YEAR 2011 REAL ESTATE & INVESTMENT FEDERAL TAX UPDATE

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MORE QUESTIONS THAN ANSWERS

There are always more questions than answers because we must deal with the ever changing rules for real estate tax issues. Most of our clients own homes so mortgage interest and home sale questions are common. More recently, falling prices in the home sale market have left us with endless client questions regarding the taxes on foreclosures and loan modifications. Investments in real estate have been a path to wealth in the past. Today a rental property's negative cash flow may result in questions about passive activity rules, real estate professional qualifications and, maybe, how foreclosures are taxed. If the property owner has a gain, often acquired through long term ownership, exchanges and installment sales are a topic of conversation. In this chapter, we will work on the answers to the following "quick client questions."

"I Have a Quick Question"

- I'm already drowning in paper work. Do I really have to do 1099s for the gardener and painter I use for my rental. Do I have to give my social security number on a 1099 to a wandering handyman?
- I haven't been audited in a really long time. Am I just lucky?
- Should I buy or rent?
- Should I help my child buy a house?
- I have a big loss on my home. If I convert it to a rental, can I deduct the loss at sale?
- Who's going to know if my home acquisition debt loan exceeds $1 million?
- Who's going to know if my home equity borrowing exceeds $100,000?
- If I make the payments, can I deduct interest on my Dad's house?
- If I borrow from my stock account to buy a vacation home, can I deduct the interest?
- Can I borrow from my home and buy a rental with the proceeds? Where is the mortgage interest deductible?
- If my sister and I own a home together, can we each deduct interest on a $1 million acquisition indebtedness?
- Can I claim a home office for managing my rentals?
- Do I have to be married for two years before I sell my personal residence in order to exclude a $500,000 gain?
- If I own half of the home, do I only qualify for half of the $250,000 exclusion?
- Can I exclude the gain on my personal residence if I rent it for two years after I move for retirement?
- Can I exclude the gain on the sale of a home that I rented for several years and then lived in for three?
- Do I pay tax if my rental property is foreclosed?
- Do I pay tax if my house is foreclosed?
- My house is selling for less than the loan. Do I pay tax at the sale?
- How is COD computed if my house is foreclosed and I have an equity loan forgiven?
- Is there a difference in the COD calculation if I have a recourse or non recourse loan on the property foreclosed?
- I have both a recourse and a non recourse loan on my property. How do I report the foreclosure?

- I exchanged into a rental property that is now being foreclosed. How is it possible that I have lost my property and I still owe tax?
- Where is COD reported?
- Can I get out of paying tax on COD?
- Do the passive loss rules apply to me?
- Can I sell on an installment sale if my loan is more than my basis in the property being sold because of refinances?
- Can I buy a rental property to get more tax deductions?
- Can I deduct the losses on my vacation rental?
- Can I qualify as a real estate professional?
- Is my recordkeeping enough to prove I am a real estate professional?
- Can I work as an engineer and still be a real estate professional?
- How important is the aggregation election in proving that I am a real estate professional?
- Can I aggregate my vacation rental into my apartment building rentals?
- Will I ever get to use my suspended passive losses? Who gets them if I die?
- Is an installment sale good for me?
- When is an installment sale bad? Shall I elect out of the installment sale?
- Do I get a tax benefit if I buy a rental to use for my incorporated law practice?
- I have a large gain on my rental building. Is an exchange good for me? What's bad about an exchange?
- Does my exchange qualify for tax deferral? Did I get constructive receipt of the sales price?
- Is the target property like-kind in the exchange? What is like-kind property?
- Who can be an intermediary in a delayed exchange? Can I trust them with my money?
- Can I exchange my rental for my Mother's house?

REAL ESTATE TAX NEWS

Congress Repeals Expanded 1099 Reporting (The Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011)

The Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 was signed into law by President Obama on April 14, 2011. The legislation repeals two controversial Form 1099 reporting provisions that would have required (1) landlords to issue forms 1099 to service providers paid $600 or more in a year and (2) all businesses that paid $600 or more to a corporation for goods and services to file a form 1099 on the payments.

Treasury Tells IRS To Increase Rental Real Estate Audits (TIGTA Report 2011-30-005)

A Treasury Inspector General for Tax Administration (TIGTA) report from August 2008 found that at least 53% of individual taxpayers with rental real estate activity for Tax Year 2001 misreported their rental real estate activity, resulting in an estimated $12.4 billion of net misreported income. Because of its 2008 findings, TIGTA revisited the subject. According to the 2011 audit report, the IRS is strongly encouraged to increase its examinations of individual tax returns that report losses from rental real estate activities. IRS management agreed with all of TIGTA's recommendations.

TIGTA also found that during Fiscal Years 2008 and 2009, the IRS's rental real estate Compliance Initiative Program (CIP) examined only a small percentage of the 318,339 examinations conducted by revenue agents and tax compliance officers. TIGTA projected that if the IRS increased the percentage of rental real estate CIP tax returns it examined, it could increase the potential tax assessments by $27.3 million over a five-year period.

TIGTA/IRS Estimates Amount of Tax Gap Created by Taxpayers Erroneously Reporting Real Estate Income/Expenses and Real Estate Professional Status (TIGTA Report 2011-30-005)

Of the $345 billion annual tax gap, the IRS estimates that individuals underreported their taxes, related to rental real estate, by as much as $13 billion. TIGTA's sample results showed taxpayers claiming to be real estate professionals deducted approximately $5 million in rental real estate activity losses that were not subject to further examination.

> **Practitioner Point**. More IRS audits are on their way. Review with your real estate professionals the rules and the recordkeeping requirements. More on this later in the chapter.

IRS Plans to Revise the 2011 Passive Loss Form 8582 Instructions (TIGTA Report 2011-30-005, Recommendation #2)

The IRS plans to revise the 2011 Instructions for Form 8582 to inform all taxpayers with prior year unallowed PAL losses to attach the form included in the instructions to their tax returns.

PERSONAL RESIDENCE

PURCHASE

Should I Buy or Rent?

This is a question of money and tax for you and me as tax and financial advisers. Neither may matter to the person looking for a home. They may find fulfilling the "American Dream" is the bigger motivating factor.

Buying a home provides tax advantages with caveats and limits. Mortgage interest is deductible. Property taxes are deductible. Office in the home may provide extra deductions. Gain on the sale is excludable.

Should I Help my Child Buy a House?

House prices have dropped but the price may still be too high for your child to achieve the American dream of owning a home. So how does Mom or Dad help with the purchase of their child's first home?

Planning Points for Helping a Child Buy a Home
1. Give them money for a down payment. Watch for gift tax reporting if the gift exceeds $13,000/ $26,000. 2. Lend them money for the down payment. Gift loan rules apply and interest may have to be charged

and paid to comply with IRS rules. Secure the loan to the property to give the child a mortgage interest deduction and you a better chance for repayment.
3. If you don't have cash, you can borrow from your home or other assets to come up with the cash to give or lend. But someone has to make those payments, so make sure you are able to service the loan whether junior pays or not.
3. Buy the house with the child. Use your credit to get a better and bigger loan. However if the child defaults on the mortgage, your credit may go into the dump along with theirs.

IRS Notifies Taxpayers About Paying Back First-Time Homebuyer Credit (Repaying the First-Time Homebuyer Credit and Understanding IRS Notice; Update on First Time Homebuyer Credit and Tax Refunds; Understanding the CPO3A Notice & CPO3A sample notice; QuickAlerts; March 2011; IR-2008-106; Form 5405; 2011 Instructions for Form 5405)

The IRS is notifying taxpayers who claimed the first-time homebuyer credit of the repayment requirements. The letters explain if and when you have to repay the credit. There are different IRS letters for different situations, including a purchase of a home in 2008, in 2009 or 2010, a sale of a main home, or a change in the use of the main home.

In the fall of 2010 or the first year after the credit is claimed, and every year until the credit is repaid, the IRS will send Notice CPO3a, Repaying your First-Time Homebuyer Credit. This notice lists the amount of the credit received and the amount to be repaid as additional tax. The repayment must be attached to a completed Form 5405. For example, if the taxpayer purchased a home in 2008 and claimed the maximum credit of $7,500, the repayment amount is $500 per year. If the homeowner stops using the home as a main home, generally entire remaining amount of the credit must be repaid for the year the home is no longer the main home. There are some exceptions to this rule.

IRS looking for 2008 payback of First-Time Homebuyer credit. The IRS released information on processing issues that are impacting a small percentage of tax returns involving repayment of the First Time Homebuyer Credit (FTHB), primarily involving 2008 home purchases. It is important to note that taxpayer returns claiming a home purchase in 2010 are not affected, and those returns are being processed as are the vast majority of other homebuyer returns.

There are different IRS letters depending on when the taxpayer purchased the home. For taxpayers who purchased a home in 2008, the letter will include the repayment schedule for the credit and instructions on how to fill out Form 5405. The letters will also discuss what happens in the event of a sale or a change in the use of the home.

While most of these returns are processing normally, the IRS recognizes the hardship caused by delayed refunds and it has assigned additional staff and resources to address the issues promptly.

1. Married Filing Joint taxpayers who received the FTHB credit on a 2008 purchase. The IRS projects that some of these taxpayers will receive their refunds as soon as April 5 and others the following week.
2. Taxpayers who received the FTHB credit and are now reporting the sale or disposition of their home. The IRS projects that taxpayers in this situation should receive their refunds by the end of April.

3. Taxpayers who received the FTHB credit and are attempting to pay back more than the amount required (typically $500). The IRS projects that taxpayers in this situation should receive their refunds by the end of April.

The time frames above assume there are no other issues impacting the taxpayer refund, including federally mandated offsets to refunds.

It is important to note that taxpayer returns claiming a home purchase in 2010 are not affected, and those returns are being processed as are the vast majority of other homebuyer returns. Because the IRS is aware of the issue and working to resolve it, taxpayers do not need to contact the Service regarding this matter. The IRS apologizes for any inconvenience.

Homebuyer Credit Purchase Date Extended Through April 2011 for Extended Duty Military, Foreign Service and Intelligence Community Workers

Military, foreign service and intelligence community workers who are on extended duty outside of the US for at least 90 days are granted a one year extension for the purchase of qualifying property. They must complete the purchase of the qualifying home by April 30, 2011. Recapture is also waived in the case of a disposition of a home due to qualified official extended duty service (§36(f)(4)(E)).

RESIDENCE SALE

SECTION 121-THE $250,000/$500,000 MFJ RULE

Up to $250,000 of gain ($500,000 for married filing jointly (MFJ)) realized on the sale or exchange of a principal residence on or after May 7, 1997, is not ***taxable*** (not just deferred) if certain prerequisites are satisfied. This permanent exclusion is allowed each time a homeowner meets the eligibility requirements, but generally no more frequently than once every two years (§121). But, this provision is denied to disqualified expatriates (§121(e); §877(a)(1)).

The §121 Qualification Requirements

To qualify for this tax break:

1. "Own for two years" rule: the taxpayer, with three notable exceptions discussed later, must own the home as his or her principal residence for a total of two years during the five-year period ending on the date of the sale or exchange (§121(a)),

2. "Occupy for two years" rule: the taxpayer, with the same three exceptions, must use the home as his or her principal residence for a total of two years during the five-year period ending on the date of the sale or exchange (§121(a)), and

3. "No more than once every two years" rule: the taxpayer cannot report, during the 2-year period ending on the date of sale, other post-May 6, 1997 sales or exchanges to which §121 applies (§121(b)(3)).

The $250,000 Exclusion Doubles to $500,000 MFJ If Four Requirements Are Met

1. ***Either*** spouse ***owns*** the property for two of the last five years,
2. ***Both*** spouses ***use*** the property as their principal residence for two of the last five years,
3. ***Neither spouse is ineligible*** because more than one sale or exchange has been used during the previous two years, and
4. A husband and wife make ***a joint return*** for the taxable year of the sale or exchange of the property (§121(b)(2)).

Surviving Spouse Entitled to $500,000 Exclusion of Gain on Home Sale for Two Years after Death of Spouse (Mortgage Forgiveness Debt Relief Act of 2007; H.R. 3648)

The $500,000 maximum exclusion of gain from sales or exchanges of principal residences that applies to joint return filers also applies to qualifying sales or exchanges by surviving spouses after December 31, 2007 (§121(b)(4)) The increased exclusion amount applies to a sale or exchange of property by an unmarried individual whose spouse is deceased on the date of such sale if:

1. the sale occurs no later than two years after the date of death of such spouse, and
2. immediately before the date of death, either spouse met the two-out-of-five year ownership requirement, both spouses met the two-out-of-five year use requirement, and neither spouse was ineligible to claim the exclusion because of another sale or exchange within the prior two years that qualified for the exclusion (§121(b)(4).

Thus, for the ownership and use requirements, only one spouse must have owned the property for periods aggregating two years or more during the five-year period immediately before the date of death. However, both spouses must have met the use requirement by using the property as a principal residence for periods aggregating two years or more during the five-year period immediately before the date of death (§121(b)(2)(A)(i) and (ii)).

Penalty if spouse remarries within two years. The new provision only applies to an unmarried person. Thus if the surviving spouse remarries and sells the house within two years of the first spouse's death, he or she is not entitled to use this special provision and would only be potentially eligible for the $250,000 exclusion.

Community property. This provision is likely to have little tax impact on the surviving spouse when the personal residence is owned as community property. Since the basis of both halves of the property steps up to fair market value at the first spouse's death, the surviving spouse that sells the personal residence within a few years often has little gain to report from the sale.

Joint tenancy property. In many cases, this provision will provide tax relief to a surviving spouse when the couple owns the property as joint tenants. The basis in only ½ (the inherited half) of joint tenant property steps up to fair market value at the first spouse's death. The surviving spouse may now exclude $500,000 of gain.

Separate property of the surviving spouse. This new provision will provide the biggest tax relief to the surviving spouse that owned the house as her separate property since she is likely to have the biggest gain at sale. Since she did not inherit the property in part or in whole from the deceased spouse, she receives no step up in basis at her spouse's death. If she sells the home within two years of the spouse's death, she'll be entitled to exclude $500,000 of gain (rather than the $250,000 under prior law.)

Example. Jane and John are married but the personal residence is Jane's separate property. Jane and John otherwise qualify for the §121 exclusion. At John's death December 2009, Jane's basis in her house was $100,000. Jane sells the house November 2011 for $700,000. Her gain at sale is $600,000 ($700,000 less $100,000.) Under the prior law, Jane would have paid tax on $350,000 ($600,000 less her $250,000 gain exclusion). Under the new law, Jane will pay tax on $100,000 ($600,000 less a $500,000 gain exclusion.)

50% Owner Gets 100% Exclusion on Sale of Home (*Sung Huey Mie Hsu v. Comm.*, TCS 2010-68)

Sung Huey Mei Hsu sold her 50% interest in a home in 2005. Ms. Hsu realized a $264,000 gain from the sale and, because she met all the §121 requirements, excluded $250,000 of the gain from her taxable income. The IRS, ignoring their own regulations, only allowed her to exclude $125,000, arguing that her exclusion should be prorated by her ownership percentage. The court, however, noted that such prorations are not required under §121 and brought to the IRS's attention that the Regulations specifically provide that joint owners of a property are allowed up to exclude up to $250,000 of that is attributable to each taxpayer's interest in the property (§1.121-2(a)(2)).

Divided Tax Court Rules Replacement Home Must Be Occupied to Qualify for §121 Exclusion (*David and Christine Gates v. Comm.*, 135 TC No. 1, 19350-05, July 1, 2010)

David Gates purchased an 880-square-foot home in 1984 for $150,000. In 1989, David married Christine Gates and the couple resided in the David's home for two years from August 1996 to August 1998. In 1996 the Gates decided to enlarge and remodel the original house. However, their architect advised them that more stringent building and permit restrictions had been enacted since the original house was built and remodeling would be cost prohibitive. The Gates decided to demolish the original house and construct a new three-bedroom house in its place.

