other expenses, the net income flows through and is taxable to Bette on her personal return. If a net loss results, the loss flows through and is deductible subject to the passive activity loss limitations.

Example #3: Dena owns a home in Missouri and a home in California, where she spends five months every year. Dena has owned and lived in the home in Missouri for 20 years and the mortgage is paid off. The Missouri home's FMV is $275,000 and Dena's basis is $85,000. She wishes to convert the Missouri home to a rental property and move to California permanently. Dena forms an S corporation, 925, Inc., to purchase the Missouri home and conduct the rental activities. Dena takes out a mortgage loan on her Missouri home in the amount of $275,000 (FMV of the home) and loans that $275,000 cash to her S corporation, 925, Inc. which purchases the home from Dena for $275,000. Dena then pays off the mortgage loan from the bank. Dena can exclude the $190,000 gain ($275,000 sale price – $85,000 basis) resulting from the sale. The S corporation, 925, Inc., owns the home with a basis for depreciation of $275,000, and income and expenses from the rental flowing through to Dena on her individual income tax return.

Possible Risks

- If there is a mortgage balance on the personal residence, it will likely need to be paid off at the time of the sale to the controlled entity.
- If the rental property is later sold, any gain will be fully taxable. In addition, depreciation must be recaptured when the property is sold.
- While the taxpayer maintains control of the property, if he or she later wants to move back into the property, they must buy it back from the S corporation/LLC, which would trigger depreciation recapture.
- If the taxpayer owns more than one home, his or her main home that qualifies for the gain exclusion is the home lived in most of the year. The main home still qualifies for the exclusion even if the taxpayer spends five months of the year in Florida.
- If Married Filing Jointly, the maximum exclusion is available if either spouse meets the 2-year ownership requirements. However, both spouses must meet the 2-year use requirement and neither spouse could have taken the exclusion within the previous two years. This may be difficult if a taxpayer was recently married or divorced.

Short-Term Rentals

Cross References

- Schedule E (Form 1040), *Supplemental Income and Loss*
- IRS Pub. 527, *Residential Rental Property (Including Rental of Vacation Homes)*
- IRC §280A, *Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.*

Tax Issue

Taxpayers who own more than one residence often consider renting out one of the homes in order to supplement income, recover duplicate housing costs, or generate deductible losses. Residential rental income is reported on Schedule E, and any net profit is ordinary income. Losses from residential rental activities are generally subject to passive activity rules. Too much personal use of the rented home will also limit loss deductions under the rules for mixed-use property. Upon the sale of the property, depreciation recapture could result in the recognition of ordinary income. When such rentals occur on an occasional or short-term basis, accurate and complete recordkeeping for a relatively limited activity may seem burdensome.

Applicable Tax Law

- A house, apartment, condominium, mobile home, boat, vacation home, or similar property is considered a dwelling unit if it contains basic living accommodations such as sleeping space, toilet, and cooking facilities. Property used solely as a hotel, motel, inn, etc., is not a dwelling unit.
- When a dwelling unit is used for personal purposes and is also rented out during the year, expenses must be allocated between personal and rental use. Some expenses might be prorated and others might be entirely personal or direct rental expenses. Any reasonable method of making the allocation may be used. Tax treatment of the income and expenses depends on the amount of personal use.
- Personal use includes use by the taxpayer, family member, or any person who has an interest in the property. ***Exceptions:*** Use of a dwelling unit as a main home by a family member who pays fair rental value is not personal use. Days spent working substantially full time on repairs or maintenance are not counted as personal days.
- Personal use must exceed the greater of 14 days or 10% of the number of days the unit was rented at fair rental value during the year, to be considered a personal residence and mixed-use property. The total rental expenses for mixed-use property (other than direct rental expenses and the rental portions of deductible mortgage interest, real estate taxes, and deductible casualty losses) are limited to rental income. Excess rental expenses are carried over to future years.
- A dwelling unit that is not mixed-use property is not considered to have been used as a personal residence by the taxpayer. Rental expenses are not limited to rental income, but passive activity limits still apply.
- If a dwelling unit used by the taxpayer as a personal residence is rented out for less than 15 days during the year, the rental income is not reported and deductions for rental expenses are not allowed. [IRC §280A(g)]
- An employee (including a shareholder) who meets home office requirements may claim the deduction for business use of the home, assuming the shareholder receives reasonable wages for services rendered. Such expenses are deducted as employee business expenses on Schedule A (Form 1040), subject to the 2% AGI limitation. However, an employee (including a shareholder) is not allowed to deduct expenses for business use of the home attributable to rent paid by an employer for whom the employee provides services. In other words, when an employee rents all or part of his or her residence to the employer, the employer is allowed a deduction for rent paid, and the employee reports the rental income with no deductions allowed. [IRC 280A(c)(6)]
- Providing substantial services for a tenant disqualifies the income as rental income and is generally reported on Schedule C (Form 1040), *Profit or Loss From Business.*

Tax Planning Strategies

The taxpayer rents out all or part of a personal residence or second home for no more than 14 days during the tax year. Such short-term rentals are not considered to be rental activities for tax reporting purposes.

- Major sporting events, conventions, holidays, etc., provide an opportunity to rent out all or part of a main or second home on a short-term basis. Rental agreements could include a security or damage deposit or other reimbursement contingency plan, since the cost of repairs and maintenance associated with the rental will not be deductible.
- A shareholder-employee of an S corporation can rent his or her main home or second home to the S corporation. The shareholder-employee may not deduct any expenses in connection with this rental, but reports deductible mortgage interest, real estate taxes, and casualty loss on Schedule A as usual. The rental income is reportable on Schedule E unless the number of days rented is 14 or fewer.

  For example, the S corporation could rent the home for monthly meetings and a holiday party or two and remain within the 14-day limitation. If the shareholder-employee does not rent the home to anyone else that year, the rental income is tax free. The S corporation deducts the rent payments, thereby reducing the amount of income to be passed to the shareholder-employee on Schedule K-1 and perhaps also reducing the amount available to be paid out in reasonable compensation to the shareholder-employee.

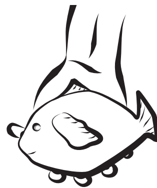
  In order to legitimize this deduction, the S corporation should:

  - Determine a business reason for having corporate meetings in a home setting rather than at some other business location. Record the business reason in the corporate minutes. Examples of a business reason could include convenience of shareholders, fewer distractions, availability of electronics, etc.
  - Keep minutes of all meetings and document the business purpose of each rental day.
  - When determining a rental fee, investigate what it would cost to rent a conference room or a suite in a nearby hotel and obtain documentation to substantiate the amount. Note that short-term rental rates are generally higher than monthly rates when computed on a daily basis.
  - Treat the corporate use of the home like any other rental expense. Create a written agreement specifying the rental fee, dates, and portions of the home available to the S corporation. Write a check from the corporate account or transfer the rental fee electronically for each rental period.

Examples

Example #1: The 2015 Young Republican National Convention was held during the week of July 12, 2015, in Mobile, Alabama. Scott's main home is in Milwaukee, but he owns a beautiful second home in Mobile that had easy access to the convention site. Scott agreed to rent his Mobile home to a group of four convention officials, who decide to remain in Mobile a couple of days following the convention. They agreed on the 14-day rental period of Sunday, July 12, 2015 through Saturday, July 25, 2015. Scott's fully furnished Mobile home is spacious and has a nice swimming pool. He charged each renter $250 a night, for a total of $14,000 in rental income. The rental agreement included a security and damage deposit, which Scott refunded at the end of the rental period, minus the cost of post-rental cleaning or damage repair. If Scott did not rent his Mobile home to anyone else during 2015, he did not have to report the $14,000 income. He could deduct any mortgage interest, property taxes, and casualty loss as usual, but he could not deduct any other expenses associated with renting his Mobile home.