Now the problem. For a variety of reasons, David and Christine never resided in the new house and put it up for sale. On April 7, 2000, they sold the new house and land for $1,100,000 and realized a gain of $591,406. The Gates agreed that $91,406 of the gain should have been included in their gross income for 2000, but they asserted that the remaining gain of $500,000 was excludable under §121. The Gates position was that the time they occupied the old home tacks onto the new home. The IRS, on the other hand, argued that the new home was never occupied and, therefore, the requirement under §121 to live in the home for two years was not met.

Court looks to legislative history to help make decision. In order makes its decision, the court determined the terms "property" and "principal residence" must be defined. It looked at legislative history and concluded that the terms refer to "a house or other dwelling unit in which the taxpayer actually resided." Because the Gates never occupied the home, they were not eligible to exclude the gain.

Dissenting opinion. Judge Halpern wrote a spirited dissent on this case and was supported by four other tax court judges. He noted that the §121 exclusion was intended to be a remedy by providing a simpler method for excluding gain than the rollover method provided by §1034. He also noted the potential inequity where a taxpayer whose longtime home is demolished by a natural disaster (e.g., hurricane) and not covered by insurance. If the taxpayer rebuilt on the same land and lived in the rebuilt house for 18 months, when the house and land are sold at a gain, under this decision by the majority, the exclusion would not apply because the live there for two or more of the last 5 years test would not be satisfied. If, however, the house had only

been damaged, and was repaired, the exclusion would apply. In a candid summary, Judge Halpern noted that he would have treated the demolition and reconstruction of the home no differently than a renovation. As a second best solution, he would have treated the demolished home as being sold for zero dollars and apply §121 to the subsequent sale of the land (and the new house).

Exclusion of Gain on Sale of a Principal Residence Does Not Apply to Nonqualified Use - The Housing and Economic Recovery Act of 2008 (§121)

For sales and exchanges after December 31, 2008, gain from the sale or exchange of a principal residence allocated to periods of nonqualified use is not excluded from gross income.

Computation. The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

Nonqualified use. A period of nonqualified use means any period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. For purposes of determining periods of nonqualified use, (i) any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period), and (ii) any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, are not taken into account.

Post-May 6, 1997 depreciation. If any gain is attributable to post-May 6, 1997, depreciation, the exclusion does not apply to that amount of gain, as under present law, and that gain is not taken into account in determining the amount of gain allocated to nonqualified use.

> **Example 1 - Rent for two years, Use for three years.** Assume that Sharon buys a property on January 1, 2010, for $400,000, and uses it as rental property for two years claiming $20,000 of depreciation deductions. On January 1, 2012, Sharon converts the property to her principal residence. On January 1, 2014, she moves out, and sells the property for $700,000 on January 1, 2015. As under present law, the $20,000 gain attributable to the depreciation deductions is included in income. Of the remaining $300,000 gain, 40% of the gain (two years divided by 5 years), or $120,000, is allocated to nonqualified use and is not eligible for the exclusion. Since the remaining gain of $180,000 is less than the maximum gain of $250,000 that may be excluded, gain of $180,000 is excluded from Sharon's gross income.
>
> **Example 2 - Rent after personal use.** Assume that Vern buys a principal residence on January 1, 2010, for $400,000, moves out on January 1, 2020, and on December 1, 2022 sells the property for $600,000. The entire $200,000 gain is excluded from gross income, as under present law, because periods after the last qualified use do not constitute nonqualified use.
>
> **Planning Point**. This exception to non qualified use allows Vern to rent the house while he waits for a better market or while he decides if his retirement move to Arizona is the right move.

Example 3 - Gain allocated before the 2009 effective date. Assume that Ron bought a vacation home on July 1, 2005 for $100,000. He converts the vacation home to his personal residence on January 1, 2011 and sells it January 1, 2014 for $300,000. Since Ron has non qualified use (after December 31, 2008) of two years of the 8½ years that he owned it, only 6½ / 8½ of the $200,000 gain on the sale of the home is excludable under §121.

What Happens If the Homeowner Can't Meet the Two Year Rule? Not to Worry!

Three exceptions permit the homeowner to still exclude some (or all?) of the gain: If the primary reason the homeowner cannot comply with any (or all) of the two-year rules is because of:

1. change in place of employment,
2. health, or
3. other unforeseen circumstances, as provided in IRS regulations,

the taxpayer will still be able to exclude a portion of the $250,000/$500,000 MFJ exclusion multiplied by a fraction, the numerator being the shorter of (1) the use period or (2) the period between the two sales dates, and the denominator being two years (730 days). Therefore, taxpayers who have owned or used a principal residence for less than two of the five years preceding the sale or exchange or who have excluded gain from another sale or exchange during the past two years may exclude from gain a reduced maximum amount if the sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances (§121(c)(2);§1.121-3(a) & (g); TR §1.121-3(b)).

Definition of Principal Residence

The IRS does not provide a bright-line test that identifies the principal residence when the seller has several residences. Facts and circumstances determine whether the taxpayer uses the house as a *residence*, and whether it is used as the *principal* residence (Treas. Reg. §1.121-1(b)(2)).

A taxpayer's principal residence is the land and building where the taxpayer *principally domiciles.* The principal residence determination is based upon all the facts and circumstances in each case, including the good faith of the taxpayer. It may be even be located in a foreign country (IRS Rev. Rul. 54-611). As there is no requirement that a principal residence be owned, a motel room or rental apartment may be a principal residence (IRS Rev. Rul. 60-189; IRS Rev. Rul. 73-529; ***Marvin Ziporyn v. Comm.,*** TC Memo 1997-151).

Taxpayers Who Own Multiple Homes

One taxpayer cannot own two principal residences simultaneously because principal is defined as "the most important" [*McDowell v. Comm.*, 40 TCM 301 (1980)].

Example - Use split between two residences in same year: David owns two residences, one in San Francisco and one in Palm Springs. From 2006 through 2011, he lives in the San Francisco residence for seven months and the Palm Springs residence for five months of each year. In the absence of facts and circumstances indicating otherwise, the San Francisco residence is David's principal residence. He would be eligible for the §121 exclusion of gain from the sale or exchange of the San Francisco residence, but not the Palm Springs residence [§1.121-1(b)(4), Ex. 1].

CONVERTING YOUR HOME TO RENTAL USE

Even though the Internal Revenue Code requires the immediate recognition of all gain on the sale or exchange of property, including the gain on the sale of a personal residence that is not excluded, any loss on the sale of personal residence is nondeductible, as it is considered a "personal, living, or family" expense.

Converting the Residence to Rental Use

Can a personal residence be converted to a business use prior to sale and thereby convert the nondeductible personal loss to a deductible one? Theoretically, it is possible (§165(c)(1) and (2)). But, this process is difficult. The length of time before a personal residence becomes a rental is not known. However, the antithesis is known. If the home is rented for less than three of the last five years before sale, §121 considers it a personal residence.

One argument for the taxpayer: How a residence is being used at the date of sale is of major importance in determining whether property is business or personal (U.S. v. Winthrop, 5 Cir. 1969, 417 F.2d 905). Therefore, the taxpayer must prove that the property is a rental when sold, and the conversion is not done for tax purposes only (William C. Horrmann, 17 TC 903 (1951)).

Basis is Lower of Cost or FMV

The adjusted basis for determining loss for property converted from personal use is the smaller of:

1. The fair market value of the property at the time of conversion, or
2. The adjusted basis of the property at the time of conversion.

Therefore, the loss created prior to conversion is still not deductible, either at the time of conversion or at the time of sale (§1.165-9(b)(2)).

> **Example**. Ron bought a personal residence in Phoenix in 2007 for $500,000. The home is now worth $300,000. If he sells the home today, he will have a nondeductible loss of $200,000. Instead he decides to convert the home to rental, rent it for a period of time and then sell it when the house is a rental and deduct the loss as an ordinary §1231 loss. That doesn't quite work. Even if the house is considered to be rental property at the sale, Ron's basis for the sale (and for depreciation) is $300,000.

FORECLOSURE

THE NEWS ON FORECLOSURES

You don't have to be a news junkie to know that foreclosures have reached historical levels in the US and more seem to be on the way. The Center for Responsible Lending says 8.1 million Americans could be at risk of losing their home to foreclosure over the next 4 years. According to Realtytrac.com, there were 1,000,000 foreclosures in 2010, an increase of 10% from 2009. Lenders filed more than 3.8 million foreclosure notices in 2010. 5 million borrowers were more than 2 payments behind on their mortgage.

Nevada, Arizona, California, and Florida lead the country in foreclosures. In sheer numbers, California accounted for almost 21% of the nation's total foreclosures for the month with 546,669 households receiving foreclosure notices.

With these foreclosure numbers, it is likely that most tax practitioners will have clients with questions about the tax impact of losing their properties. New law eases the tax burden for some, but others will be caught by surprise when they have lost their home and still face a tax bill.

> **Comment:** the IRS explains the mostly negative tax ramifications upon foreclosure on its website (Pub. 4681, Q&A on Home Foreclosure & Debt Cancellation, Mortgage Debt Relief Act of 2007).

Another One of Those Quick Questions

"How can a foreclosure be taxable? I lost the property. I don't have anything." The couple, the husband with an MBA and the wife with a law degree, financed their old house to buy a new bigger and better house. The market was soft so they rented out the old house for a few years until they could get what they thought it was worth. Instead the old house is underwater. They are in the middle of a short sale and wonder what the tax consequences will be. The FMV of the old house is $450,000. The loan is $600,000. We can easily see that the bank is going to be short on the pay off by $150,000. That is COD income to our clients unless (1) the mortgage is acquisition debt or (2) the couple is insolvent. The mortgage is not acquisition debt as the clients borrowed from the house to buy another. As the computation works out, they do have $150,000 in COD income unless they can show insolvency. So let's ask about their assets and liabilities. Their bigger and better new house has a mortgage of $900,000 and a FMV of $700,000. Ouch, both houses went down in value, of course. Well at least there isn't any equity in that asset. We are on our way to insolvency. But what else might they have? They have pensions of $35,000, cash and securities of $25,000, two autos with no equity, and nothing else. And then there is the $150,000 student loan on the other side of the ledger. The clients are insolvent, so they won't have to pay tax on the COD, and they are relieved, as they should be.

Cancellation of Debt (COD) Creates Income

A property owner's gross income, for tax purposes, includes income from discharge of indebtedness or cancellation of debt (COD)(§61(a)(12)).

Canceled Debt that Qualifies for Exception to Inclusion in Gross Income:

1. Amounts specifically excluded from income by law such as gifts or bequests
2. Cancellation of certain qualified student loans
3. Canceled debt that if paid by a cash basis taxpayer is otherwise deductible
4. A qualified purchase price reduction given by a seller

Canceled Debt that Qualifies for Exclusion from Gross Income:

1. Cancellation of qualified principal residence indebtedness
2. Debt canceled in a Title 11 bankruptcy case
3. Debt canceled due to insolvency
4. Cancellation of qualified farm indebtedness
5. Cancellation of qualified real property business indebtedness

Taxable as ordinary income. Cancellation of debt income is taxable as ordinary income, even if the COD arises from the sale of a personal residence or other capital gain property. COD income results when any of the borrower's debt is reduced (by compromise, negotiation, or otherwise) for less than the full amount due. COD income most commonly emanates when restructuring or settling a loan (*U.S. v. Kirby Lumber Co.*, 284 U.S. 1 (1931)).

IRS reporting. A financial institution that forecloses on a property must file a Form 1099-A with the IRS and provide a copy to the property owner. If the financial institution discounts (reduces) the loan, it must file a Form 1099-C with the IRS and provide a copy to the borrower. The IRS matching program often leads to tax due notices to unsuspecting taxpayers who can't believe that the Form 1099 received really means that there is taxable income to report. Well, maybe there isn't, and the Taxpayer Advocate wants the IRS to do more to clarify **(National Taxpayer Advocate Report (IR-2008-4))**

> **New Pub**. See new IRS Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals).*

Tax Results When Borrower Loses Property by Foreclosure, Deed in Lieu, or Abandonment

When a property owner surrenders property to a lender in exchange for debt forgiveness, phantom income from the transaction may be created, either as "income from the discharge of debt" or as "income from the sale of property" or as a combination of both.

Foreclosure–A Forced Surrender of Property by the Borrower to the Lender

When a borrower fails to pay a mortgage on time, the lender generally starts legal proceedings to sell the property securing that debt. This involuntary sale normally causes adverse tax ramifications to the borrower.

Debt relief causes transfer of property to be a sale–and a sale creates a gain (or loss). A foreclosure, even though the property owner has no choice, is a sale for tax purposes (it is not a gift from the borrower back to the lender!) (*G. Hammel v. Helvering,* SCt, (*rev'g* CA-6), 41-1 USTC ¶9169, 311 U.S. 504, 61, S. Ct 368).

RECOURSE DEBT VERSUS NONRECOURSE DEBT

When Is a Debt Recourse and When Is it non Recourse?

At foreclosure, the cancellation of debt income and the deemed sales price of the property are different, depending on whether the taxpayer is personally liable on the mortgage (i.e., a recourse mortgage) or not personally liable on the mortgage (i.e., a nonrecourse mortgage) (*J. G. Abramson,* CA-2, 42-1 USTC ¶9200, 124 F2d 416).

> **Preparer tip:** The lender indicates on the Form 1099-A or Form 1099-C if the defaulted mortgage is recourse or nonrecourse.

In California, the mortgage to buy the borrower's personal residence is nonrecourse by state law. If the loan is refinanced or if the loan is secured by business or investment property, it is generally recourse unless the borrower specifically negotiates a nonrecourse loan.

NonRecourse Debt Cancelled

A foreclosure when the borrower is not personally liable requires only a one-step approach. In a nonrecourse debt, the lending institution looks only to the property for recovery of the mortgage and cannot additionally look to the borrower's other assets. In effect, the debtor never owes more than the fair market value of the asset securing the loan! Therefore, the sales price is equal to the entire amount of the nonrecourse debt, even if the fair market value is less than the amount of the loan. The result is that there will never be COD income in the foreclosure of a property with nonrecourse debt (§1.1001-2(b); *Comm., v. John F. Tufts*, SCt, 83-1 USTC ¶9328, 461 U.S. 300 (1983)).

The calculation. The gain on the surrender of secured property in exchange for the discharge of nonrecourse indebtedness is calculated as follows:

Step 1: Gain or loss from foreclosure (the one and only step). Subtract the adjusted basis from the mortgage relief. Gain from foreclosure results in income to the borrower when the mortgage forgiven exceeds the borrower's adjusted basis in the secured property (§1.1001-2(c)(7); §7701(g)).

> **Example- Nonrecourse debt:** Sue purchased property for $600,000 with a $550,000 adjustable rate mortgage (ARM) due and payable in five years (nonrecourse debt). The escalating interest rate on the ARM makes it impossible for Sue to make her mortgage payments. The lending institution forecloses and the property is sold at a sheriff's sale for $500,000. Even though the property is sold by the lender for a lesser amount, Sue has a sales price for tax purposes equal to the debt forgiveness of $550,000. Thus, Sue has a $50,000 loss on the property sale ($550,000 sales price less $600,000 basis = $50,000 loss.) If this is Sue's personal residence, the loss is not deductible.

Foreclosure of real property secured by NON-RECOURSE debt	
Sales price - loan	$550,000
Basis	$600,000
Loss	($50,000)

> **Preparer Point**. The tax reporting is the same under old law or new law. Nonrecourse loan forgiveness is treated as the sales price of the foreclosed property. Thus, the Mortgage and Debt Relief Act of 2007 has no impact on Sue's taxes.

Recourse Debt Cancelled

A foreclosure when the borrower is personally liable requires a two-step calculation. Generally the deemed "sales price" when a recourse mortgage note is turned back to the lender is the actual debt relief as a result of the foreclosure. But this sales price cannot include any COD income. Therefore, a foreclosure involving a recourse debt must be bifurcated or divided into two parts: (1) income from the discharge of indebtedness and (2) gain (or loss) created by foreclosure (§1.1001-2(a)(2), and (c) (Example 8); Rev. Rul. 90-16, 1990-1 CB 12; *Bressi v. Comm.*, TC Memo 1991-651, 62 TCM 1668).

> **Planning Point**. The Mortgage and Debt Relief Act of 2007 excludes COD income from the cancellation of "qualified acquisition debt" on a personal residence. Cancellation of other debt on

the personal residence as well as debt on vacation homes, investment property and business property still generates taxable income.

The calculation. The income on the surrender of secured property in exchange for the discharge of recourse debt is calculated as follows:

Step 1: COD income. The excess of the amount of the debt discharge over the property's fair market value, if any, is income from the discharge of indebtedness (ordinary income). This is the only amount that may be sheltered by bankruptcy and insolvency relief provisions. Of course, there is no COD income if the borrower remains liable for the deficiency (§1.1001-2(a)(2); Rev. Rul. 90-16, 1990-1 CB 12).

Step 2 : Gain or loss from foreclosure. The sales price (or fair market value when there is no sale) of property surrendered less the property's adjusted basis is the gain or loss from the disposition of property (generally capital gain or loss).

Example - Recourse debt: Sue purchased a vacation home for $600,000 with a $550,000 adjustable rate mortgage due and payable in five years. The debt is a recourse debt. When the value of the property dropped to $500,000, Sue stops making payments. The lending institution forecloses and the property is sold at a sheriff's sale for $500,000. The lending institution forgives the remaining amount due as it determines that "there's no blood left in the turnip." Even though Sue receives no money and has lost her property in foreclosure, the IRS doesn't care. She has both ordinary income from COD of $50,000 and a $100,000 loss on the sale. Since this is Sue's vacation home, the loss is not deductible.

Foreclosure of real property secured by RECOURSE debt	
Mortgage	$550,000
FMV	$500,000
COD	$50,000
Sales price - FMV	$500,000
Basis	$600,000
Loss	($100,000)

Planning Point. COD income can be excluded under §108 only if Sue is bankrupt or insolvent.

Preparer Point. Whether Sue gives the property back to the lender or convinces the lender to discount the mortgage to the property's FMV, the COD income is the same.

New law. If the foreclosed property was Sue's personal residence instead of a vacation home, the COD income in the example can be excluded.

Worksheet for Foreclosures and Repossessions

Part 1. Figure ordinary income from the cancellation of debt upon foreclosure or repossession. Complete this part only if taxpayer was personally liable (recourse) for the debt. Otherwise, go to Part 2.		
1.	Enter the amount of outstanding debt immediately before the transfer of property reduced by any amount for which you remain personally liable immediately after the transfer of property	
2.	Enter the fair market value of the transferred property	
3.	**Ordinary income from the cancellation of debt upon foreclosure or repossession**. Subtract line 2 from line 1. If less than zero, enter zero. Next, go to Part 2	
Part 2. Figure your gain or loss from foreclosure or repossession.		
4.	If you completed Part 1, enter the smaller of line 1 or line 2. If you did not complete Part 1 enter the amount of outstanding debt immediately before the transfer of property	
5.	Enter any proceeds you received from the foreclosure sale	
6.	Add line 4 and 5	
7.	Enter the adjusted basis of the transferred property	
8.	**Gain or loss from foreclosure or repossession.** Subtract line 7 from line 6	

Foreclosure of Business and Investment Properties

Whether the foreclosed property is used for personal, business or investment, COD income can result at its foreclosure. However, the overall effect to the taxpayer differs. In the above example, Sue lost her vacation home to foreclosure. The tax calculation resulted in $50,000 of ordinary income and $100,000 of non deductible personal loss. If instead of a vacation home, Sue lost a rental house to foreclosure, she would still have $50,000 of COD income since the mortgage on the house exceeds the FMV by $50,000. But the loss would be a §1231 loss reported on the form 4797 as an ordinary loss. The net tax affect to Sue would be an ordinary loss of $50,000 (which miraculously represents her true economic loss.)

Character of the Gain or Loss in a Foreclosure

Foreclosure gain or loss is governed by the normal gain or loss rules; that is, a capital asset creates a capital gain or loss, business assets create capital gain and ordinary loss, and dealer realty creates ordinary gain and loss. Sadly, foreclosure on a personal residence creates a nondeductible loss!

Example 1- Sharon loses Las Vegas rental property to foreclosure

In 2007, Sharon purchased a condo in Las Vegas for $450,000, with $50,000 down and a $400,000 recourse mortgage. Sharon expected to rent the condo for a few years and then make a killing when she sold it. Instead rental income was not enough to pay the mortgage payments, property taxes, condo fees and other expenses. Negative cash hurt a lot and then the property value plummeted to $250,000. Sharon stopped making payments and the bank foreclosed in 2011. Sharon must report COD income of $150,000 ($400,000 loan less $250,000 FMV). But Sharon will have an ordinary loss at the "sale" of the property. The FMV of the condo at its foreclosure becomes her sales price on the Form 4797, $250,000. She offsets the sales price with her adjusted basis in the property ($450,000 less depreciation claimed of say $20,000). Thus, she'll report a ordinary loss of $180,000.

> **Check the result.** Test that net taxable answer. Sharon put $50,000 down and wrote off $20,000 of depreciation. She lost real money of $30,000, the net between the COD of $150,000 and the loss on sale of $180,000).

Example 2 - Bill loses apartment building acquired in an exchange to foreclosure

Bill exchanged a San Jose four-plex into a Phoenix apartment building. The $200,000 gain on the sale of relinquished property was deferred into the purchase price of the new property, reducing his basis accordingly. Although the apartment building has declined in value $300,000 since he purchased it, if Bill loses the property to foreclosure, he may have a gain on the "sale."

FACTS		
Purchase apartment building	$1,300,000	
Down payment	$250,000	
Mortgage	$1,050,000	
Deferred gain	$200,000	
Depreciation claimed	$125,000	
FMV at foreclosure	$1,000,000	
TAXABLE RESULT		
COD at foreclosure	$50,000	$1,050,000 mortgage less $1,000,000 FMV
Gain at "sale"	$25,000	$1,000,000 FMV less $975,000 adjusted basis. Gain is subject to depreciation recapture at 25%.

Example 3 - Ray Borrows from His Paid off Sunnyvale Four-plex to Make a down Payment on a San Diego Office Building

Ray borrows $400,000 from his four-plex to make a down payment on an office building. Ray can't make the payments on the $400,000 loan and is forced to sell it recognizing a big gain. The value of the new office building has dropped below the mortgage and Ray lets the building go back to the bank in foreclosure. Ray

will recognize a net loss on the sale of the office building and that may be enough to shelter the gain from the four-plex. But Ray's woes are not only about taxes. He has lost both of his properties and his money.

Short Pay or Short Sales–How Are They Taxed?

One phenomenon in a declining residential mortgage market is dubbed a "short pay" or a "short sale," that is, the home is sold for less than ("short of") what is owed on the mortgage. Property advertisements sometimes refer to it as a "pre-foreclosure" sale. While the home is marketed by the mortgage holder in a foreclosure, it is marketed by the homeowner in a short sale, generally with the disclosure "subject to lender approval." Often the lender agrees to the sale of mortgaged property by the debtor for an amount less than the outstanding debt. In addition, the debtor may be required to pay some cash to the lender.

> **Planning Point:** In a short pay transaction, the lender, not the property owner, makes the ultimate decision to sell. For the property owner, a short sale is sometimes better for their credit rating then going through foreclosure proceedings. For the lender, the short sale alternative cuts their losses faster than the protracted foreclosure process.

If the loan being extinguished is nonrecourse (perhaps the original purchase mortgage), the loan balance is treated as the sales price of the property. If the loan being extinguished is recourse, the excess of the property's loan over fair market value (FMV) is COD income. The FMV is treated as the sales price of the property.

> **Preparer Point**: It seems the debtor is merely selling the property on the lender's behalf (the lender must agree to the sale) and that the amount realized by the debtor is the amount of the debt pursuant to §1.1001-2(a)(1), as would be the case if the lender took back the property.

§108 RELIEF

Exception to the COD Income Rule

The Supreme Court long ago formulated the principle that increases in net worth from forgiveness or cancellation of indebtedness give rise to gross income, *United States v. Kirby Lumber Co.,* 284 U.S. 1 (1931), but there are recognized exceptions to this general principle. The Court of Appeals for the Fifth Circuit was among the first Courts of Appeals to develop an "insolvency exception," in *Dallas Transfer & Terminal Warehouse Co. v. Commissioner,* 70 F.2d 95 (5th Cir. 1934), revg. 27 B.T.A. 651 (1933).

In *Dallas Transfer*, the taxpayer's relief from indebtedness did not result in gross income where he was insolvent both before and after the debt was discharged. The court stated: This (relief from indebtedness) does not result in the debtor acquiring something of exchangeable value in addition to what he had before. There is a reduction or extinguishment of liabilities without any increase of assets. There is an absence of such a gain or profit as is required to come within the accepted definition of income.

Section 108, Income from Discharge of Indebtedness, codifies the result reached in *Dallas Transfer,* and identifies in subsection (a), Exclusions From Gross Income, situations in which discharge of indebtedness is not included in gross income.

Exclusion from Income (§108)

COD is excludable from income if it occurs:

1. In bankruptcy,
2. To an insolvent borrower, but only to the extent of insolvency,
3. With qualified farm debt,
4. With qualified real property business debt (for taxpayers other than C corporations (§108(a)),
5. With seller financing (§108(e)(5)),
6. When payment of the debt would result in a tax deduction to the borrower (§108(e)(2)),
7. With certain student loans (§108(f)), or
8. Bona fide dispute.

Excluding COD in a bankruptcy case. Income from the discharge of debt incurred by a taxpayer in bankruptcy is excluded from income all together, provided the bankruptcy case is not dismissed prior to debt discharge. The exclusion applies only if the taxpayer is under the jurisdiction of the court and the discharge of indebtedness is by the court or pursuant to a plan approved by the court. However, to the extent available, a certain amount of a borrower's future tax benefits (called tax attributes) will be reduced. This exclusion from income is allowed, though, regardless of whether the amount of such income exceeds the borrower's future tax benefits (tax attributes) available for reduction (§108(a)(1)(A); §108(b)).

Excluding COD when the taxpayer is insolvent. Gross income does not include COD income when the borrower is insolvent. However, the amount excluded cannot exceed the amount by which the borrower is insolvent. Certain of the borrower's future tax benefits (i.e., tax attributes) must be reduced by the amount of income excluded under this insolvency exception. If a taxpayer is bankrupt and insolvent, only the bankruptcy exclusion applies. If the borrower remains insolvent after the discharge, all income from the discharge is permanently excluded, regardless of whether the amount of such income exceeds the amount of future tax benefits (i.e., tax attributes) available for reduction (§108(a)(1)(B); §108(a)(3); §108(b)).

What is insolvency? Being insolvent means the investor's liabilities exceed the fair market value (FMV) of his or her assets determined immediately before the discharge (i.e., FMV assets less liabilities equals a negative number).

> **Example**. Jon has assets with a fair market value of $200,000 and has liabilities of $250,000, the amount by which he is insolvent is $50,000. Therefore, if the liabilities were discharged, only $50,000 can be excluded from gross income.

How to calculate insolvency. Unlike bankruptcy, insolvency is much more difficult to determine. The Code defines insolvency as the excess of liabilities over the fair market value of assets (§108(d)(3)). Thus the taxpayer must prepare a balance sheet (showing all assets including personal residence, pension plan and IRA accounts at their fair market value) in order to determine the amount of insolvency and the availability of this COD exclusion. The taxpayer has the burden of proving insolvency. Appraisals and business valuations may be required.

Nonrecourse debt is included in this calculation only when it is involved in the debt discharge transaction itself, and in such cases only the amount discharged is counted (§108(d)(3); Rev. Rul. 92-53, 1992-27 IRB).

> **Planning Point**. Contingent liabilities are not included in the insolvency computation (see *Dudley B. Merkel V. Comm.*, 109 TC 463, aff'd, CA-9, 99-2 USTC 50,848, 192 F3d 844).

Property Protected from Creditor Claims in Bankruptcy Included in Calculation of Insolvency

Although bankruptcy law protects pension funds from creditor claims, pension funds are included in assets for calculating insolvency (see PLR 199932013 and 199935002). This is also true of residences protected from creditor claims, such as in California (*Stuart Raymond Quartemont v. Comm.*, TCS 2007-19).

IRS Issues Insolvency Worksheet

A comprehensive new insolvency worksheet tax practitioners can use to determine whether and to what extent taxpayers are insolvent is included in the newly revised edition of Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals). The result can then be used to determine whether and to what extent the canceled debts are excluded from gross income.

Tax Attributes Are Reduced by Excluded COD Income

Ordering rule for reduction of future tax attributes. In the absence of an election to first reduce depreciable basis, future tax benefits (tax attributes) of the borrower will be reduced to the extent of debt discharge income (or its equivalent) in the following order:

1. Net operating losses: Reduce NOL dollar for dollar.
2. General business credit: Reduce at a 33.3% rate for each dollar of COD excluded.
3. Alternative minimum tax credits: Reduce the minimum tax credits as of the beginning of the tax year immediately after the tax year of the discharge.
4. Capital losses: Reduce dollar for dollar.
5. Basis reduction: Reduce, dollar for dollar, the basis of both depreciable and *nondepreciable* property. But this basis cannot be reduced below total liabilities immediately after the discharge (§108(b)(2)(D)).
6. Passive activity losses (and credits): Reduce the passive activity losses and credit carryovers from the tax year of the discharge.
7. Foreign tax credit carryovers: Reduce at a 33.3% rate for each dollar of COD excluded.
8. Acquisition debt on principal residences. (For the years 2007-2012)

PERSONAL RESIDENCE AND THE CANCELLATION OF DEBT

Ten Facts about Mortgage Debt Forgiveness (IR 2011-44)

Here are 10 facts the IRS wants you to know if your client's personal residence is foreclosed.

IRS Top Ten

1. Normally, debt forgiveness results in taxable income. However, under the Mortgage Forgiveness Debt Relief Act of 2007, the taxpayer may be able to exclude up to $2 million of debt forgiven on his or her principal residence.
2. The limit is $1 million for a married person filing a separate return.
3. The taxpayer may exclude debt reduced through mortgage restructuring, as well as mortgage debt forgiven in a foreclosure.
4. To qualify, the debt must have been used to buy, build or substantially improve the taxpayer's principal residence and be secured by that residence.

5.	Refinanced debt proceeds used for the purpose of substantially improving the taxpayer's principal residence also qualify for the exclusion.
6.	Proceeds of refinanced debt used for other purposes – for example, to pay off credit card debt – do not qualify for the exclusion.
7.	If the homeowner qualifies, claim the special exclusion by filling out Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, and attach it to his or her federal income tax return for the tax year in which the qualified debt was forgiven.
8.	Debt forgiven on second homes, rental property, business property, credit cards or car loans does not qualify for the tax relief provision. In some cases, however, other tax relief provisions – such as insolvency – may be applicable. IRS Form 982 provides more details about these provisions.
9.	If the debt is reduced or eliminated the homeowner normally will receive a year-end statement, Form 1099-C, Cancellation of Debt, from the lender. By law, this form must show the amount of debt forgiven and the fair market value of any property foreclosed.
10.	Examine the Form 1099-C carefully. Notify the lender immediately if any of the information shown is incorrect. You should pay particular attention to the amount of debt forgiven in Box 2 as well as the value listed for the home in Box 7.