Example #2: The International Guppy Education and Exhibition Society (IGEES) held its first annual convention (GuppyCon) in Boston, October 16–18, 2015. Betsy, a part-time seamstress, owns a townhome near the convention location and decided to rent out her spare rooms to a group of guppy breeders from Minnesota. They agreed on the 8-day rental period of Thursday, October 15, 2015 through Thursday, October 22, 2015. Betsy charged the group $400 per night, which included breakfast each day and personally guided tours of Colonial Boston after GuppyCon is over. Betsy should have limited the rental agreement to use of her spare rooms. The $2,800 she collected from the Minnesotans was not excludable under the short-term rental rule because Betsy provided services in addition to rented space. She must report the income and associated expenses on Schedule C, subject to self-employment tax on net self-employment income, unless she can demonstrate that this activity qualifies as a hobby rather than a trade or business. In that case, the income is reported on line 21, Form 1040, and expenses are deducted according to the hobby rules.



Example #3: George and Martha, a married couple, are the owners and sole shareholders of a profitable consulting firm, taxed as an S corporation. They generally meet with clients and run their business from a small rented office space in a professional building. They decide to hold some information seminars for prospective clients. Average attendance will be about 20 people, but their rented office space is too small, doesn't have adequate audio-visual capability, and doesn't allow for serving refreshments. George and Martha determine that the one-day cost of renting a nice furnished conference room at a nearby hotel would be $500. They decide to hold the seminars at their home, where they have a home theater large enough to hold 20 people comfortably, great electronics, and a bar area. They create a rental agreement between themselves and their S corporation, stipulating that the corporation will rent the portion of their home that includes the theater area, adjacent restroom, bar area, entryway, use of installed equipment, and some parking access. Rent is set at $500 per seminar, payable to George and Martha on the day of each seminar by corporate check and fully deductible by the S corporation. George and Martha have established a clear business purpose for renting part of their home to their S corporation and they have determined a fair rental value. As long as there are less than 15 rental days, and the home is not rented out for any other purpose during the tax year, George and Martha do not report the rental income on their personal tax return. Under their current agreement, this tax-free income could be as high as $7,000 a year.

Example #4: In Example #3, suppose that George and Martha have a qualifying home office in which they produce informational and sales literature and videos for use by their S corporation. The qualifying area is 20% of the entire home. They have an accountable plan in place, which reimburses them for the corporation's business use of their home in producing these items. (See *Use of Accountable Plans to Pay Home Office Expenses of Shareholder-Employees,* page 6-10). When George and Martha set up the rental agreement detailed in Example #3, they mistakenly refer to the entire house as the property being rented. The IRS audits their personal return and determines that 20% of the rental payments can be allocated to the home office area. Since the home office is an ongoing activity, rent is being paid for use of the home for more than 14 days in the year. George and Martha must report all the rental payments as income on Schedule E of their personal return.

Example #5: Jack owns a cabin, which he plans to rent to his S corporation for monthly board of directors meetings. The rental days for the year include the monthly meetings and an extra day for a holiday party, for a total of 13 rental days. Jack does everything right: he determines the business purpose for the rental use, sets a fair rental value, implements a proper rental agreement and payment arrangements, and keeps careful minutes and records of the monthly meetings. But Jack is having a busy year and only uses the cabin personally for one day during the summer.

Jack's use of the cabin is insufficient to meet the test for use as a personal residence (less than 14 days). The short-term rental rules do not apply and Jack must report all the rental payments as income on his personal return. If Jack had allowed his brother-in-law to stay at the cabin during a 16-day fishing trip in August, personal use would have totaled 17 days and Jack's use of the cabin would have met the test for use of the residence. In that case, Jack could have excluded the corporate rental payments from his income.

Possible Risks

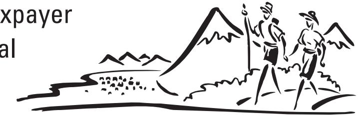
- If the dwelling unit being rented out does not meet the requirements for use as a personal residence during the year, then the exception allowed by IRC section 280A(g) does not apply. All rental income is reportable even if the number of rental days was less than 15 days.
- The taxpayer may actually realize a loss on the short-term rental. Such a loss is not deductible. Short-term renters may damage the property or the neighborhood. Repair costs and attorney fees incurred in bringing legal action against bad short-term renters are not deductible.
- A corporation that does not have a bona fide business reason for renting a shareholder-employee's home, or does not keep careful records, may have the rental expense challenged by the IRS. The consequences of losing the rental deduction will affect not only the corporation, but also its shareholders.
- A shareholder-employee in an S corporation might be making use of an accountable plan to obtain reimbursement for home office expenses, and at the same time, may wish to rent the home to the corporation. Reimbursements for home office use that can be construed as rent might invalidate both the accountable plan and the short-term rental strategy. The home office area must not be included in the part of the home being rented to the S corporation.

Court Cases

Court Case: In *Roy,* the taxpayer was hired to manage a farm operated by an S corporation in which he held a minority interest. The taxpayer's home was on a five-acre parcel of land next to the farm. For the convenience of his employer, he provided storage space for farming vehicles, equipment, and other items on the land surrounding his home. Harvested crops were kept on his property until they were hauled away, cars and trucks used his private roads, and farm personnel had access to his home. The S corporation paid the taxpayer $1,000 per month to compensate for the wear and tear on his roads, use of the bathroom, telephone, and other facilities in his home, and storage of farm equipment and materials on his property. The taxpayer reported $12,000 as rental income and deducted $12,000 in business expenses and depreciation.

The Tax Court determined that the taxpayer's dwelling unit included the entire five-acre parcel on which the home stood, despite the fact that the taxpayer maintained exclusive personal use of the house as a residence during the tax years in question. The court said that the monthly $1,000 payments were rent payments made by the employer for the use of the taxpayer's home, and thus the taxpayer was not allowed to claim rental expense deductions. The taxpayer then attempted to argue that since the rent was paid annually in a lump sum, he was renting his home to his employer for less than 15 days each year and could exclude the income under the short-term rental rules. The court disagreed, stating that the payments were for year-round use of the taxpayer's home, not just for a period of less than 15 days. The rent was fully taxable. (*Roy,* T.C Memo 1998-125)

Court Case: During 2004, a taxpayer rented out his cabin for a total of 12 days and nine nights, an average rental period of three days. He used the cabin himself for 27 days and 19 nights in 2004, accompanied by family members each time. He stated that the purpose of his travel to the cabin was for maintenance, repair, resupply, management, oversight, hiring contractors, and so on, although he had no evidence to support that claim. The taxpayer reported the rental income on Schedule E and claimed over $20,000 in rental expenses, generating a rental loss.



The IRS initially disallowed all the rental expenses but left the rental income on the return. The taxpayer tried to show that his 27 days at the cabin should not be counted as personal use days but the Tax Court disagreed. His use of the cabin met the test for use as a personal residence and rental expenses in excess of income would not be deductible. But the court didn't stop there, noting that the rental period was less than 15 days. Therefore, the rental income was not reportable, the rental expenses were not deductible, and the rental loss was disallowed. (*Akers,* T.C. Memo 2010-85)

Like-Kind Exchanges—Deferred Exchanges

Cross References

- Form 8824, *Like-Kind Exchanges*
- IRS Pub. 544, *Sales and Other Dispositions of Assets*
- IRS Pub. 550, *Investment Income and Expenses*
- IRC §1031, *Exchange of property held for productive use or investment*

Tax Issue

A taxpayer will usually realize gain or loss when property is sold or exchanged. When a taxpayer has appreciated property that he or she wants to dispose of, a direct sale may result in a significant tax liability. Frequently, the taxpayer will want to take the profit from the sale of one property and invest it in another similar property. However, the taxes assessed on the gain will reduce the amount that the taxpayer has available to purchase the new property. If the taxpayer is looking to replace his or her property, a like-kind exchange could significantly reduce or even eliminate a current tax liability. But it can be difficult to locate a suitable property owned by a party willing to make the exchange.