§108 Exclusion for Cancellation of Acquisition Indebtedness on Principal Residences (Emergency Economic Stabilization Act of 2008; Mortgage Forgiveness Debt Relief Act of 2007 (HR 3648)

A taxpayer subject to foreclosure might end up homeless and still face a nasty tax bill from Uncle Sam for cancellation of debt income. To address this looming tax dilemma, Congress retroactively added a new §108 exclusion to cancellation of debt income and then extended it for three years, to 2012. Effective for discharges of indebtedness on or after January 1, 2007 and before December 31, 2012, the Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648) excludes from a taxpayer's gross income any discharge (in whole or in part) of qualified principal residence indebtedness (new §108(a)(1)(E)).

Qualified Principal Residence Indebtedness.

Principal residence. For these purposes, the term "principal residence" has the same meaning as under §121. It does not include the taxpayer's vacation home, rental or investment property.

Qualified principal residence indebtedness means debt which is incurred in the acquisition, construction, or substantial improvement of the principal residence by the individual and is secured by the residence (see §163(h)(3)(B)) except that the dollar limit is $2 million ($1 million in the case of a separate return), Qualified principal residence indebtedness does not include home equity indebtedness.

When a portion of the mortgage is acquisition indebtedness. If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness.

> **Example.** In 2006, Holly purchased her personal residence in Livermore, California for $700,000. She made a $100,000 down payment and financed $600,000. A year later she used a $200,000 home equity line to finance her kitchen remodeling. In 2008 she refinanced the property for $1 million and used the proceeds to pay off personal debts and finance her daughter's Stanford tuition. In 2010, the

value of the property has dropped well below the $1 million mortgage. Holly stops making payments on her loan, the property is foreclosed and sold at auction for $700,000. What are Holly's tax consequences?

If the residence is sold for $700,000 and $300,000 of the debt is discharged, only $100,000 of the amount discharged may be excluded from Holly's gross income under the new law. The $200,000 COD in excess of "qualified acquisition indebtedness" is taxable as ordinary income unless Holly is bankrupt or insolvent.

Planning Point. Homeowners who refinanced their principal residence mortgage to pay off personal credit card debts, car loans or for other personal uses are not entitled to this new exclusion and will have cancellation of debt income.

Mortgage Modification

Not all troubled home owners will lose their house to foreclosure some will be able to work out a loan modification with the lender. A loan modification still results in cancellation of debt and therefore the potential of tax able income.

IRS Website Includes Interactive Calculator for Cancellation of Debt Income on Foreclosure of Home (Do I Have Cancellation of Debt Income on My Personal Residence?)

The IRS website now includes an interactive calculator for determining taxable COD income on the foreclosure, loan modification or short sale of a personal residence.

Checklist for Exclusion of Cancellation of Home Mortgage Indebtedness	
Must be principal residence as defined under §121	√
Must be acquisition indebtedness as defined in §163 √original or refinanced debt √used for acquisition, construction or improvement of principal residence √debt not used for personal purposes √secured by the principal residence √recourse debt √under $2 million	√
Homeowner has not filed bankruptcy	√
If homeowner is insolvent, may elect to use this provision	√
Cancellation is not for personal services rendered	√

Basis Reduction

The basis of the individual's principal residence is reduced by the amount excluded from income, the theory being that his or her reduction will be subsequently reported as additional gain upon a future sale. Essentially

this rule converts the potential COD ordinary income back into potential capital gain. This gain, of course, would become taxable only if it exceeded $250,000/$500,000 MFJ.

> **Example**. Karen bought her Riverside home for $600,000, financing the purchase with a $540,000 first mortgage and a $60,000 second mortgage. The value of her home has dropped below the first mortgage balance. Karen talks the second mortgage lender into writing off its $60,000 note. Thus she has COD income of $60,000 and she'll receive a Form 1099C from the lender. The $60,000 COD can be excluded under the new law but Karen's basis in her home will be reduced by the excluded amount. Her basis will be $540,000 rather than $600,000.

Form 982 Revised to Exclude Mortgage Forgiveness Debt (IR-2008-17)

IRS issued a revised Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, to allow for the reporting of the home mortgage exclusion and the basis reduction. According to the IRS, in most cases, eligible homeowners will only need to fill out a few lines on Form 982 (specifically, lines 1e, 2 and 10b).

THE PASSIVE LOSS RULES

Do the Passive Loss Rules Apply to Me?

Prior to 1986, a taxpayer could generally deduct losses in full from rental activities and trades or businesses regardless of his or her participation. This gave rise to significant numbers of tax shelters that allowed taxpayers to deduct non-economic losses against wages and investment income. The Tax Reform Act of 1986, added §469, which limits the taxpayer's ability to deduct losses from businesses in which he or she does not materially participate and from rental activities.

The passive activity loss rules are applied at the individual level and extend beyond tax shelters to virtually every business or rental activity whether reported on Schedule C, Schedule F; or Schedule E, as well as to flow through income and losses from partnerships, S Corporations, and trusts.

> **Note**. The passive loss limitations also apply in full to personal service corporations. The §469 rules also apply to closely-held C Corporations, but has a limited application.

The §469 Passive Loss Rules–Overview

As a first giant step toward implementing a loss deduction limitation philosophy, Congress simply states that losses (and credits) from passive trade or business activities, to the extent they exceed income from all such passive activities, generally, may not be deducted against other income, such as salaries and wages or interest and dividends. The two major exceptions are (1) the exemption granted real estate professionals (§469(c)(7)) and (2) the ability of middle-income taxpayers to deduct up to $25,000 of rental losses from "actively managed" real estate (§469(a)).

Passive losses (and credits) disallowed in prior year are deductible against current passive income. Any passive activity loss not currently deductible (disallowed) is suspended and becomes deductible in a

subsequent year in which the taxpayer *either* has net passive activity income *or* completely disposes of the passive activity property in a taxable manner. In addition, with exceptions, the PAL rules continue to allow losses and credits from one passive activity to be applied against income for the taxable year from another passive activity [§469(b)].

PALs are "triggered" at time of sale. If the disallowed losses are not fully utilized when taxpayers dispose of their entire interest in the activity in a fully taxable transaction, the remaining losses are allowed (i.e., "triggered") in full, even against active income. In addition, losses from earthquakes, fire, storm, and shipwreck and certain other casualty or theft losses are nonpassive deduction losses. These rules also exclude casualty and theft reimbursements from passive activity gross income and exclude capital loss carrybacks from passive activity deductions. This exception does not apply if similar losses recur regularly in the business (e.g., shoplifting losses at Nordstroms or accident losses at Hertz) [§469(g)(1); Notice 90-21].

BASIC PASSIVE LOSS RULES

Only Two Activities Are Considered Passive:

1. ***A rental activity*** without regard to whether or to what extent the taxpayer participates in such activity (therefore, a rental activity is treated as a passive activity, regardless of the level of the taxpayer's participation) and
2. ***A trade or business activity in which the taxpayer does not materially participate*** for the taxable year (§469(c)(1)).

Definition of a Rental Activity for Passive Loss Purposes

A rental activity is any transfer of property for compensation. With some major exceptions, an activity is a rental activity for a taxable year if

1. during the taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and
2. the gross income attributable to the conduct of the activity during the tax year represents amounts paid principally for the use of the tangible property (§1.469-1T(e)(3)).

Rentals. A rental activity is treated as a per se passive activity regardless of whether the taxpayer materially participates (§469(c)(2), (4)). But, the rental activities of a taxpayer in the real property business (real estate professional) are not per se passive activities but are treated as a trade or business and subject to the material participation requirements (§469(c)(2); §469(c)(1); §469(c)(7)(B)).

Seven Tips About Rental Income and Expenses From the IRS (IRS Tax Tip 2011-45)

If a landlord rents property to others, here are seven tips from the IRS about rental income and expenses that professional tax preparers may want to forward to clients. Publication 527, Residential Rental Property, includes information on rental expenses.

1. **When to report income.** You generally must report rental income on your tax return in the year that you actually receive it.

2. **Advance rent.** Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it, regardless of the period covered.
3. **Security deposits.** Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But if you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income in that year.
4. **Property or services in lieu of rent.** If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income. If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary.
5. **Expenses paid by tenant.** If your tenant pays any of your expenses, the payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses. See Rental Expenses in Publication 527, for more information.
6. **Rental expenses.** Generally, the expenses of renting your property, such as maintenance, insurance, taxes, and interest, can be deducted from your rental income.
7. **Personal use of vacation home.** If you have any personal use of a vacation home or other dwelling unit that you rent out, you must divide your expenses between rental use and personal use. If your expenses for rental use are more than your rental income, you may not be able to deduct all of the rental expenses.

Activities That Are Not Rental Activities (Temp. Reg. §1.469-1T(e)(3))

When is a rental activity really a business? The real complexity of the passive loss rules, in light of the above definition, is in making the determination whether a particular activity is a "rental activity," a "trade or business," or an "investment." The regulations exclude from the definition of a rental activity those activities in which the importance of providing services to customers outweighs the importance of providing tangible property to customers (i.e., normally a hotel is a business, not a rental activity). It is important to note that substance controls over form, and the use of a legal document stating that a relationship is a lease is irrelevant.

The Regulations have identified certain rental activities as not being passive rental activities. These include activities where:

1. **The average period of customer use is seven days or less.** Those renting vacation homes may fall under this exception.
2. **The average period of customer use is thirty days or less and significant personal services are provided by or on behalf of the owner of the property.** For example, significant personal services includes maid or linen services. Certain services are specifically excluded, such as cleaning public entrances, stairways, or lobbies and collecting and removing trash.
3. **Extraordinary personal services are provided by or on behalf of the owner of the property.** For example, a hospital room.
4. **The rental of such property is treated as incidental to a non-rental activity of the taxpayer.** This exception applies to property rented to employees at the employers convenience and investment property that is held primarily for appreciation and the gross rental income from the property is less than two percent of the lesser of the unadjusted basis or the fair market value of such property.

5. **The taxpayer customarily makes the property available during defined business hours for non-exclusive use by various customers.** An example of this would be a golf course.
6. **The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.** See discussion later.

"What is an Activity For Passive Loss Purposes?"

Combining, or separating, multiple businesses properly; a tax disaster if taxpayer does this wrong! When applying the passive loss rules, the first, and most important, determination made by a taxpayer is defining how many different businesses (i.e., activities) the taxpayer must report to the IRS on the Passive Activity Form 8582. The taxpayer may aggregate, for passive loss purposes, two or more activities reported separately elsewhere on his or her tax return (§1.469-4(c)). But, defining separate activities too narrowly, or too broadly, can either lead to evasion of the passive loss rules or, more tragically, make it impossible for the investor to take advantage of the relief provisions afforded them under the passive loss regulations.

Reasons for identifying each activity. It is also necessary to identify every separate activity of a taxpayer for the following purposes:

- For determining whether the activity is a rental activity;
- For determining whether the taxpayer materially participates in the activity (may make it easier to meet the 500 hour test if the activity is a trade or business);
- For determining whether the taxpayer has completely disposed of his or her entire interest in the activity (to ascertain if the triggering of loss occurs); and
- For applying the transitional rules for pre enactment interests in passive activities.

Entrepreneur learns, the hard way, why failure to make the "single activity" election leads to "heads, IRS wins; tails, taxpayer loses!" Sidney Shaw, of Stillwater, Oklahoma, owned, or partially owned, through four partnerships (a) real estate investment properties; (b) interests in various business activities, such as convenience stores, gas stations, car washes, and Western Sizzlin' restaurants; (c) gasoline-hauling trailers; and (d) an airplane. He received a separate K-1 from each partnership. Shaw, or his partnerships, generally purchased and developed the property and *leased* them to Shaw's Gulf, Inc., which managed the day-to-day business operations through on-site managers. Shaw was a 44.9% shareholder, and president, of Shaw's Gulf. He did not take into account the impact of the passive loss rules by making the election to treat each separate business as a "single activity." Instead he created extensive taxable rental income for himself as a landlord while simultaneously creating large nondeductible passive losses as the tenant! Shaw's use of multiple entities in which to operate his various businesses is very common in the business community, and, as will be shown, can lead to a disastrous tax result.

Entrepreneur forgot to group businesses into one activity! Shaw, who participated on both sides of the rental activity (e.g., as both lessor and lessee), did not treat all of his business interests as a single business activity. To avoid the passive loss rules, he needed to materially participate (defined later) in *each* activity (e.g., 500 hours at each of his 50+ businesses[1]) . . . an impossible task. Additionally, Shaw did not materially

[1] To materially participate in all 50+ activities, Shaw would have to prove he worked a total of 25,000+ hours a year and there are only 8,760 hours in a year!

participate in *each* activity because each activity had a day-to-day manager! To make matters worse, the self-rented property recharacterization rule (explained later) applied to Shaw's rental property being treated as nonpassive (i.e., active) income and the net rental losses from his losing self-rent property being treated as passive losses (§1.469-2(f)(6)). In other words, all his businesses that were profitable created "active" income and all his businesses that were generating losses created nondeductible losses, with no offsetting between the activities allowed! Because of Shaw's decision to treat each business entity as a separate passive activity, the IRS essentially said to Shaw: "heads, I win; tails, you lose!" ((*Sidney Shaw v. Comm.*, TC Memo 2002-35).

> **Note:** When the entrepreneur's profitable businesses generate income that more than offsets the other business losses each year, the "single activity" reporting will generally create the best tax result. Why? By simply treating all his separate businesses as one activity, Shaw would have totally avoided the passive loss rules after working 500 hours!

Any reasonable method for grouping allowed! In spite of the importance of this definition, §469 does not define the term activity (e.g., determining how many different businesses the taxpayer owns). As a general rule, the legislative history suggests a definition of activity that entails dividing economic "endeavors" into fairly small units but Congress, in its infinite wisdom, left to the Department of the Treasury the definition of the term in regulations.

The five most important factors. The factors given the greatest weight when determining whether activities should be grouped together or kept separate are as follows (§1.469-4(c)(2)).

1. ***The similarities and differences in the respective types of businesses***
2. ***The extent of common control between the businesses***
3. ***The respective geographical locations of each business***
4. ***The extent of common ownership between the businesses***
5. ***The interdependencies between the businesses***

Grouping of Passive Activities Will Require Statement on Tax Return (Rev. Proc. 2010-13)

For tax years beginning on or after January 25, 2010 (2011 calendar year) taxpayers are required to annually report to the IRS their groupings and regroupings of activities (Rev. Proc.2010-13, replacing Notice 2008-64). Any additions of specific activities within their existing groupings for purposes of §469 and §1.469-4 is also required (Rev. Proc. 2010-13, Sec. 4.01).

Statement required for new groupings. A taxpayer must file a written statement with its original income tax return for the first taxable year in which two or more trade or business activities or rental activities are originally grouped as a single activity. This statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business activities or rental activities that are being grouped as a single activity. In addition, any statement reporting a new grouping of two or more trade or business activities or rental activities as a single activity must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469 (Rev. Proc. 2010-13, Sec. 4.02).

§1.469-4 Election Statement For New Groupings

The taxpayer hereby elects to group together the following business (rentals):

Name:	Name:
Address:	Address:
EIN # (if applicable):	EIN # (if applicable):
Name:	Name:
Address:	Address:
EIN# (if applicable):	EIN # (if applicable):

The taxpayer declares that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for §469 purposes and that this election is being made by being attached to the taxpayer's original return filed in the first taxable year in which two or more business or rental activities could be grouped as a single activity.

Statement required for addition of new activities to existing groupings. If a taxpayer adds a new trade or business activity or a rental activity to an existing grouping for a taxable year, the taxpayer must file a written statement with the taxpayer's original income tax return for that taxable year. This statement must identify the names, addresses, and employer identification numbers, if applicable, for the new trade or business activity or rental activity that is being added to the existing grouping, as well as the names, addresses, and employer identification numbers, if applicable, for the activity or activities within the existing grouping. In addition, the statement reporting an addition to an existing grouping must contain a declaration that the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469 (Rev. Proc. 2010-13, Sec. 4.03).

Statement For Adding New Activities to Existing Groupings

The taxpayer hereby elects to add the following business (rental) activities to the taxpayer's existing grouping:

Name of new activity:	Name of new activity:
Address:	Address:
EIN # (if applicable):	EIN # (if applicable):
Name of existing grouping being added to:	Name of existing grouping being added to:
Address:	Address:
EIN# (if applicable):	EIN # (if applicable):

The taxpayer declares that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for §469 purposes and that this election is being made by being attached to the original return filed in the first taxable year in which the new activity in two or more business or rental activities could be grouped as a single activity.

Statement required for regroupings. If it is determined that the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original

grouping clearly inappropriate, the taxpayer must regroup the activities and a written statement must be filed with the taxpayer's original income tax return for the taxable year in which the trade or business activities or rental activities are regrouped (§1.469-4(e)(2)). This statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business or rental activities that are being regrouped. If two or more activities are regrouped into a single activity, the regrouping statement must also contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469. Furthermore, an explanation of why the taxpayer's original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate must be included (Rev. Proc. 2010-13, Sec. 4.04).

Sample Election Statement of Regrouping Because Original Grouping Inappropriate

The taxpayer has determined the original grouping is clearly inappropriate, and therefore a regrouping must be made, because:

The taxpayer elects to group together the following business (rentals):

Name:	Name:
Address:	Address:
EIN # (if applicable):	EIN # (if applicable):
Name:	Name:
Address:	Address:
EIN# (if applicable):	EIN # (if applicable):

The taxpayer declares that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for §469 purposes and that this election is being made by being attached to the original return filed in the first taxable year in which the original grouping is deemed inappropriate.

Pre-existing groupings grandfathered in. A taxpayer is not required to file a written statement reporting the grouping of the trade or business activities and rental activities that have been made prior to taxable years beginning on or after January 25, 2010 (the effective date of Rev. Proc. 2010-13) until the taxpayer makes a change to the original grouping (Rev. Proc. 2010-13, Sec. 4.06).

> **Planning Point.** This is a great relief provision for those taxpayers who never actually made a grouping prior to 2011.

Starting in 2011, if taxpayer fails to report groupings each activity is treated separately. Unless the special grouping rules by partnerships and S corporations apply, if a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity, then each trade or business activity or rental activity will be treated as a separate activity under §469 (Rev. Proc. 2010-13, Sec. 4.07). The Commissioner, however, may regroup a taxpayer's activities to prevent tax avoidance (§1.469-4(f); Rev. Proc. 2010-13, Sec. 4.07).

Wow! Relief provision also available if taxpayer reported, but failed to make election, to group. An exception to the default rules that unreported activities will be treated as separate activities is when a timely disclosure is made by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer. If the failure to disclose is first discovered by the Service, however, the taxpayer must also have reasonable cause for not making the required disclosures (Rev. Proc. 2010-13, Sec. 4.07).

Extension Granted for Election to Treat Rental Real Estate Interests as Single Activity (LTR 201029004; LTR 201027018, LTR 201027028)

Taxpayers were granted an extension of time of sixty days from the date of their letter (but in no event later than the authorized period for filing an amended return for the year at issue) to make an election under §469(c)(7)(A) to treat all their interests in rental real estate as a single rental real estate activity effective for the year at issue.

Even a Limited Partner Maybe Able to Materially Participate.

Generally, a limited partner is not considered as materially participating in any activity in which he or she is a limited partner. The regulations similarly adopt this rule but also provide four exceptions. The general rule does not apply if the limited partner would otherwise be treated as materially participating for the taxable year:

1. by participating *more than 500 hours*,
2. having participated for *five of the last ten years*,
3. having participated for *any three years in a personal service activity, or*
4. if the limited partner *is also a general partner* at the times during the partnership's tax year that ends with or within the partner's tax year (§469(h)(2); §1.469-5T(e)(2); §1.469-5T(e)(3)(ii)).

LLC members are not limited partnerships. The court, in *Steven A. Gregg v. Comm.* (2001-1 USTC ¶50,169 (DC Ore.)), felt that the limited liability statutes create a new business entity that is materially distinguishable from a limited partnership, for no other reason than that a limited partnership must, by definition, have at least one general partner; limited partners in a limited partnership cannot, by definition, participate in the management; and LLC members retain limited liability regardless of their level of participation in the management of the LLC. The court concluded, "the limited partnership test is not applicable to all LLC members, because LLCs are designed to permit active involvement by LLC members in the management of the business." Therefore, the higher standard of material participation test for limited partners did not apply to *Gregg* and Gregg was allowed to use all seven material participation tests in his defense.

IRS Will No Longer Litigate the Position That All LLC Members Must Be Treated As Limited Partners

IRS plans to issue proposed regulations on LLCs. In 2010, the IRS acquiesced in *James R. Thompson v. U.S.*, [2009-2 USTC ¶50,501] (similar fact pattern to Newell) and will no longer litigate this issue (Action on Decision Memorandum IRPO ¶51,286, 2010FED ¶46,300, March 10, 2010). They plan to issue guidance by

the end of June, 2010, that will create some new tests to determine whether or not LLC members are limited partners for the passive loss rules.

Thompson owned an airplane charter business in an LLC. James Thompson directly owned 99% of an LLC that was in the airplane charter business. He indirectly owned the remaining 1% interest through a wholly-owned S corporation. The IRS disallowed losses that Thompson claimed arguing that he failed to meet the restricted material participation requirements that applied to limited partners (§1.469-5T(e)(3)(i)). Both the IRS and Thompson stipulated that if the Thompson's LLC interest was not characterized as a limited partnership interest then he could use all seven of the material participation tests (§ 1.469-5T(a)). The Court in Thompson held that his interest was not a limited partnership interest for purposes of §469, and that even if the interest was treated as an interest in a limited partnership, Thompson's interest would best be categorized as a general partnership interest under §1.469-5T(e)(3)(ii). Consequently, the Court held that Thompson could establish material participation using any of the seven tests in § 1.469-5T(a). Thompson joined *Garnett v. Comm.*, 132 T.C. 19 (2009) and *Gregg v. U.S.*, 186 F. Supp. 2d 1123 (D. Or. 2000) as the third case to rule against the position that an interest in an LLC is a limited partnership interest under §1.469-5T(e)(3)(i).

LLC Member's Losses Are Not Passive *per se* (*Paul Garnett v. Comm.*, USTC, Dkt. No. 9898-06, 132 TC _, No. 19 (6-30-09); *Sean Kieran and Kerry Ann Hegarty v. Comm.*, TCS 2009-153, married couple, who operated a charter fishing business through an LLC, materially participated in the activity because they were involved for more than 100 hours, which was not less than the participation by anyone else; also see *Gregg v. US*, 186 F. Supp 2d 1123 (D. Or. 2000) which held that Oregon LLCs and *James R. Thompson* v. US, Fed. Cl. (7-20-09) which held that Texas LLCs were not subject to the special provisions of §469(h)(2).

REAL ESTATE PROFESSIONAL

The Passive Loss Rules and Real Estate Professionals - Deducting Real Estate Losses Against Ordinary Income (§469(c)(7))

Passive loss rules don't apply to real estate professionals. A taxpayer's rental real estate activities in which he or she materially participates are not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which the taxpayer performs services. This means that real estate investors who qualify are permitted to deduct their rental real estate losses against other income sources (e.g., commissions, wages, etc.) (§469(c)(7)).

An Individual Satisfies the Real Estate Professional Eligibility Requirements When Three Requirements are Met

1. **Rental real estate is owned.** The individual must own at least one interest in rental real estate (§1.469–9(b)(6)).
2. **The 50% test.** More than 50% of the individual's personal services during the tax year must be performed in real property trades or businesses (defined below) in which the individual *materially* participates (defined below), and
3. **The 750-hour test.** The individual must perform more than 750 hours of service in those same trades or businesses (§469(c)(7)(B)).

It's a time test that requires proof. The total time spent in any combination real estate related activities (see list below) is used to determine if the 50% and the 750 hour tests are met.

> **Comment.** As discussed later, a number of Tax Courts are getting this requirement wrong. Real estate professionals must prove that more than 750 hours (and more than 50%) is spent in ALL real estate businesses, not more than 750 hours in each real estate activity.

3. The real estate businesses that can be combined. Real property trade or business means "any real property:

- development,
- redevelopment,
- construction,
- reconstruction,
- acquisition,
- conversion,
- ***rental,***
- operation,
- management,
- leasing, or
- brokerage[2] trade or business" (§469(c)(7)(C)).

> **Planning Tip**. According to this passive loss relief provision, the "blessed" businesses generally include most (1) real estate builders and contractors, (2) owners of rentals, (3) property managers and (4) participants in the real estate brokerage business - if they meet the 50% participation and the 750-hour requirements. Real estate appraisers and loan brokers are excluded from receiving this tax treatment.

> **Planning Point.** Any hourly combination in these four "blessed" businesses is permitted. For example, a taxpayer who spends 100 hours managing rentals and 651 hours selling real estate exceeds the 750-hour minimum.

Only one spouse needs to be the real estate professional. In the case of a joint return, the foregoing requirements for qualification as a real estate professional are satisfied if, and only if, either spouse ***separately*** satisfies the requirements (§469(c)(7)(B); *Tony R. and Denelda Sims Goolsby v. Comm.*, TCM 2010-64). Thus, if either spouse qualifies as a real estate professional, the rental activities of the real estate professional are not passive per se under §469(c)(2). Instead, the real estate professional's rental activities would be governed by the trade or business passive activity criteria (whether or not the taxpayer materially participated in the trade or business) under §469(c)(1).

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[2] A real estate "agent" is in the real estate brokerage business, see: *Shri G. And Sudha Agarwal v. Comm.*, TCS 2009-29.

Required work for the 50%/750 hour test is different than the required work for material participation. With two restrictions, participation is any work done by an individual *in any capacity*, management or operations, in connection with an activity in which the individual owns an interest (§469(c)(7)(B) & (D)).

***Restriction for employees*.** When this eligibility test is applied, the personal services of an employee are not counted unless the employee is also at least a 5% owner (i.e., owns more than 5% of the outstanding stock or more than 5% of the total combined voting power) [§469(c)(7)(D)(ii)].

- *Gregory John Bahas and Linda Bahas pro se v. Comm.*, TCS 2010-115, the time spent as an employee/manager didn't count toward the 750 hour test as the taxpayer was a non-owner of the real estate agency. It would have counted if she had been at least a 5% owner. One more issue. The tax court erroneously held that the 750 hour test applied to each rental. It does not. It is only important that the taxpayer spend 750 *cumulatively* in all real estate businesses.

- *James F. and Lynn M. Moss v. Comm.*, USTC No. 26600-08, 135 TC No. 18, Sept. 20, 2010, the time spent "on-call" is not counted as hours working in real estate profession for purposes of satisfying the 750 hour real estate professional test.

***Eligible corporations*.** A closely held C corporation satisfies the eligibility test if, during the tax year, more than 50% of the gross receipts of the corporation are derived from real property trades or businesses in which the corporation materially participates (§469(c)(7)(D)(i)).

> **Tax Tip:** This relief provision does not apply to estates, trusts, or limited partnerships owning real estate rentals. It only grants relief to individuals and closely held corporations.

Substantiation of time requirement. With respect to the evidence that may be used to establish hours of participation, the extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries (§1.469-5T(f)(4)).

Material participation. After determining if the taxpayer is a real estate professional, the real estate professional must prove he or she materially participated in managing the real estate rentals. This is again a time test, but different -- and more restrictive -- than the 50%/750 hour test. An individual is treated as participating *"materially"* for the taxable year if the individual's participation meets one of the seven enumerated material participation tests (§1.469-5T(a)(1)-(7)). The three most common ways that real estate investors meet this "material participation" test are by:

1. managing and operating the rental real estate activity for more than 500 hours during the year,
2. doing substantially all the work required to manage and operate the rental real estate during the year (probably more than 70% of the total business hours are performed by the landlord) or
3. working more than 100 hours during the year with no one (including nonowner employees and independent property managers) participating more than the landlord (§1.469-5T(a)(1)-(3)).

Owner can "tack" spouse's time. Any participation by one spouse is attributed to the other spouse, even if no joint return is filed and/or the participating spouse has no ownership interest in the activity. In effect, therefore, material participant status of both spouses is determined as though the two spouses were one individual (§1.469-5T(f)(3)).

When management does not count–work not customarily performed by an owner. Management time is disregarded when determining participation if it is *not* a type "customarily performed" by owners (e.g., Donald Trump acting as a security guard at one of his casinos) *and* one of the principal purposes of such work is avoiding the PAL rules (§1.469-5T(f)(2)(i)).

When management does not count–only counting the money. If the total amount of the taxpayer's involvement is studying and reviewing financial statements, preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use, and monitoring the finances or operations of the activity in a nonmanagerial capacity, this management time is ignored (§1.469-5T(f)(4)).

Finally! Real Estate "Agent" is in the Real Estate Brokerage Business (§469; *Shri G. And Sudha Agarwal v. Comm.*, TCS 2009-29)

Issue - Can only "brokers" be in the "brokerage" business? Despite an ongoing position by IRS auditors that only someone holding a real estate broker's license in California can be considered in a "real estate brokerage trade or business" (§469(c)(7)(C)), the tax court held that married taxpayers qualified to deduct losses from rental real estate activities in which they materially participated based upon the wife's occupation as a real estate agent.

California real estate agent claimed to be in the brokerage business. During 2001 and 2002 Shri Agarwal (Mr. Agarwal) worked full time as an engineer. During the same time Sudha Agarwal (Mrs. Agarwal) worked full time as a real estate agent at "Century 21 Albert Foulad Realty" (brokerage firm). During 2001 and 2002 Mrs. Agarwal was licensed as a real estate agent under California law; she was not licensed as a broker. She worked for a brokerage firm pursuant to an "Independent Contractor Agreement (Between Broker and Associate Licensee)." The contract provided that she was an independent contractor, not an employee of the brokerage firm. Consistent with Mrs. Agarwal's independent contractor status, the brokerage firm issued a Form 1099 to her for each year, and it did not pay her a salary; rather, she received commissions. The contract also required Mrs. Agarwal to sell, exchange, lease, or rent properties and solicit additional listings, clients, and customers diligently and with her best efforts.

During 2001 and 2002 Mr. And Mrs. Agarwal owned two rental properties. Together they spent approximately 170 hours managing the "Wanda Property" and approximately 170 hours managing the "Mohave Property" during 2001 and 2002. They were the only persons who managed their rental properties. Mrs. Agarwal spent a total of 1,400 and 1,600 hours managing their rental properties and selling real estate in 2001 and 2002, respectively.