Applicable Tax Law

- If business or investment property is exchanged solely for either business or investment property of a like-kind, no gain or loss is recognized.
- To be like-kind, both the property traded and the property received must be held for productive use in the taxpayer's trade or business or for investment.
- A deferred exchange occurs when the taxpayer transfers qualifying business or investment property and later receives like-kind property to use in business or hold for investment.
- For a deferred exchange, the replacement property must be identified in a written document signed by the taxpayer and delivered to the person obligated to transfer the replacement property within 45 days after the relinquished property is transferred (identification requirement).
- In a deferred exchange, the replacement property must be received by the earlier of 180 days after the transfer of the relinquished property or the due date, including extensions, of the tax return for the tax year in which the transfer of the relinquished property occurs (receipt requirement).
- If property intended to be part of a like-kind exchange is transferred through a qualified intermediary, the transfer of the relinquished property and the replacement property is treated as a like-kind exchange.

- The like-kind exchange rules are mandatory. A taxpayer who sells property and buys similar property in two mutually dependent transactions may have to treat the sale and purchase as a single nontaxable exchange unless the transactions are structured to avoid the like-kind exchange rules.

Tax Planning Strategies

A taxpayer who wants to dispose of property and reinvest the money in a similar property may want to utilize the tax advantages of a like-kind exchange. A like-kind exchange may be achieved, even if the taxpayer is unable to make a suitable exchange immediately, by means of a deferred exchange. The exchange must be an exchange of property for property rather than a transfer of property for money used to buy replacement property. To avoid actually or constructively receiving money rather than property, a qualified intermediary may be used to acquire and transfer the relinquished property and to acquire the replacement property and subsequently transfer it to the taxpayer.

Examples

Example #1: Brenda, a calendar year taxpayer, and Charis agree to enter into a deferred exchange. Under their agreement, Brenda transfers her vacant lot to Charis on May 17, 2015. The lot, which has been held by Brenda for investment, has a fair market value on that date of $100,000. On or before July 1, 2015 (the end of the identification period), Brenda is to identify like-kind replacement property. On or before November 13, 2015 (the end of the exchange period), Charis is required to purchase the property identified by Brenda and to transfer that property to her.

On May 1, 2015, Dan offers to purchase the vacant lot for $100,000. However, Dan is unwilling to participate in a like-kind exchange. Brenda thus enters into an exchange agreement with Charis whereby Brenda retains Charis to facilitate an exchange with respect to the lot. Charis is not a disqualified person for purposes of being a qualified intermediary. The exchange agreement between Brenda and Charis provides that Brenda is to execute and deliver a deed conveying the lot to Charis who, in turn, is to execute and deliver a deed conveying the lot to Dan. The exchange agreement expressly limits Brenda's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by Charis.

On May 3, 2015, Charis enters into an agreement with Dan to transfer the lot to him for $100,000. On May 17, 2015, Brenda executes and delivers to Charis a deed conveying the lot to her. On the same date, Charis executes and delivers to Dan a deed conveying the lot to him, and Dan deposits $100,000 in escrow. The escrow holder is not a disqualified person and the escrow agreement expressly limits Brenda's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow. However, the escrow agreement provides that the money in escrow may be used to purchase replacement property. On June 3, 2015, Brenda identifies pasture land as replacement property. On August 9, 2015, Elmer executes and delivers to Charis a deed conveying the pasture land to Charis and $100,000 is released from the escrow and paid to Elmer. On the same date, Charis executes and delivers to Brenda a deed conveying the pasture land to Brenda.

Brenda and Charis entered into an agreement that satisfied the like-kind exchange rules. The agreement expressly limited Brenda's rights to obtain benefits from the cash held by Charis. Charis is treated as having acquired and transferred both properties because she acquired and transferred legal title to both properties. She is therefore a qualified intermediary.

Example #2: Assume the same facts as Example #1, except that Charis neither enters into an agreement with Dan to transfer the lot to him nor is Charis assigned Brenda's rights in Brenda's agreement to sell the lot to Dan. On May 17, 2015, Brenda transfers the lot to Dan and instructs Dan to transfer the $100,000 to Charis. On June 1, 2015, Brenda identifies the pasture land as replacement property. On August, 9, 2015, Charis purchases the pasture land from Elmer for $100,000, and Elmer executes and delivers to Charis a deed conveying the pasture land to her. On the same date, Charis executes and delivers to Brenda a deed conveying the pasture land to her.

Because Brenda transferred the lot directly to Dan under her agreement with him, Charis did not acquire the lot from Brenda and transfer it to Dan. Moreover, because Charis did not acquire legal title to the lot, did not enter into an agreement with Dan to transfer the lot to him, and was not assigned Brenda's rights in Brenda's agreement to sell the lot to Dan, Charis is not treated as acquiring and transferring the lot. Thus, Charis was not a qualified intermediary. Brenda did not exchange the vacant lot for the pasture land. Rather, Brenda sold the lot to Dan and purchased, through Charis, the pasture land. Therefore, the transfer of the lot does not qualify for nonrecognition of gain or loss under the like-kind exchange rules.

Possible Risks

- If, prior to receiving the replacement property, the taxpayer actually or constructively receives money or unlike property in consideration for the property transferred, the transaction will be treated as a sale rather than a deferred exchange.
- If an exchange facilitator is not a qualified intermediary, or is considered an agent of the taxpayer for tax purposes, the taxpayer may violate the constructive receipt rules and end up with a taxable sale of the original property.
- A like-kind exchange would not be appropriate for disposing of a passive property that has accumulated passive activity losses. Since a like-kind exchange is not taxable, no passive gain would be generated to offset the accumulated losses. The losses remain suspended until other passive income could offset them. In such case, it would be better to structure the transaction so that it does not qualify as a like-kind exchange and thus allow suspended passive losses to offset gain generated by the sale.
- If the taxpayer has other losses in the current year, or losses carrying over from a prior year, he or she may want to intentionally disqualify the transaction from the like-kind treatment and utilize those losses to offset the gain.
- Like-kind exchanges defer losses as well as gains. If the property being disposed of contains built-in losses, the losses will be deferred until the exchanged property is disposed of.
- If the taxpayer anticipates increases in future taxable income, or future tax rate increases, it may make sense to pay the tax on the gain currently rather than defer it to a year when the taxpayer's tax liability may be greater.
- If a taxpayer engages in a like-kind exchange with a related party, and within two years either party disposes of the property received, the previously-deferred gain is recognized.