The general rule is that a rental activity is treated as a *per se* passive activity regardless of whether the taxpayer materially participates (§469(c)(2)). But under §469(c)(7), rental activities of a qualifying taxpayer in a real property trade or business are not a *per se* passive activity under §469(c)(2). Rather, the qualifying

taxpayer's rental activities are treated as a trade or business—subject to the material participation requirements of §469(c)(1). And in determining whether a taxpayer materially participates, the participation of the taxpayer's spouse is taken into account. (§469(h)(5)).

IRS argues that real estate agents can't be in the business of real estate brokerage. The IRS argued that Mrs. Agarwal was a licensed real estate agent, not a licensed real estate broker. Thus, under California law, according to the IRS, Mrs. Agarwal could not be engaged in a brokerage trade or business, and therefore, she was not engaged in a real property trade or business as defined by §469(c)(7)(C).

Examining prior court cases helps determine the definition of "brokerage.". The term "brokerage" is not defined in §469, within the legislative history of §469, or by any court decision. Thus, the Court turned to principles of statutory construction to determine its meaning.

"Statutory words are uniformly presumed, unless the contrary appears, to be used in their ordinary and usual sense, and with the meaning commonly attributed to them" (***Caminetti v. United States***, 242 U.S. 470, 485-486 (1917)). In addition, a statutory term is construed "in its context and in light of the terms surrounding it" (***Leocal v. Ashcroft***, 543 U.S. 1, 9 (2004); see also ***Jarecki v. G. D. Searle & Co.***, 367 U.S. 303, 307 (1961) ("a word is known by the company it keeps")). Legislatures are presumed to have intended that a statute's terms "'be given a reasonable construction'" (***Hazlett v. Evans***, 943 F. Supp. 785, 788 (E.D. Ky. 1996) (quoting ***D.L.C. v. Walsh***, 908 S.W.2d 791 (Mo. Ct. App. 1995)).

A term's common or approved usage may be established by a dictionary (***Rousey v. Jacoway***, 544 U.S. 320 (2005); ***Smith v. United States***, 508 U.S. 223, 228-229 (1993)). *Webster's Third New International Dictionary* defines the term "brokerage" as "the business of a broker" or "the fee or commission for transacting business as a broker."

Real estate brokerages typically encompass brokers, agents, and salespersons (*Robert C. Kersey*, 66 TCM 1863). People involved in brokerage firms are generally "involved in the sale, leasing, acquisition, and development of industrial and commercial real estate" (*Alfred Rice*, 38 TCM 990) and may even specialize "in sales, property management, mortgage financing, appraisals, and insurance primarily on a commission or fee basis" (*Norman A. Grant*, CA-4 *aff'g* 64-2 USTC 9586, 333 F2d 603) or simply "appraisal" (*Charles W. Yeager*, 18 TCM 192).

Brokerage businesses hire salespersons (*FB Tippins, Jr.*, 24 TCM 521), and both salespersons and brokers may be involved in the same real estate brokerage business *(Floyd Wright*, 49 TCM 906).

Another place to find the definition of real estate brokerage is state law; all 50 states have real estate brokerage licensing acts, and generally states require that real estate salespeople and brokers be licensed under the same statutory provisions (*J. G. Mendoza*, 22 TCM 528).

State law in California. As is relevant in the *Agarwal* case, California law defines the term "real estate broker" as a person who does, or negotiates to do, any one of the enumerated activities for compensation. (Cal. Bus. & Prof. Code sec. 10131 (West 2008)). Similarly, California law also defines the term "real estate salesman" as a person who is employed by a broker and who does any one of the enumerated activities. (Cal. Bus. & Prof. Code sec. 10132 (West 2008)). But the Court found that whether Mrs. Agarwal is characterized

as a broker or a salesperson for State law purposes is irrelevant for Federal income tax purposes —the test is whether she was engaged in "brokerage" within the meaning of §469, as defined supra. Consistent with her real estate salesman's license and pursuant to her contract with the brokerage firm, Mrs. Agarwal was engaged in "brokerage"; i.e., she sold, exchanged, leased, or rented real property and solicited listings. Therefore, Mrs. Agarwal was engaged in a "brokerage" trade or business within the meaning of §469(c)(7)(C).

Brokerage includes the actions of both brokers and non-broker agents, e.g., real estate salespersons. The Court, in *Agarwal,* concluded that Congress is presumed to have defined the term "brokerage" in its common or ordinary meaning. The Court further concluded that for purposes of §469, the "business" of a real estate broker includes, but is not limited to:

1. selling, exchanging, purchasing, renting, or leasing real property;
2. offering to do those activities;
3. negotiating the terms of a real estate contract;
4. listing of real property for sale, lease, or exchange; or
5. procuring prospective sellers, purchasers, lessors, or lessees.

Aggregation of Rental Real Estate When a Real Estate Professional

Each rental is a separate activity, unless all rentals are combined. Each interest of the taxpayer in rental real estate is to be considered as a separate activity, but a taxpayer may elect to treat all interests in real estate, including real estate held through passthrough entities, as one activity (§469(c)(7)(A)).

> **Planning Point**. The aggregation option permits the taxpayer to meet the material participation test after *cumulatively* materially participating (e.g., working 100 hours or 500 hours) *in all the real estate rentals*. Without the aggregation option, the investor would be required to materially participate (i.e., spend 100 hours or 500 hours) in ***each*** activity, probably an impossible task for investors owning more than four rentals! Because *Sidney Shaw* (TC Memo 2002-35) failed to attach to his tax return an election to treat his multiple interests in rental real estate as a single rental real estate activity, he failed to meet the 750-hour requirement for each rental, and therefore was not a real estate professional. If he had made the election, he would have qualified! (Also see *William C. Fowler v. Comm.*, TC Memo 2002-223.)
>
> **Planning Point**. When would taxpayers *not* want to aggregate their rental real estate? When the rental real estate is throwing off passive income, and they purposely want to flunk this test! The rental real estate passive profit is then usable against other passive losses, such as other rentals in which they are not materially participating or vacation homes in rental pools in which they cannot materially participate.

The election must be properly made. The election to treat all interests in rental real estate as a single rental real estate activity is binding for all future years unless there is a material change in a taxpayer's facts and circumstances. The taxpayer makes the election by filing a statement with his or her original income tax return. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to §469(c)(7)(A) (§1.469-9(g)).

Wording for Single Rental Real Estate Activity Election
"In accordance with §1.469-9(g)(3), the taxpayer hereby states that he (or she) is a qualifying real estate professional under IRC §469(c)(7), and elects under IRC Sec. 469(c)(7)(A) to treat all interests in real estate as a single rental real estate activity."

Planning Pointer: It might be safer to let our software print the aggregation election each year. No question that it is in place. Can't hurt.

It looks like IRS will permit a late election --- if the taxpayer blames the tax professional (LTR 200816005; LTR 200722006; LTR 200606016). The IRS has granted numerous extensions when the taxpayer intended to elect single rental real estate activity treatment, but failed to include the required statement with the taxpayer's return, when the IRS determined the taxpayer had acted reasonably and in good faith, e.g., taxpayers relying on tax professionals who failed to advise them of the availability and benefits of the election.

Real Estate Professional Cases

Average Rental under 7 Days Means Property is not a "Rental Activity" (*Todd D. and Pamela J. Bailey, Jr. v. Comm.* TCS 2011-22)

A bed-and-breakfast is not a rental activity, it's a business like a hotel (which is still passive if the taxpayer doesn't materially participate!) Todd Bailey was a CA emergency room physician. His wife, Pamela, managed their four rental properties. One of the rental properties consisted of a two-bedroom, 1,200-square-foot, 3/4-bath (no tub) front house, built in 1949 or 1950, and a smaller back unit that had been converted from a one-car garage into a separate residential dwelling. They named this combined property "The Inn on Alisal Road" (Inn). As the name indicates, the Baileys furnished the two units and offered them together or separately for short-term rent to overnight lodgers, usually for about 3 days at a time. They provided a coffeemaker and coffee, but guests were responsible for their own meals. Typical guests were repeat customers, most often couples or small groups, who were in town for a wedding or other special occasion. The Baileys rented the Inn for 48 nights in 2004, with no guests in January and February. June was the most active month with guests on 12 nights. The Baileys usually charged $200 or $250 per night. Pamela did not employ a management company. Instead, she operated the Inn herself.

Pamela's onsite tasks included meeting potential guests and cleaning the interior: Dusting, vacuuming, washing sheets, ironing, and running water to maintain the plumbing during periods when the Inn was inactive. She also maintained the exterior, including gardening, hand watering the roses, caring for a plum tree and two cherry trees, inspecting the water drip irrigation system, taking out trash, reviewing the work of a lawn service, and periodically cleaning leaves out of the gutters. On average during 2004, for the two units combined, Pamela spent 5 hours per week on the interior and exterior maintenance of the Inn, for a total of 260 hours for the year. She did not record the guest names in a bookkeeping journal she maintained in which she listed her receipts for the Inn by date for 2004.

Pamela also worked offsite with respect to the Inn. She would deposit guest payments at her bank. She received telephone calls inquiring about the Inn and calls for reservations. She paid bills and reconciled the

bank account. On occasion, Pamela would wash and iron the Inn's linens in her large-capacity washer and dryer at home. She went to hardware and home improvement stores to buy replacement items, such as light bulbs, a new showerhead, and a new telephone. On average, Pamela spent 5 hours per month offsite related to the Inn, for a total of 60 hours for the year. Pamela also spent 4 hours during the year refinancing the property. This totaled 324 hours for the year.

For the year 2004, the Baileys deducted a loss of $20,683 from the Inn, which they reported on Schedule C, Profit or Loss From Business. The loss consisted of $10,680 in guest receipts offset by $31,363 in expenses. Interest payments on first and second mortgages, depreciation, and property taxes were her largest expenses. In audit, the IRS agent allowed the entire loss. So why did this get to court?

Individual Fails Real Estate Professional 750 Hour Time Test (*Todd D. and Pamela J. Bailey, Jr. v. Comm.* TCS 2011-22)

Three rentals plus a bed and breakfast. In the year at issue, 2004, Pamela Bailey managed four rental properties:

1. The above-mentioned bed and breakfast, "The Inn on Alisal Road." This was determined by the Tax Court to be a trade or business, not a rental.
2. The Second Street Property, which was purchased for $292,000 in 2000 and consisted of two structures. The front unit was a 1,149-square-foot, three-bedroom home, with 1-3/4 baths. The back unit was a one-car garage that Pamela converted in 2002 into a small residence with a three-quarter bath and a kitchenette. Pamela managed this property personally, not using a management company. Pamela claimed she spent 358 hours managing the Second Street property, including 3 hours a month depositing the monthly rent payment at her bank, paying bills from her home, and reconciling the bank account, for a total of 36 hours for the year. Even though the Baileys sought year-to-year tenants for each unit, they incurred an operating loss of $17,167 for 2004. The loss consisted of $11,000 in rent Pamela collected on the back unit minus $28,167 in operating expenses related to both units. Mortgage interest, depreciation, supplies, and property taxes were the largest expenses. The Baileys also spent $70,109 in 2004 for attorney's fees related to the mold litigation for the front unit.
3. The Boise, Idaho property on Rose Hill Street, earned the Baileys a $345 profit, consisting of $6,000 in rent Pamela received minus $5,655 in expenses. Mortgage interest, property taxes, and depreciation were the largest expenses. Pamela's duties consisted solely of spending 2 hours per month, for a total of 24 hours for the year, depositing to her bank account the monthly rent check she received by mail, paying from her home occasional bills such as the annual water bill and a one-time special sewer connection charge, and reconciling the bank account.
4. A second property in Boise, Idaho was purchased in 2004, the year at issue. Pamela claimed 105 hours related to the purchase, but did not have any 2004 income and did not report her expenses related to this new acquisition. She also spent another 192 hours investigating other potential acquisitions over the internet.

Summary of the time landlord spent managing her rental income properties in 2004.

Activity	**Hours**
The Inn on Alisal Road	324

The Second Street property	358
The existing Boise property	24
The acquisition of the new Boise property	105
Researching potential acquisitions	1,003
Less: Inn on Alisal Road property	(324)
Total hour excluding "The Inn"	679

In the year 2004, the Baileys deducted a loss of $86,931 from the two rental properties, which they reported on Schedule E, Supplemental Income and Loss. The Schedule E loss consisted of three components: (1) The $17,167 operating loss on the Second Street property; (2) the $70,109 in attorney's fees for the Second Street property; and (3) the $345 profit on the existing Boise property. In a notice of deficiency, the IRS disallowed the $70,109 in attorney's fees related to the Second Street property, determining that the fees were not a currently deductible ordinary and necessary business expense. The IRS also disallowed the remaining Schedule E loss of $16,822, consisting of the $17,167 loss on the Second Street property offset by the $345 profit on the existing Boise property, determining that the $16,822 net loss was a passive activity loss that was not currently deductible for 2004.

The taxpayer materially participated and, evidentially, aggregated the rentals . The IRS conceded that Pamela materially participated in the activities as she had no other vocation in 2004 and her involvement was regular, continuous, and substantial. What the IRS objected to was that Pamela performed more than 750 hours of services in "real property trades or businesses" during 2004.

The law. §1.469-9(b)(3) defines "rental real estate" as "any real property used by customers or held for use by customers in a rental activity within the meaning of §1.469-1T(e)(3)." §1.469-1T(e)(3) states that, except as otherwise provided, an activity is a "rental activity" for a taxable year, if "during such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers" (also see § 469(j)(8)). An "activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year * * * [the] average period of customer use for such property is seven days or less" (§1.469-1T(e)(3)(ii)(A)). Rental activities of a real estate professional are not per se passive activities under §469(c)(2) (§469(c)(7)(A)(i); *James F and Lynn M. Moss v. Comm.*, 135 TC 18, released Sept. 20, 2010, at (slip op. at 6); §1.469-9(e)(1)).

Application of the 750-hour requirement. The issue was whether Pamela performed more than 750 hours of services in "real property trades or businesses" during 2004. To compute the 750 hours, the Code treats each real estate activity as a separate activity unless the taxpayer makes an election to combine some or all of the activities (§469(c)(7)(A); §1.469-9(e)(1); *Cheryl Elizabeth and Donald Edward Hill v. Comm.*, T.C. Memo. 2010-200). An election is binding for the year of election and for all future years in which the taxpayer qualifies (§1.469-9(g)). The IRS did not assert that the Pamela and Todd Respondent had failed to elect to combine all of their rental properties as one activity.

Is a bed and breakfast a "real property trade or business" for the 750-hour test? What the IRS argued was that "The Inn on Alisal Road" was not a "real property trade or business" for purposes of the 750-hour test.

- It Pamela can include the hours she spent on the Inn, then she easily satisfied the 750-hour requirement because she spent 1,003 hours on all of her rental activities for the year.
- If the IRS argument is sustained, Pamela cannot include the hours relating to the Inn, then she spent only 679 hours on her real estate activities (as indicated in the previous table).

To support this position, the IRS referred to an opinion of this Court, *Bruce and Judy Bailey v. Comm.*, T.C. Memo. 2001-296 (no relation to Todd and Pamela), which involved a similar set of facts.

Results. Pamela therefore, would not satisfy the 750-hour requirement and she would not qualify as a real estate professional. This would mean the two rental properties at issue would be per se passive activities, and as a result the $16,822 net loss would not be deductible in 2004.

Court conclusion. The court stated: "When a taxpayer spends time on a real estate property that the taxpayer rents for periods averaging less than 7 days, that property is no longer a 'rental activity'. Therefore, ***the taxpayer must exclude or "disregard" the time he or she spent on the property for purposes of counting hours for the 750-hour §469(c)(7)(B)(ii) test to be a real estate professional." "A rental property with average use of less than 7 days is not an activity that a taxpayer can include in computing the more than 750 hours of services that a taxpayer needs to qualify as a real estate professional under §469(c)(7)(B)(ii)."***

> **Comment.** I don't see where the bold/italic requirement is in §469(c)(7). Is this court conclusion correct? Why couldn't the short-term rental be considered a different type of a §469(c)(7)(C) real property trade or business, such as "operation," "management" or even "rental"? That is, why would Congress include "rental" in the §469(c)(7)(C) definition of a real property trade or business and also exclude the same "rental" under §469(c)(7)(B) in the sentence "taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates."?