Court Cases

Court Case: The taxpayers intended to exchange one property for another by means of using qualified escrow accounts to facilitate a deferred like-kind exchange. However, the escrow accounts did not expressly restrict the taxpayers' access to and use of the funds held there. Neither did the escrow agreements make any mention of a like-kind exchange. The lack of express limitations in the agreement resulted in the taxpayers being treated as having constructively received the proceeds. Even though the money was used only to purchase the replacement property, the transaction failed to qualify for nonrecognition of gain under the like-kind exchange rules. *(Crandall, Jr, and Dulin,* T.C. Summary 2011-14, February 15, 2011)

Court Case: A taxpayer treated the sale of one aircraft and subsequent purchase of another aircraft as a like-kind exchange. The taxpayer had appointed a qualified intermediary to facilitate the exchange. The funds were accidently placed into the taxpayer's account instead of the escrow agent's account but were immediately returned to be placed in escrow. The taxpayer was bound by contract not to receive, pledge, borrow, or otherwise obtain the benefits of the exchange value for at least 45 days. Legally he could do nothing with the funds except return them to the proper account or be guilty of theft. Because the error was out of his control, and the taxpayer had complied with the requirements in all other aspects, the court concluded that he had validly effected a deferred like-kind exchange. *(Morton,* U.S. Court of Federal Claims, April 27, 2011)

Court Case: On September 23, 2005, the taxpayer sold an apartment building and received gross sales proceeds of $700,000. After sales expenses and reporting $56,417 as taxable boot under IRC section 1031(b), the taxpayer used $519,843 of the sales proceeds to purchase a single-family home on November 4, 2005, with the intent to use it as rental property for investment purposes. $429,296 of gain from the sale of the apartment building was excluded from income under IRC section 1031(a). The taxpayers posted flyers advertising the home for rent, but did not advertise in the newspaper. They never lowered their monthly asking price, nor did they ever find tenants to rent the home.

After failing to rent the property, the taxpayer became concerned that he could no longer afford the property. On April 4, 2006, the taxpayer entered into a contract to list his primary residence for sale. On June 30, 2006, the taxpayer closed on the sale of his principal residence and moved his family into the single-family home that he was trying to rent as investment property.

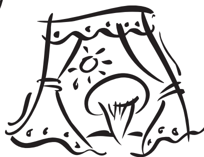
The IRS claimed the taxpayer did not intend the home to be used as investment property at the time of the like-kind exchange. Courts have ruled that investment intent must be the taxpayer's primary motivation for holding the exchanged property in order for the property to qualify as held for investment for purposes of IRC section 1031.

The court ruled in favor of the taxpayer. Even though the decision to sell their primary residence and move into the rental home was only six months after the like-kind exchange, the intent of the taxpayer at the time of the exchange was to use the property as rental property. The taxpayer posted flyers advertising the property as rental property and showed the home to potential renters. A witness had also testified before the court that the taxpayer did not plan on selling his personal residence until his children were out of high school. The taxpayer's oldest son was only 15 years old when they sold their residence and moved into the exchanged home. Therefore, the taxpayer acquired the property with investment intent at the time of the exchange, and the tax-free like-kind exchange rules under IRC section 1031 applied. *(Reesink,* T.C. Memo 2012-118)

Vacation Homes—Maximizing Deductions

Cross References

- Schedule E (Form 1040), *Supplemental Income and Loss*
- IRS Pub. 527, *Residential Rental Property (Including Rental of Vacation Homes)*
- IRC §280A, *Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.*



Tax Issue

Any dwelling used for both personal purposes and rented out during the year is subject to special tax rules. The amount of rental expenses allowed as a deduction against rental income is based on an allocation between personal and rental use. The rental expense deduction for mixed-use property may be further limited by the amount of rental income received each year, resulting in a potential disallowance and carry forward of excess rental expenses.

Applicable Tax Law

- When a dwelling unit is used for both personal purposes and rented out during the year, treatment of income and expenses depends on the amount of personal use.
- A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property if the property contains basic living accommodations such as sleeping space, toilet, and cooking facilities. A dwelling unit does not include property (or part of the property) used solely as a hotel, motel, inn, or similar establishment.
- If a dwelling unit that is used by the taxpayer as a residence is rented out for 14 days or less during the year, rental income is not reported and rental expenses are not allowed.
- If personal use of a dwelling is more than the greater of 14 days, or 10% of the days the unit is rented at fair rental value, the deduction for expenses is limited to rental income. A loss cannot be reported on the tax return. Expenses that are limited by this provision are carried over to future years.
- Certain expenses are allowed in full for mixed-use property, including rental portion of deductible home mortgage interest, rental portion or real estate taxes, rental portion of deductible casualty and theft losses, and direct rental expenses such as rental agency fees, advertising, office supplies, and other expenses that are related only to the rental of the property.
- Use of a dwelling unit by the taxpayer, family member, or any person who has an interest in the property is considered personal use for purposes of allocating expenses. An exception exists if the family member uses the dwelling as their main home and fair rental value is paid. Days spent working substantially full time on repairs or maintenance do not count as personal days.
- Expenses are allocated between personal and rental based on the number of days during the year the unit is rented out. The allocation is computed by dividing the number of days the property is rented out by the total number of days the unit is occupied. A more advantageous *Bolton method* has been allowed by the courts.
- Deductions for mixed-use rental property are taken in the following order: (1) amounts allowed as deductions without regard to the rental use, such as mortgage interest and real estate taxes, (2) rental expenses that do not result in an adjustment to basis of the property, such as the rental portion of utilities and maintenance expense, and (3) expenses that result in a basis adjustment, such as depreciation.

Tax Planning Strategies

Rental expenses are limited to rental income for a vacation home that is used personally more than the greater of 14 days or 10% of the days rented. The Tax Court has allowed a method of allocating rental expenses that is more advantageous to the taxpayer. Known as the *Bolton method,* this method allocates mortgage interest and real estate taxes based on the number of days in the year instead of the number of days the unit is actually used. This method allocates a higher amount of mortgage interest and real estate taxes to Schedule A, allowing a larger amount of other rental expenses to be applied against rental income.

Examples

Ellen owns a vacation lake cabin. In 2015, she used the cabin personally 42 days and rented the cabin at fair market rental for 112 days. Ellen received $12,800 of rental income and incurred the following expenses during the year.

Mortgage interest	$12,000	Other operating expenses	
Real estate taxes	2,000	Insurance	$2,500
Total mortgage interest		Repairs	1,800
and real estate taxes	$14,000	Utilities	2,400
Depreciation	$5,400	Total other operating	
		expenses	$6,700

Ellen calculated allowable rental expenses using the IRS prescribed method as follows.

The percentage of expenses allowed for rental purposes is 73% [112 days ÷ (112 days + 42 days)], the number of days the cabin was rented divided by the total number of days occupied.

Rental income		$12,800
Mortgage interest and real estate taxes	$14,000	
	× 73%	(10,220)
Other operating expenses	6,700	
	× 73%	(4,891)
Depreciation	5,400	
	× 73%	(3,942)
Excess operating expenses and depreciation to be carried over to next year		($6,253)

Using the *Bolton method,* the allowable rental expenses are calculated as follows:

The percentage applied to other operating expenses and depreciation is 73%, the same as the IRS prescribed method. The percentage applied to mortgage interest and real estate taxes is based on the number of days the cabin was rented divided by the number of days in the year (112 days ÷ 365 days = 31%).

Rental income		$12,800
Mortgage interest and real estate taxes	$14,000	
	× 31%	(4,340)
Other operating expenses	6,700	
	× 73%	(4,891)
Depreciation	5,400	
	× 73%	(3,942)
Excess operating expenses and depreciation to be carried over to next year		($373)

Conclusion: Using the *Bolton method* to calculate allowable rental expenses, Ellen is able to deduct an additional $5,880 [($373) minus ($6,253)] currently. The *Bolton method* creates a current income tax benefit by increasing current year tax deductions and decreasing the amount of excess rental expenses carried over to future years.