The court found this case to be similar to the 2001 *Bruce and Judy Bailey* case (which is discussed later). In the Bruce and Judy Bailey case (no relative to Todd and Pamela Bailey), the Tax Court agreed with the IRS's disallowance of the losses on the Bailey's other two rental properties because the Judy did not establish that she expended more than 750 hours of personal services on her rental properties *excluding* her time on one property in which the rental period was less than the 7-day rental threshold. In summary, the short rental period made the property a trade or business, not a rental real estate activity.

Following this thought, both courts concluded that trade or business rental property (such as the "Inn on Alisal Road") should be disregarded for purposes of determining whether Pamela was a real estate professional, because the Inn was not "rental real estate" (as defined in §1.469-9(b)(3)).

Pamela argued that her situation was different from the 2001 Bruce and Judy Bailey case because she materially participated in managing her rental "trade or business" and they didn't. The court found this argument was irrelevant as material participation is only significant for determining whether a trade or business is, or is not, a passive activity. As a matter of fact, the IRS allowed Pamela's Schedule C loss for the Inn because she did materially participate in the activity in 2004.

Real Estate Professional Must Spend More Than ½ of Time on Real Estate Activities (*Bruce and Judy Bailey v. Comm.*, TCM 2001-296)

During 1997, the Baileys owned several real estate properties. The Baileys filed an election, with their income tax return in 1994, to treat all interests in rental real estate as a single rental real estate activity pursuant to §469(c)(7)(A) and claimed losses sustained on their properties were not subject to passive loss limits because Judy Bailey was a real estate professional.

> **Note**: The aggregation election makes it easier to meet the material participation standard. For example, the taxpayer may work more than 500 hours in his 3 businesses if they are aggregated and treated as if they were one business but not qualify as a material participant if each business is tested separately.

Vacation rental does not qualify for real estate professional exception: The IRS maintained that the Baileys were not entitled to deduct 1996 and 1997 losses generated from their Lake Arrowhead property because the property was real estate held in a trade or business subject to §469(c)(1), rather than a rental activity under §469(c)(2).

Less than 7-day rental use makes vacation rental a trade or business. The average period of customer use for the Lake Arrowhead property was less than seven days during 1996 and 1997. Thus, the rental of the Lake Arrowhead property was not a "rental activity" as defined in §1.469-1T(e)(3)(ii)(A), not "rental real estate" under §1.469-9(b)(3) and not included in the election under §469(c)(7) to treat all interests in rental real estate as a single rental real estate activity (See *Scheiner v. Comm.*, TCM 1996-554 (where average period of customer use less than seven days, condominium hotel activity was not rental activity under §469(j)(8) and not considered a passive activity under §469(c)(2)); *Mordkin v. Comm.*, T.C. Memo. 1996-187.

Time spent on vacation rental does not count in 750-hour test. Judy Bailey's activities that were related to the Lake Arrowhead property were disregarded for purposes of determining whether she was a real estate professional, because the Lake Arrowhead property was not "rental real estate" as defined in Reg. 1.469-9(b)(3) which defines "rental real estate" as "any real property used by customers or held for use by customers in a rental activity within the meaning of §1.469-1T(e)(3)." Reg. 1.469-1T(e)(3) states that an activity is a "rental activity" for a taxable year, if "during such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers." See also §469(j)(8). As provided in §1.469-1T(e)(3)(ii)(A) an "activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year . . . [the] average period of customer use for such property is seven days or less."

Records are required to establish time requirements: The IRS maintained that Judy Bailey was not a real estate professional for 1997 because: (1) The Baileys did not substantiate through any reasonable means that Judy Bailey performed more than 750 hours of service in relation to her rental activities and (2) her personal services performed in her rental activities during 1997 did not exceed the 876 hours that she spent in her law practice.

Judy Bailey kept daily calendars for 1996 and 1997 that contained various appointments related to her law practice and real estate activities. In preparation for trial, Ms. Bailey prepared a separate summary report of her calendars for 1996 and 1997. Each summary report provided an estimate of the total number of hours spent

on activities related to each rental property and gave a general description of the activities performed by her. The summary report also provided a general list of the legal activities performed by Judy Bailey and estimated the time she spent in the practice of law in 1997.

Law practice	876	
Indian Wells rental condos		311
Elderwood rental four plexes		412
General activities for all real estate properties (including the Lake Arrowhead vacation rental)		104
Total	876	828

With respect to the evidence that may be used to establish hours of participation, §1.469-5T(f)(4) provides that the extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

The Court did not believe that the methods that Judy Bailey used to approximate the time that she spent performing these services during 1997 were reasonable within the meaning of §1.469-5T(f)(4). Judy Bailey's estimates were uncorroborated and did not reliably reflect the hours that she devoted to her rental real estate activities. Judy Bailey assigned hours to activities years later, and in preparation for trial, based solely on her judgment and experience as to how much time the activities must have taken her. Courts have previously noted that, while the regulations are somewhat ambivalent concerning the records to be maintained by taxpayers, they do not allow a post event "ballpark guesstimate." *Carlstedt v. Commissioner*, TCM 1997-331; *Speer v. Commissioner,* TCM 1996-323; *Goshorn v. Commissioner*, TCM 1993-578.

The Court found the following factors to further diminish the credibility and accuracy of the summary report prepared by Judy Bailey: (1) The number of hours claimed appears excessive in relation to the tasks described; (2) Judy Bailey testified that she usually combined a trip to the rental properties with a trip related to her law practice; (3) the Elderwood properties were vacant during 1997; (4) the Elderwood properties and Indian Wells properties were for sale during 1997; and (5) Judy Bailey had a commission agreement with a rental agent to manage the rental of the Indian Wells condominium during 1997.

Not enough hours in real estate activities to qualify as a real estate professional. Judy Bailey's personal services performed in her rental activities of 827 hours did not exceed the 876 hours that she spent in 1997 in her practice of law. Judy Bailey therefore did not qualify as a real estate professional under §469(c)(7), and the rental activities of the Indian Wells properties and Elderwood properties are passive activities under §469(c)(2) during 1997.

Real Estate Professional's Rental Activity Losses Not Deductible Due to Failure to Properly Make and File Election (*Donald Wm. Trask pro se v. Comm.*, TCM 2010-78)

Owned and managed 33 rentals. Donald Trask owned 33 rental properties in Southern California throughout 2001. Donald filed a Schedule E with his 2001 Federal income tax return, claiming a net loss of $27,340 from his rental real estate activities[3]. Donald aggregated his rental income and expenses as a single activity and consistently followed this practice on the Schedules E attached to his 1995, 1998, 1999, 2001, 2002, and 2003 Federal income tax returns.

> **Comment.** A passive activity loss is defined as the excess of the aggregate losses from all passive activities for the taxable year over the aggregate income from all passive activities (§469(d)(1)). As a relief provision, a taxpayer who "actively" participates in a rental real estate activity can deduct a maximum loss of up to $25,000 per year related to the activity (§469(i)(1), (2), and (3)). This relief provision phases out, in a 2:1 ratio, as the taxpayer's adjusted gross income (without regard to net passive losses, IRA contributions, and taxable Social Security benefits) increases from $100,000 to $150,000 (§469(i)(3)).

Synopsis. To avoid the passive loss limitation rules, Donald must satisfy three requirements:

1. He must establish that he qualifies as a real estate professional pursuant to §469(c)(7)(B);
2. He has elected under §469(c)(7)(A) to treat his rental real estate activities as a single rental real estate activity at some point since 1994; and
3. He materially participated in the combined rental real estate activity.

The IRS contended that Donald failed to satisfy ***any*** of these requirements.

#1: Taxpayer was a real estate professional. Donald has established that he spent more than 750 hours performing significant work on his rental properties and that this was his sole business during 2001, thereby also meeting the more than 50% test. He provided evidence to support that he handled more than 80 issues for 11 pieces of property. The IRS conceded that Donald performed repairs for larger projects himself and also hired contractors. Donald presented work logs for his properties identifying the portions of the properties being repaired and whether a specific contractor was hired. The court determined that Donald was a qualified real estate professional within the meaning of §469(c)(7)(B).

#2: The §469(c)(7)(A) single activity election is a formal election, not a "deemed" election. To satisfy the requirements to make an election to treat all rental real estate activities as a single activity under §469(c)(7)(A), a taxpayer must make an explicit election with his or her original return. Since 1994, Donald aggregated his rental income and expenses as if the rental real estate activities were a single activity, but he did not attach to any return a statement electing to treat his rental real estate activities as a single activity. The fact that Donald consistently aggregated the rental income and expenses from the rental properties on his Schedules E does not meet the proper election requirements under §469(c)(7)(A) (*William C. Fowler v. Comm.* TCM 2002-223; *Sidney Shaw v. Comm.,* TCM 2002-35)). It is not sufficient to aggregate rental income and expenses on the Schedule E (*Kosonen v. Comm.* TCM 2000-107).

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[3] Donald reported $328,779 of gross receipts and $356,119 of claimed expenses, yielding a loss of $27,340.

#3: He didn't materially participate in each real estate activity. As Donald testified that he hired contractors, he did not contend that he materially participated in each of his rental activities when viewed separately.

The court ruled that Donald was a real estate professional in 2001 but that he did not satisfy the §469(c)(7) exception, did not materially participate in each activity and therefore, was not entitled to deduct his real estate losses in excess of $25,000.

- Also see: *Anjum Shiekh, pro se v. Comm.*, TCM 2010-126, United Airline pilot qualified as a real estate professional but failed to elect aggregation of passive activities and therefore failed to meet material participation requirements.

Employed Engineer Not a Real Estate Professional (*Yusufu Yerodin Anyika and Cecelia Francis-Anyika v. Comm.*, TC Memo 2011-69)

Mr. Anyika was employed as an engineer, where he worked 37.5 hours per week, 48 weeks per year. Mrs. Francis-Anyika was employed as a nurse, working 24 hours per week. Mr. Anyika had purchased, renovated, managed, and sold rental properties since the 1990s. He viewed his rental real estate activity as a second job and as an investment. During 2005 and 2006, Mr. Anyika owned two rental properties.

Rental losses not treated as passive. The Anyikas used TurboTax software to prepare their 2005 and 2006 tax returns, having not consulted a tax professional. The Anyikas claimed they were real estate professionals and deducted $23,551 in rental real estate losses on their 2005 tax return and $15,265 in rental real estate losses on their 2006 tax return. On audit, the IRS disallowed the losses.

Husband claimed to be a real estate professional, having exceeded the 750 hour test. In order to qualify as a real estate professional under §469(c)(7)(B), a taxpayer must spend at least 750 hours materially participating in the real estate business and, additionally, must devote more than one-half of his total personal services working hours to his real estate business. In an Information Document Request (IDR), Mr. Anyika represented to the IRS agent that he worked 800 hours a year (aha more than the 750 hours required) on his two rentals.

Didn't meet the 50% test. After understanding that, to qualify, he had to spend more hours engaged in managing the rental properties than he did working as an engineer, Mr. Anyika began to contend that he had spent the equivalent of eight hours per day, five days per week, 48 weeks per year (1,920 hours per year) working on the rental properties. After being confronted during trial by the evidence of his prior signed statement that he worked 800 hours per year on the rental properties, Mr. Anyika stated that he was "speaking from memory without the exact numbers," and that to be sure, he would need to look over the numbers more closely. The Court disallowed the losses.

Real Estate Professional's Rental Activity Losses Not Deductible Due to Failure to Prove Compliance with the 750 Hour Requirement (*Tony R. and Denelda Sims Goolsby pro se, v. Comm.*, TCM 2010-64)

Tony and Denelda Goolsby owned several rental properties for which they claimed losses of $109,919 and $31,857 on their Federal income tax returns for tax years 2003 and 2004, respectively. Denelda served as the

primary caretaker of the Goolsbys' rental properties. Denelda failed to keep contemporaneous logs of her time spent managing the rental properties, but did create "activity" logs after their Federal income tax returns for 2003 and 2004 were examined by the IRS. For tax year 2003, Denelda initially claimed to have spent 785 hours managing their rental properties. However, Denelda created another 2003 activity log before trial because of errors they perceived in the "original" 2003 activity log. In the newly created and reconstructed 2003 activity log Denelda claimed to have spent 799 hours managing their rental properties. For tax year 2004, Denelda claimed to have spent 716 hours managing their rental properties.

#1: Taxpayer meets the over 50% test to be a real estate professional. Denelda's only work in connection with a trade or business for the years in issue was to manage the Goolsbys' rental properties. Thus, more than one-half of the personal services performed by Denelda during 2003 and 2004 were performed for the rental property business. Accordingly, the only dispute was whether Denelda meet the 750 hour requirement.

#2: The taxpayer 2003 activity log to prove more than 750 hours of service was not credible and the 2004 activity log indicated only 716 hours! The 2003 activity log indicated that Denelda spent 799 hours managing their rental properties, which the court found unbelievable as: (1) the activity log was created years after 2003; (2) Denelda presented no evidence of contemporaneous records, such as appointment books, calendars, or narrative summaries, that would credibly support the activity log; (3) incredibly, the activity log lists days during which Denelda allegedly logged more than 24 hours of work; (4) the activity log included hours worked on the Pebble Beach property at the time Tony and Denelda were using the Pebble Beach property as their principal residence; and (5) the activity log was the second log Denelda prepared because they perceived that the first log they created for 2003 would not meet the 750 hour requirement. The court concluded that the 2003 activity log was not credible or persuasive. Accordingly, the court held that Denelda had not met her burden of proving that she was a real estate professional for the 2003 tax year. Consequently, the losses from Goolsby's rental properties were passive activity losses in 2003. In 2004, Denelda's stipulation and her activity log indicated that she worked 716 hours with respect to the Goolsby's rental properties. Those 716 hours were less than the 750 hours required pursuant to §469(c)(7)(B)(ii). Accordingly, the court ruled that Denelda had not met her burden of proving that she was a real estate professional in 2004. Consequently, the losses from the Goolsbys' rental properties were also passive activity losses in 2004.

> **Comment.** Why would a taxpayer go to court with a log indicating <750 hours? Yep, they represented themselves!

The §469(c)(7)(A) single activity election was formally made. Interestingly, the Goolsbys properly filed an election to treat all interests in rental real estate as a single rental activity pursuant to §469(c)(7)(A) and §1.469-9(g). Accordingly, their compliance with the requirements of §469(c)(7) was measured by treating all of their interests in rental properties as one real estate trade or business.

> **Comment.** As a practical matter, this election is only helpful *after* Denelda has met the 50%/750 hour standard and therefore the rentals are no longer treated as rentals but rather are treated as businesses in which she must prove material participation. Denelda first needed to prove she spent 750 hours in *all* her real estate professional activities, which, in her case, was limited to managing her rentals. After suppling that proof, the court would have required Denelda to prove she also materially participated in managing her business rentals because the §469(c)(7)(A) single activity election was properly made. But, alas, it was not to be.