Possible Risks

- The *Bolton method* is generally more advantageous in the current year. The disallowed expenses carried forward as a result of using the IRS method may be more beneficial in future years to offset increased rents received or when the taxpayer is in a higher tax bracket.
- The Ninth and Tenth Circuit Courts of Appeals which covers the states of AZ, CA, CO, ID, KS, MT, NM, NV, OK, OR, UT, WA, and WY, have upheld the *Bolton* decision. Taxpayers residing in other districts could have the method challenged by the IRS.
- When the taxpayer receives a greater deduction using the standard deduction, even after considering the increased Schedule A deductions, the benefit from the increased mortgage interest and real estate taxes allocated to Schedule A is lost. In this situation, using the *Bolton method* is disadvantageous to the taxpayer.
- Taxpayers subject to the alternative minimum tax (AMT) may not receive additional benefits from the increased Schedule A deductions. In this situation, the taxpayer receives a greater benefit using the IRS prescribed method for allocating rental expenses and having a larger carry forward of unallowed rental expenses.
- If the taxpayer is already deducting mortgage interest from two homes on Schedule A, the allocated mortgage interest from this third home is not deductible on Schedule A and would be a lost deduction. The allocated real estate tax is deductible on Schedule A.

Court Cases

The Tax Court allowed a method of allocating expenses for mixed-use property that was more advantageous to the taxpayer than the IRS prescribed method. The Boltons allocated mortgage interest and taxes based on a fraction, using the number of days in the year as the denominator, instead of the number of days the dwelling was occupied. They allocated other operating expenses, including depreciation, according

to the IRS method using the number of days occupied. The *Bolton method* applied a smaller percentage to mortgage interest and taxes against the rental, which allowed a higher amount of other operating expenses to be applied against the income limit. Interest and taxes not deducted against the rental were allowed as itemized deductions.

Even though the *Bolton method* applied a different computation to interest and taxes than it applied to other expenses, the Tax Court allowed the method because interest and taxes accrue evenly throughout the year, but other operating expenses are more closely connected with actual days of occupancy. *(Bolton,* 77 T.C. No. 104)

Bolton decision: Mixed-use property • Personal use 30 days, rented out 91 days = 121 days occupied • Gross rents $2,700 • Interest and property taxes $3,475 • Operating expenses $2,693

Bolton Method	IRS-Preferred Method
Rental income limit $2,700	Rental income limit $2,700
Interest and taxes 91 ÷ 365 = 25% × $3,475........ (869)	Interest and taxes 91 ÷ 121 = 75% × $3,475..... (2,606)
Operating expenses 91 ÷ 121 = 75% × $2,693... ($2,020)	Operating expenses 91 ÷ 121 = 75% × $2,693..... (2,020)
Unallowed deduction......... ($189)	Unallowed deduction...... ($1,926)

Hold Real Estate Outside the Corporation

Cross References

- Schedule E (Form 1040), *Supplemental Income and Loss*
- Form 1120S, *U.S. Income Tax Return for an S Corporation*
- IRS Pub. 527, *Residential Rental Property*
- IRS Pub. 542, *Corporations*
- IRC §351, *Transfer to corporation controlled by transferor*

Tax Issue

Transferring real estate or low-basis assets to a corporation in an IRC section 351 exchange can cause negative tax consequences. Corporations do not receive the same favorable tax rates on capital gains as individuals. If assets are transferred into a corporation, the assets will produce taxable income if sold. If those assets are transferred back out of the corporation to the shareholder, they produce taxable income to the extent that FMV exceeds basis. This can convert what would have been capital gains at favorable rates into regular corporation income, or can even trigger double taxation on the asset.

Applicable Tax Law

- The basis of property contributed to the capital of a corporation is the same as the basis the shareholder had in the property, increased by any gain the shareholder recognized on the exchange.
- If capital contributions are made to a corporation, and the shareholder (or shareholders) controls the corporation immediately after the exchange, no gain or loss results (IRC section 351 transfer).
- C corporations pay tax on net capital gains at the same rate as other corporation income. The favorable capital gains tax rates for individuals do not apply to corporations.
- If a C corporation distributes appreciated property to a shareholder, the corporation recognizes a gain as if it sold the property at fair market value.
- If a C corporation liquidates, the corporation recognizes gain or loss on the distribution of the property as if the corporation sold it at fair market value. The shareholder treats the distribution as payment for his or her stock and reports gain or loss as if the shareholder had sold stock back to the corporation.

Tax Planning Strategies

Instead of contributing real estate to a corporation, the shareholder should keep the building in his or her name and rent it to the corporation. The following tax benefits will be achieved.

- Rental payments made by the corporation are deductible and will reduce the corporation's earnings and profits.
- Appreciation on the property during the corporation's use will not trigger a current tax liability as it would if the corporation owned the real property and had to sell it or transfer it back to the shareholder.
- Sale of the real property by the shareholder owner will result in tax at favorable individual capital gain tax rates instead of at corporation tax rates.

Examples

Example #1: Joan owned a nonresidential building with a FMV of $200,000 and basis of $120,000. In 2010, Joan created Cactus Corporation and contributed the building in an IRC section 351 transfer in exchange for 100% of the corporation's stock. After the transfer, Joan's basis in stock was $120,000, and the corporation's basis in the building was $120,000. Cactus Corporation used the building for operations. In 2014, the corporation outgrew the building and moved to a new location. The corporation transferred ownership of the property back to Joan. At the time of the transfer, the FMV of the property was $230,000. Assume a corporate marginal tax rate of 35%. Also assume a negative basis adjustment of $10,000 from depreciation claimed. In the process of Joan transferring ownership of

the building to the corporation, and ownership of the building subsequently being transferred back to Joan, the following tax effects occurred.

Corporation

Transfer of building back to Joan at FMV	$230,000
Corporation's basis in building	(110,000)
Gain	$120,000
Corporate tax at 35%	$ 42,000

With Joan transferring the building to the corporation and back out again, tax on the building's appreciation is triggered, resulting in a tax liability of $42,000. The transactions also increase the corporation's earnings and profits by $78,000 ($120,000 gain less tax of $42,000). In addition, the transactions do not increase Joan's basis in corporate stock.

Example #2: Assume the same facts as Example #1, except Joan keeps the building in her name and rents it to the corporation. Rental payments made by the corporation to Joan are deductible and reduce the corporation's earnings and profits. The $42,000 tax upon transfer would not apply because the corporation never owned the property. Joan will eventually pay tax on the appreciation of the property but not until she sells the property and receives money for it. In addition, her capital gain tax rate is 15% as compared to the corporate rate of 35%.

Example #3: Bill owns a building he uses in his sole proprietorship. The building's basis is $80,000, and FMV is $230,000. Bill is considering forming a C corporation. He runs projections to see if forming a C corporation will provide him with any tax benefit from ownership of the building.

Fair rental value of the building is $24,000 per year. Bill's marginal tax rate is 25%, and the corporation's marginal tax rate is projected at 25%. The projections compare the tax effects of $24,000 in profits received as earned income from a sole proprietorship compared to that received from rent.

Use in sole proprietorship. $24,000 in profits.

SE tax	$3,391
Income tax at 25%	6,000
Total tax	$9,391

Rent to C corporation. $24,000 deducted by C corporation, reported as rental income on Bill's Form 1040.

SE tax	$ 0
Income tax at 25%	6,000
Total tax	$6,000

Bill saves $3,391 in SE tax by forming a C corporation and renting the building to the corporation.

Example #4: Assume the same facts as Example #3, except Bill transferred the building to the corporation in exchange for stock. After one year, cash flow problems require Bill to go out of business and liquidate the corporation.

The corporation owned the building so there was no deduction for rent paid.

$24,000 profit × 25% corporate tax rate = $6,000 corporate tax.

Remaining $18,000 distributed × 15% dividend rate = $2,700 Bill's tax.

In a liquidation, the corporation recognizes gain or loss on distributions of property as if the property had been sold at FMV.

FMV of building	$230,000
Less basis	80,000
Gain	$150,000
25% corporate tax	$ 37,500

By transferring the real estate into the corporation, Bill paid an extra $2,700 in income tax and had to pay $37,500 tax on the property's appreciation when he liquidated the corporation.

Possible Risks

- If a taxpayer rents property to an activity in which he or she materially participates, any net rental income for the year is treated as nonpassive income while any loss is treated as passive. The effect of this rule is to not allow self-rental income to offset passive losses.
- If a corporation pays a shareholder higher rent than what the shareholder would charge an unrelated party, the excess rent can be reclassified as a constructive dividend. A constructive dividend is taxable to the shareholder and is not deductible to the corporation. In other words, a constructive dividend is double-taxed.

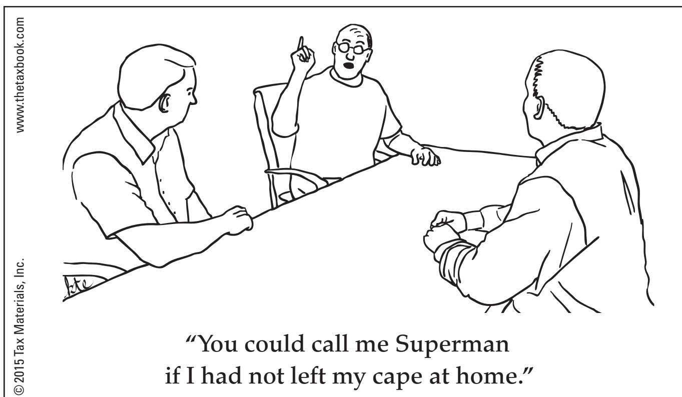
Court Cases

Court Case: Married taxpayers owned and materially participated in two S corporations. The taxpayers rented real estate to the corporations. The taxpayers realized a gain on one of the rental properties and a loss on the other rental property. The court determined that even though the two activities did constitute an appropriate economic unit, under the self-rental rule the gain was nonpassive while the loss was passive. The passive loss was not available to offset the nonpassive gain. The gain was taxable, and the loss was nondeductible (suspended under the passive loss rules). *(Carlos,* 123 T.C. No. 275, September 20, 2004)

Court Case: Mr. Graves acquired six and one half lots in Sparks, Nevada and transferred the title to the lots to Sparks Development, a corporation wholly owned by him and his wife. Sparks Development in turn leased the lots to Challenger, Inc., another corporation wholly owned by Mr. and Mrs. Graves. These lots were used by Challenger as parking lots in connection with its operation of a casino. The lease agreement negotiated by Mr. Graves on behalf of both Challenger and Sparks Development determined the rent on the basis of the amount of income that Sparks Development would need to pay its income tax, its purchase obligation on the lots, and Mr. Grave's compensation.

For the two years in question, Challenger, Inc. deducted rental expenses of $37,000 and $107,200 respectively. The IRS disallowed the rental deductions claimed by Challenger with respect to the lots to the extent the monthly payments exceeded $4,000 on the grounds that such excess amounts were not ordinary and necessary business expenses required to be made for the use of the lots. The Tax Court agreed with the disallowance, finding that the reasonable rental of the lots during the years in question did not exceed $4,000 per month. Those portions of the payments which were in excess of this reasonable rental value were deemed to be constructive dividends to Mr. and Mrs. Graves.

The Graves appealed. The Appellate Court agreed with the Tax Court. It concluded that the parking lot lease was negotiated between closely related parties not dealing at arm's length. It found the Tax Court's allowance of $4,000 per month rental expense to be based on sound evidence. In addition, the appellate court found that the Graves, not Challenger, Inc., benefitted financially from the leasing agreement by transferring money from one corporation to the other. The Graves contended that the disallowed rents should be treated as capital paid from Challenger, Inc. to Sparks Development rather than as constructive dividends to themselves. However, the appellate court ruled that had Challenger been independent from control by the Graves, it would have had no reason to make capital contributions to Sparks Development. The appellate court upheld the Tax Court's decision. The disallowed rents were constructive dividends to the shareholders. *(Sparks Nugget, Inc.,* 9th Cir., April 6, 1972)



"You could call me Superman if I had not left my cape at home."

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Election to Capitalize Interest and Taxes on Real Property

Cross References

- Form 1040 (Schedule A), *Itemized Deductions*
- IRC §266, *Carrying charges*
- Reg. §1.266-1, *Taxes and carrying charges chargeable to capital account and treated as capital items*

Tax Issue

Carrying charges, such as interest and taxes incurred on real property, may be allowable as itemized deductions on Schedule A (Form 1040). However, instead of deducting these amounts, an election is available to capitalize carrying charges, which will add to the basis of the property. Depending on the taxpayer's situation, making the election to capitalize carrying charges can produce a significant tax benefit.

Applicable Tax Law

- Under Treasury Regulation section 1.266-1, an election to capitalize carrying charges, such as interest and taxes on real property, may be available, even though the items might otherwise be deductible under different provisions of the Internal Revenue Code. If the election is made to capitalize an item, that item may not be deducted under any other provision.
- The election to capitalize carrying charges is made by filing a statement with the taxpayer's return indicating the item or items the taxpayer wishes to capitalize. The statement must be filed with an original return for the tax year.
- For unimproved and unproductive real estate, the election to capitalize carrying charges must be made on a yearly basis.
- The election to capitalize carrying charges on improved real property is allowed only during a period of construction or further improvement of the property. The statement electing to capitalize the carrying charges must be attached to the taxpayer's return each year during the period of construction or improvement.
- Items such as interest and taxes may be deductible on an individual's tax return, but the taxpayer's itemized deductions are lost if the taxpayer's deductions are less than the standard deduction amount. For other taxpayers, interest and taxes may be an exclusion or deferral item for purposes of the alternative minimum tax, eliminating the benefit of the deduction. Investment interest expense may be limited to investment income.
- Capitalization of carrying charges will increase the basis of the property. Tax benefits from an increased basis include lower gain upon sale, higher deductible loss upon sale, or higher depreciation deductions for property used in a business or for rental.

Tax Planning Strategies

Analyze the taxpayer's situation to determine what, if any, benefit the taxpayer receives from deducting carrying charges on real property. Issues to consider include whether the taxpayer's itemized deductions are less than the standard deduction amount, whether a current deduction for the carrying charges are offset by the alternative minimum tax, and whether the taxpayer's potential deduction for interest is reduced or eliminated by investment income limitations.

Examples

Example #1: Bruce and Julie Lundberg are married and file a joint tax return. Their principal residence is paid off. In 2005, the Lundbergs purchased a vacant lot near their favorite fishing lake with the intent of eventually building a retirement home on the site. The cost of the lot was $100,000, which is financed by a 30-year loan at 6% interest. Property taxes on the lot are $1,500 per year. Even with the addition of interest and taxes paid on the lot, the Lundberg's total itemized deductions annually are less than their standard deduction.

The Lundbergs attach a statement to their return every year beginning in 2005, making the election to capitalize carrying charges.

Interest paid 2005 – 2014	$40,500
Property taxes paid 2005 – 2014	$13,500
Total carrying charges	$54,000

In 2015, the Lundbergs retire. Unfortunately, their plans for building a new home on their lot did not work out. The couple sells the lot for $160,000. Assume their net capital gains are taxed at 18%, along with a 5% state tax, for a total tax rate on capital gains of 23%. By increasing basis by capitalizing the annual interest and taxes, the election to capitalize interest and taxes reduced the gain by $54,000 and saved the Lundbergs $12,420 in taxes.

Tax benefit without the election to capitalize carrying charges	$ 0
Tax benefit with the election to capitalize carrying charges ($54,000 × 23%)	$12,420

Example #2: Assume the same facts as Example #1, except the Lundbergs have a mortgage on their main home and claim itemized deductions each year. The Lundberg's marginal tax rate is 25% federal and 5% state, for a total marginal tax rate of 30%.

Combined benefit of itemized deductions 2005 – 2014 ($54,000 × 30% marginal tax rate)	$16,200
Reduced benefit at time of sale without addition to basis	($12,420)
Benefit of deducting interest and taxes instead of capitalization	$ 3,780

✎ **Author's Comment:** Analysis of possible factors affecting the taxpayer, and tax projections taking into consideration different scenarios, is necessary to determine the possible benefit of capitalizing carrying charges. If the expenses reduce taxable income each year, a current deduction is generally the most beneficial. If the expenses are not currently deductible because of standard deduction amounts, alternative minimum tax, or investment interest deduction limits, the election to capitalize carrying charges will generally be the most beneficial strategy.

Possible Risks

- Complete historical records are needed to prove basis adjustments. If the taxpayer does not maintain good records, the additions to basis may be lost.
- Carrying charges on unimproved real estate qualify for the election on a yearly basis. However, carrying charges on improved or productive assets may be capitalized only until the project is complete. If improvements are made to the property, the ability to capitalize carrying charges may be lost for future years.
- For improved property, carrying charges may be capitalized only during the period of construction or improvement. Activities classified as improvements by the taxpayer may be at risk for reclassification by the IRS as repairs, which may or may not be deductible depending on the statute of limitations.

Court Cases

In *Hodgkins v. Commissioner,* the taxpayer elected to capitalize carrying charges on improved real property. The Tax Court cited the rule stating mortgage interest on improved real property is capitalized only during a period of construction or further improvement. The taxpayer documented amounts spent to work on the property, but the court determined the amounts represented repairs, not improvements. The taxpayers were assessed additional taxes and accuracy-related penalties. *(Hodgkins,* T.C. Memo 1996-53)

Homeowners' Associations— How to Save Tax

Cross References

- Form 1120, *U.S. Corporation Income Tax Return*
- Form 1120-H, *U.S. Income Tax Return for Homeowners Associations*
- IRC §528, *Certain Homeowners Associations*
- Rev. Rul. 70-604
- Rev. Rul. 74-99
- Rev. Rul. 75-370
- Rev. Rul. 75-371
- Rev. Rul. 88-56

Tax Issue

Homeowners' associations are organizations formed by a group of homeowners for the purpose of preserving and maintaining the appearance of an area and the ownership and maintenance of common property and facilities, such as recreational facilities, streets, and sidewalks. Because most homeowners' associations operate for the benefit of a specific group of people, rather than the community at large, they have difficulty meeting the tax-exempt purposes required under IRC section 501(c)(4) and IRC section 501(c)(7). (Rev. Rul. 74-99)

Congress enacted IRC section 528 with the view that it is not appropriate to tax revenues of an association of homeowners who act together if an individual homeowner acting alone would not be taxed on that same activity. Qualified homeowners' associations can make a choice between filing tax forms with different tax rates.

Applicable Tax Law

- A condominium management association, residential real estate management association, or a timeshare association qualifies as a homeowners' association if:
  - At least 60% of the association's gross income for the tax year consists solely of membership fees, dues, or assessments from property owners,
  - At least 90% of the association's expenses for the tax year consists of expenses to acquire, build, manage, maintain, or care for association property, or in the case of a timeshare association, for activities provided to, or on behalf of, members of the timeshares association, and

  - No private shareholder or individual profits from the association's net earnings except by acquiring, building, managing, or caring for association property or by a rebate of excess membership dues, fees, or assessments.
- A qualified homeowners' association can file Form 1120, *U.S. Corporation Income Tax Return,* and pay tax as if it were a C corporation or elect to file Form 1120-H, *U.S. Income Tax Return for Homeowners Associations.*
- The election to file Form 1120-H is available on a yearly basis. Generally, the election must be made by the due date, including extensions, of the income tax return. Once Form 1120-H is filed, the association cannot revoke its election for that year unless the IRS consents. The association may request IRS consent by filing a ruling request. A user fee must be paid with all ruling requests.
- Exempt-function income consists of dues, fees, or assessments paid by property owner-members for maintenance and improvement of the property.
- Income that is not considered exempt-function income includes interest, dividends, coin laundry income, vending machine income, rental of units owned by the association, rental of garage parking and storage areas, party room rentals, etc.

- On Form 1120-H, net income attributable to exempt-function income is tax free. All other income is taxed at a flat rate of 30% (32% for timeshare associations).
- On Form 1120-H, expenses must be allocated between exempt-function income and other income. For example, management fees may include services for maintenance of common areas, as well as fees for managing the association's investments. Only the amounts allocable to taxable income are deductible on Form 1120-H.
- On Form 1120-H, a specific deduction of $100 is allowed.
- Form 1120 tax rate on the first $50,000 is 15%.
- On Form 1120, net income from members and net income from nonmembers is calculated separately and subject to separate loss carryover rules. Exempt-function income is subject to tax on Form 1120.
- A homeowners' association filing Form 1120 may avoid tax on its excess net membership income by electing under Revenue Ruling 70-604 to return the excess to the owners or apply the excess against the next year's assessments.

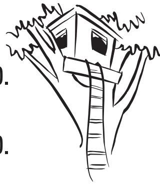
Tax Planning Strategies

Homeowners' associations are faced with a unique situation each year in that they have the choice of which tax form to file and what tax rate to pay. Many homeowners' associations choose to file Form 1120-H. This form was designed specifically for homeowners' associations and is easier to prepare than Form 1120. On Form 1120, membership net income may be taxable, however, it has a lower tax rate. Homeowners' associations, with proper planning and budgeting, may reduce its taxes by filing Form 1120.

Examples

Majestic Oaks Homeowners Association (Majestic) is a qualified homeowners' association. Majestic's income is from member assessments which qualify as exempt-function income and interest income on a reserve fund. All its expenses are for the maintenance and care of association property. Over a 4-year period, after deducting allowable expenses, Majestic has the following income or (loss).

- 2012 – Net loss of ($5,000) from member transactions and interest income of $800.
- 2013 – Net income of $1,000 from member transactions and interest income of $800.
- 2014 – Net income of $3,500 from member transactions and interest income of $800.
- 2015 – Net income of $1,500 from member transactions and interest income of $800.



Scenario #1: Majestic elects to be treated as a homeowners' association and files Form 1120-H for all four years. As a result of this election, only the interest income is taxed. The exempt-function income is not taxed and the exempt-function (loss) cannot be carried forward or used to offset non-exempt-function income. Majestic's tax liability is $210 each year for a total of $840 for the four years.

Form 1120-H	Net Exempt Function Income (Loss)	Net Non-Exempt Function Income	Taxable Income	Tax at 30%
2012				
Income/(loss)	($5,000)	$800		
Specific deduction allowed	0	(100)		
Income/(loss)	(5,000)	700	$700	$210
2013				
Income/(loss)	$1,000	$800		
Specific deduction allowed	0	(100)		
Income/(loss)	1,000	700	$700	$210
2014				
Income/(loss)	$3,500	$800		
Specific deduction allowed	0	(100)		
Income/(loss)	3,500	700	$700	$210
2015				
Income/(loss)	$1,500	$800		
Specific deduction allowed	0	(100)		
Income/(loss)	1,500	700	$700	$210

Scenario #2: Majestic decides to file as a regular corporation using Form 1120 for all four years. On Form 1120, member income is taxable. Losses from member activities cannot be used against nonmember income, but the loss can be carried forward and offset member income in a subsequent year. By filing Form 1120, Majestic's total tax liability for the four years is $630 ($120 + $120 + $120 + $270).

Form 1120	Member Income (Loss)	Nonmember & Investment Income	Taxable Income	Tax at 15%
2012				
Income/(loss) before carryforward	($5,000)	$800		
Minus loss carried forward	N/A	N/A		
Income/(loss)	(5,000)	800	$800	$120
Loss carryforward	(5,000)	0		
2013				
Income/(loss) before carryforward	$1,000	$800		
Minus loss carried forward	(5,000)	0		
Income/(loss)	(4,000)	800	$800	$120
Loss carryforward	(4,000)	0		
2014				
Income/(loss) before carryforward	$3,500	$800		
Minus loss carried forward	(4,000)	0		
Income/(loss)	(500)	800	$800	$120
Loss carryforward	(500)	0		
2015				
Income/(loss) before carryforward	$1,500	$800		
Minus loss carried forward	(500)	0		
Income/(loss)	1,000	800	$1,800	$270
Loss carryforward	0	0		

Scenario #3: Each year, Majestic can choose which form to file. In this situation, because Majestic has a membership activity loss in 2012, it will pay less tax by filing Form 1120 in the years the loss offsets membership income. If Majestic files Form 1120 for 2012, 2013, and 2014, and then elects to file Form 1120-H for 2015, the total tax liability for the four years totals $570 ($120 + $120 + $120 + $210).

✎ **Author's Comment:** Majestic pays $210 ($840 – $630) more tax by electing to file Form 1120-H for all four years than if it had filed Form 1120 for those same years. Majestic pays the least amount of tax in Scenario #3 by choosing to file Form 1120 for three years, and then Form 1120-H for year four. Thus, the question of which form to file should be made on a year-by-year basis, depending upon the income and deductions specific to each year.

Possible Risks

- There is little guidance for a homeowners' association filing Form 1120, *U.S. Corporation Income Tax Return.*
- There are more restrictive accounting procedures and allocations that need to be followed when filing Form 1120, including accounting for reserve assessments (IRC §118), membership income and deductions (IRC §263), and reserve expenditures (IRC §263).
- One of the planning tools used by homeowners' association filing Form 1120 is Revenue Ruling 70-604. This

ruling is elective and does not automatically apply. All procedures must be followed to receive the benefit.

- Homeowners' associations that fail to make the election to be treated as a homeowners' association (Form 1120-H) can get an automatic 12-month extension to make the election, provided corrective action is taken within 12 months of the due date (including extensions) of the return. If the homeowners' association fails to take advantage of the 12-month extension, it loses the option of choosing which form to file. When it is past the automatic 12-month extension time frame, Form 1120 must be filed.

Revenue Rulings

Revenue Ruling: A condominium management corporation assesses its stockholder-owners for the purposes of managing, operating, maintaining, and replacing the common elements of the condominium property. This is the sole activity of the corporation and its by-laws do not authorize any other activity. A meeting is held each year by the stockholder-owners of the corporations, at which they decide what is to be done with any excess assessments not actually used for the purposes described above, i.e., they decide either to return the excess to themselves or they have the excess applied against the following year's assessments.

The IRS held that the excess assessments for the taxable year, over and above the amounts used for the operation of the condominium property, that are returned to the stockholder-owners or applied to the following year's assessments are not taxable to the corporation. (Rev. Rul. 70-604)

Revenue Ruling: The taxpayer, a condominium corporation, provided management, maintenance, and care of common elements of a condominium housing project. The by-laws of the management corporation require any assessments must be approved at a stockholder meeting by a majority vote of the unit owner-stockholders. At their annual meeting, the unit owner-stockholders decided to levy and collect two special assessments totaling 15x dollars a month for three years from each unit owner. The assessments will be deposited in two separate bank accounts and will not be commingled with the general assessment funds.

The assessments, 10x dollars and 5x dollars a month respectively, can be used only to replace the roof and elevators located in the common elements of the condominium project.

The IRS determined the taxpayer receives no benefit from the funds. The funds are specifically designated for the replacement of the roof and elevators located in the common elements of the condominium project for the sole benefit of the unit owners. The taxpayer has a fiduciary obligation to expend the funds collected in the manner approved by its unit owner-stockholders. Accordingly, in this case, since the funds are received by the taxpayer as an agent for the unit owners to be used solely for the benefit of the unit owners, the special assessments are not includible in the taxpayer's gross income.

The IRS noted that this Revenue Ruling does not apply to the funds collected by a condominium management corporation to provide the services for which it was formed, such as maintenance of common elements (painting, repairs, gardening, janitorial services, etc.). Thus, for example, funds accumulated to paint the common elements would not qualify under this Revenue Ruling. (Rev. Rul. 75-370)

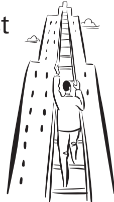
Revenue Ruling: The taxpayer, a condominium corporation, provided management, maintenance, and care of common elements, including the swimming pool, of a condominium housing project. Under the provisions of its charter, the corporation may own personal property. The corporation owns all the equipment and tools necessary to provide services to the unit owners and any other personal property located or used in the common elements of the project.

The by-laws of the management corporation require any assessments must be approved at a stockholder meeting by a majority vote of the unit owner-stockholders. At their annual meeting, the unit owner-stockholders decided to levy and collect a special assessment of 2x dollars a month for 14 months from each unit owner. The assessment will be deposited in a special account and will not be commingled with the general assessment funds. The assessment will be used only to replace the outdoor furniture surrounding the swimming pool.

In this case, the special assessment is specifically earmarked and segregated to replace the outdoor furniture surrounding the swimming pool. It is assessed pro rata upon each unit owner-stockholder. The availability of various types of property, including outdoor furniture, adds to the attractiveness or usefulness of the condominium project and, therefore, enhances the value of a unit owner-stockholder's property. The IRS determined that this enhanced value is sufficient to show the purpose and intent for paying the special assessment is something other than a payment for services rendered by the taxpayer to its unit owner-stockholders.

Accordingly, the special assessment for replacing outdoor furniture is a contribution to capital and not includible in the taxpayer's gross income. Regular assessments collected for the purpose of normal operating expenses are taxable as ordinary income. Any funds accumulated as contingency reserves are also includible in the organization's gross income. (Rev. Rul. 75-371)

Revenue Ruling: A residential real estate management association was a qualified homeowners' association and had timely elected to be treated as such by filing Form 1120-H for each year since it was formed. During the development phase, the developer owned a majority of the lots and controlled the homeowners' association. After control of the homeowners' association was passed to the individual lot owners, the association's board of directors determined that the developer, while in control of the association, had assessed dues at a level that was inadequate to provide for current and future maintenance of the common area improvements of the development. The association filed a lawsuit against the developer for the amount that had been under assessed with respect to the lots owned by the developer during the development stage. To settle the lawsuit, the developer agreed to pay a specified amount to the association.



The taxpayer requested an IRS ruling on whether the amount paid in settlement of the litigation was exempt-function income of the homeowners' association. The IRS determined that the amounts paid by the developer to the association pursuant to the settlement agreement represented compensation for inadequate past assessments. Accordingly, they were properly characterized as assessments that are exempt-function income. (Rev. Rul. 88-56)

~ End ~