"Ballpark Guesstimate" Participation Calculation Rejected by Court (*Marcel and Jennifer Ajah, pro se v. Comm.*, TCS 2010-90)

One rental was the Doctor's office and the other rental was a single-family residence. Jennifer Ajah is an attorney, and Marcel Ajah her husband, is a medical doctor. The Ajahs owned two rental properties in 2005. One was a commercial property located in Jamaica, New York, which was the location of Dr. Ajah's medical practice. The second was a single-family residence in Baltimore, Maryland. With their 2005 return, the Ajahs filed a Schedule E reporting rental income for both properties of $36,500 and total expenses, including depreciation, for both properties of $97,415, claiming a $60,915 loss. No election to aggregate the rental properties was filed with the return.

The lawyer claimed to be a real estate professional with only "ballpark guesstimates." Only Jennifer was involved in the rental real estate activities, arguing that she was a real estate professional. She relied upon certificates from the Long Island Board of Realtors, Inc., the Multiple Listing Service of Long Island, Inc., and the State of New York Department of State Division of Licensing Services. Jennifer also testified that she worked at least 20 hours a week for the 52 weeks of 2005 on the two rental properties but didn't offer any evidence as to the number of hours she worked as an attorney in 2005. Pejoratively, no contemporaneous record, calendar, appointment book, or any other method of recording time spent between rental real estate activities and activities as an attorney was provided.

Must prove business hours spent in both real estate and non-real estate activities. Thus, the Court was unable to conclude that more than one-half of Mrs. Ajah's personal services were devoted to the rental properties. In addition, the court concluded that Jennifer's method of calculating her time spent participating in the rental activities constituted an impermissible "ballpark guesstimate." Therefore, she did not establish by reasonable means that she performed more than one-half of her personal services in real property trades or businesses.

No aggregation election made, requiring 750 hours at each rental. To make matters worse, the Ajahs did not file an election with their return to treat the two rental real estate interests as one activity, although they had aggregated the rental properties on their Schedule E and may have done so in the past. The Tax Court has consistently held that aggregating rental properties on Schedule E is not a deemed election under the requirements of §469(c)(7)(A). The court pointed out, "(Jennifer) would needed to perform 750 hours of service for each rental real estate interest for a total of 1,500 hours to meet the test in §469(c)(7)(B)(ii). As (Jennifer) testified that she worked a minimum of 20 hours per week in the real estate activities, her total hours for both rental properties would be 1,040 hours, less than the required 1,500 hours."

> **Comment.** The court probably got this one wrong, as the 750 hours must be performed in the real property trades or businesses in which the individual *materially* participates. If Jennifer had proven she spent 750 cumulatively to be a real estate professional, she must next have proven she materially participated in each rental [using the: (1) 500 hour rule, (2) 100 hour and no one does more rule, or (3) all the work rule] *unless* she made the aggregation election. Therefore, the most she would have had to work to materially participate is 1,000 hours – which she testified she did (20 hours a week for 52 weeks). But, Jennifer would still have lost because the court ruled that she was using unacceptable "ballpark guesstimates."

Comment. Taxpayers are allowed a $25,000 maximum offset; however, this offset is phased out for taxpayers whose adjusted gross income exceeds $100,000 and is completely phased out for taxpayers whose adjusted gross income exceeds $150,000. In this case, the Ajah's adjusted gross income exceeded $150,000; therefore, they were not entitled to any offset.

Also see: also see: (*Wanda Harmon v. Comm.*, TCS 2007-127, vague hours recorded on palm pilot not enough to prove landlord worked more hours managing rentals than hours as full time employee; *Carolyn D. Fenderson v. Comm.*, TCS 2007-191, court-prepared exhibits rejected and contemporaneously prepared log of 759 hours was less than 780 hours spent selling Norton AntiVirus program); *Kai H. and Susanna Lee v. Comm. & Ulysses K. and Jane Lee v. Comm.*, TCM 2006-193; *Andrew M. D'Avanzo v. Comm.*, (FedCl), 2006-1 USTC ¶50,229, court rejects "ballpark guesstimates" made 10 years later; *Andre and Vena Nelson v. Comm.*, TCS 2004-62, no "single activity" election made and taxpayer couldn't prove he materially participated at each of his three apartments; *Alfredo Galagar v. Comm.*, TCS 2004-39; *Luis Acle, Jr. v. Comm.*, TCS 2004-82, who admitted to the judge that he wasn't a real estate professional; *Alexander & Camilla Firsow v. Comm.*, TCS 2004-112, daily logs weren't credible.)

The Recharacterization Rules and Self-Rented Property

Taxpayer renting property to the taxpayer's own business will have to recharacterize income. Gross rental income equal to net rental income (including any income from a sale) is recharacterized as active income if the property is rented to a trade or business activity in which the taxpayer materially participates for the taxable year (without regard to the limited partner rules) so long as the property is not property rented incidental to a development activity (§1.469-2(f)(6); §1.469-2(f)(9)(iii)).

Warning: This rule negatively impacts more taxpayers than any other recharacterization rule (see *Thomas and Ermina Krukowski v. Comm.*, (CA-7) 2002-1 USTC ¶50,219). It is intended to deter taxpayers from attempting to generate passive rental income and active business rental deductions by establishing rental arrangements between their own businesses. It does that and more.

Rental to C corporations. This recharacterization rule is not limited to rental arrangements with passthrough entities such as partnerships and S corporations. The Tax Court has required rental income from a C corporation to be recharacterized as nonpassive (active) if the taxpayer receiving the income materially participated in the C corporation's trade or business [*Chester and Faye Sidell*, (CA-1) 2000-2 USTC ¶50,751; *Thomas Krukowski v. Comm.*, (CA-7) 2002-1 USTC ¶50,219]. A transition rule exempts rentals pursuant to a written binding contract entered into before February 19, 1988 (§1.469-11(c)(1)(ii)). As can be seen by the next case, any subsequent change in the terms of a lease will be viewed as a series of different leases and not a continuation of the original lease.

Dentist Renting Building and Equipment Under Two Separate Leases Cannot Combine Activities (*C. Michael and Gwendolyn Willock V. Comm.*, TCM 2010-75; also see: *Tony R. Carlos v. Comm.* 123 TC –, No. 16. 9/20/2004, owner of two buildings rented to two separate S corporations could not combine the profit and losses from the separate activities.)

Dentist Michael Willock operated his dental practice as an S corporation. In 2002 and 2003, Michael leased a CEREC milling machine to his corporation, incurring personal losses of $13,119 and $27,628 respectively. He did not lease any other equipment to any other individual or entity in either year. Michael also owned the building where his dental practice was located, which he rented to his corporation at a profit. Michael deducted the passive losses from the CEREC lease from the profit generated from the building lease, first claiming both were passive activities, and then, at trial, arguing both activities were active trades or businesses.

The "heads IRS wins, tails taxpayer loses" rule: Although rental income is generally characterized as "passive," the self-rental rule provides that income from rental realty is not passive income if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the tax year (§1.469-2(f)(6)). Michael worked full time in his dental practice during 2002 and 2003. Clearly, he materially participated in the dentistry trade or business. Accordingly, under the self-rental rule, the income he received from renting the building was nonpassive income, and, the losses he incurred from the rental of the CEREC machine were passive losses. The two could not offset each other.

Previously held court decisions: Similar circumstances have been decided at the appellate level:

1. Seventh: *Krukowski v. Comm.*, (CA7 2002), 279 F.3rd 547; 89 AFTR 2d 2002-827
2. First: *Sidell v. Comm.*, (CA1 2000), 225 F3d 103; 86 AFTR 2d 2000-6229
3. Fifth: *Fransen v U.S.*, (CA5 1999), 191 F3d 599; 84 AFTR 2d 99-6360
4. Ninth: *Beecher v. Comm.,* (CA9 2007) 481 F3d 717

DISPOSITION OF PASSIVE ACTIVITY

Suspended Losses

Current and carryforward passive losses are fully deductible on the disposition of a passive activity. However, §469(g) sets forth three criteria to be met before losses are deductible against nonpassive income. It requires that the taxpayer dispose of **an entire interest** in a **fully taxable transaction** to **an unrelated party.** All gain realized must be recognized. If these three criteria are met, the overall net loss is fully deductible (presuming, of course, that the taxpayer has basis) (§469(g)(1)).

The overall net loss is any loss on disposition and any current or suspended losses from the activity in excess of any gain on disposition or net income from the activity, or net income from all other passive activities. If there is overall net loss on the disposition (gain/loss on sale does not exceed current and prior year losses), the entire disposition is not reflected on Form 8582 and the entire loss is reflected on the appropriate schedules. If there are two dispositions, one with an overall net loss and one with an overall net gain, they should be netted.

Nonqualifying Dispositions

A taxpayer is required to dispose of an entire activity in a fully taxable transaction to an unrelated party to fully deduct the current and prior year losses. Note that §469(g) requires a fully taxable event. The following are not fully taxable transactions:

✏ Like-kind exchanges
✏ Conversion to personal use
✏ Gift
✏ Transfer due to divorce (treated as gift-IRC sections 469(g) and 1041(b)
✏ Installment sale (PALs triggered in ratio to gain reported)
✏ Transfer due to death
✏ Disposition to a related party

Transfers by reason of death. A transfer of a passive activity by death often means the decedent took the loss with him or her as suspended losses are eliminated to the extent of the amount of the basis increase (§469(g)(2)).

> **Example.** For example, if Dad had property worth $100,000 with a basis of $40,000 and suspended losses of $10,000, his daughter would have a stepped up basis of $100,000, the fair market value (assuming we have a stepped up basis estate tax regime). As the suspended losses were less than the $60,000 increase in basis, nobody gets to use the $10,000 and Dad has reported $10,000 more of income during his lifetime than what economically occurred. If Dad had sold the property prior to his death, he would have had a $10,000 deduction (the suspended loss) in the year of disposition, and a $60,000 capital gain, and the children would have inherited cash less the taxes paid on only the $50,000 net gain. Now change the facts. Dad's property was worth $40,000 at date of death with a basis of $100,000 and suspended losses of $10,000. His daughter would have a stepped down basis of $40,000. As there was *no* basis increase, the $10,000 suspended losses would have been triggered and reported on Dad's final return.

Installment Sales

If a taxpayer disposes of a passive activity on the installment basis (as defined in §453), §469(g)(3) provides that current and carryforward losses may only be deducted in the same ratio as the gain is reported. The allowable loss is calculated by the following fraction: gain recognized in the current year divided by unrecognized gain as of the beginning of the current year.

> **Preparer Pointer:** When the gain recognized in the current year exceeds all the current and carryforward losses of the taxpayer, all of those losses are deductible in the current year.

Disposition Planning Pointers
* If the taxpayer disposes of an activity by **gift**, the accumulated current and prior year unallowed losses cannot be deducted in any year. Instead, the basis of the transferred interest must be increased by the unallowed losses. * A mere **change in status**, whether it be to a partnership, corporation, or limited liability company does not constitute a qualifying disposition which would trigger deductibility of suspended losses. Similarly, conversion of a business or rental activity from passive to nonpassive does not trigger losses. * The transfer of passive activities **incident to a divorce** is not considered a fully taxable transaction

and any suspended losses would not be freed-up under §469(g). §1041(b) states that any transfer of property incident to a divorce will be treated as a gift for purposes of Subtitle A (Income Taxes). Since §469 is part of Subtitle A, the transfer of passive activities incident to a divorce would be treated as gifts and the losses of the "donor" spouse are added to basis.

* In a **bankruptcy**, nothing is triggered until the bankruptcy is complete, in other words, when gain or loss is recognized. Furthermore, beginning in 1993, suspended passive losses must first be applied against any relief of indebtedness (debt cancellation). In many instances, the debt forgiven under §108 fully absorbs the current and suspended passive losses, and therefore nothing is deductible on the return.

* On the **death of a taxpayer**, suspended passive losses are allowed only to the extent they exceed the amount by which the transferee's basis in the passive activity has been increased. (Basis is generally stepped-up to fair market value.) If the increase in basis exceeds unused passive losses, no PALs are deductible on the decedent's return.

* On any **disposition**, be sure to verify that it is an entire disposition of "substantially all" of the property. On the sale of rental real estate if the taxpayer made an election to group his or her rentals as one activity under §469(c)(7), the sale of one property would not constitute an entire disposition.

* Only a disposition to an **unrelated party** is considered a complete disposition. The following are related parties: spouse, brother(s), sister(s), son(s), daughter(s), grandchildren; an individual and a corporation owned more than 50 percent by the same person; a partnership and a partner who owns more than 50 percent. See IRC sections 267 and 707(b) for other related parties.

* If taxpayer sold a piece of rental real estate and is **a real estate professional** who meets the relief provisions of §469(c)(7), he or she may have made an election to treat all of the rental real estate activities as a *single* activity. If the real estate professional did make the election, he or she cannot trigger suspended losses as there was not a disposition of the entire activity as required by §469(g).

LIKE-KIND EXCHANGES

BASIC EXCHANGE RULES - §1031

§1031 and the related regulations lay out the following rules related to exchanges.

1. No gain or loss will be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment (§1031(a)(1)).
2. To the extent of cash or other "boot" (not like kind property) received, gain is recognized (§ 1031(b)).
3. Net relief of the transferor taxpayer's mortgage debt is considered boot received (§1.1031(b)-1).
4. The amount of boot received is decreased by the taxpayer's exchange expenses (§1.1031-(d)-2, Ex. (2)).

Gain Recognized

Gain to be recognized on an exchange is the sum of:

Money or Other Boot Received	_____
Plus: Net Mortgage Relief	_____
Reduced by Exchange Expenses	_____
Gain Recognized	_____

Note. Money or other boot given can offset mortgage relief. However, an increase in mortgage does not offset cash or other boot received.

Planning Points on Usefulness of Exchange
Why do an exchange? You want a bigger and better like kind property You want to use your tax dollars from the sale of the old to pay for part of the new property
Why sell instead of exchange? You don't want another rental property You have a loss on the property and you can't recognize losses in an exchange You have other losses (stock losses, suspended losses or an NOL) that will cover the gain on sale

ESSENTIAL INGREDIENTS IN AN EXCHANGE

Exchange, Not Sale, must Be Planned

the escrows should be part of an *integrated plan* showing that the exchanger wishes to effect a §1031 exchange. This is evidenced by showing that an integrated plan for a like-kind exchange is conceived and implemented; the exchanger's actions are consistent with exchanging; the conditions required to effect that intent are met; the contracts providing for the necessary series of transfers are interdependent; and *no cash proceeds from the sale of the original property are actually or constructively received by the exchanger* (*Garcia v Comm.*, 80 TC 491 (1983), acq. 1984-1 CB 1).

Exchanger must Not Actually or Constructively Receive Cash

As a general rule, the problem with not using an accommodator is that a transaction will constitute a taxable sale and not an exchange if the exchanger *actually or constructively* receives money or other property (boot) for the relinquished property before he or she actually receives the like-kind replacement property. The result is that the exchange becomes a taxable sale and subsequent repurchase, not an exchange, even though the taxpayer desired an exchange from the inception.

Actual receipt. The taxpayer is in *actual receipt* of money or property *at the time* the taxpayer actually receives such money or property, or receives the economic benefit of such money or property (e.g., pledging the property as security for a loan) (§1.1031(k)-1(f)(2)).

Constructive receipt. The taxpayer is in *constructive receipt* of money or property at the time such money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer *may* draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to withdraw is given (§1.1031(k)-1(f)(2)).

> **Example.** Barb transfers a $100,000 fair market value (FMV) rental property to Carol in a deferred exchange on May 17, 2007. On or before November 13, 2007 (the end of the exchange period), Carol is required to purchase and transfer the property identified by Barb. At any time after May 17, 2007, and before Carol has purchased the replacement property, Barb has the right, upon notice, to demand that Carol pay $100,000 cash in lieu of acquiring the property.
>
> **Result.** *No §1031(a) exchange available.* It is a taxable sale followed by a subsequent repurchase because Barb has the unrestricted right to demand cash as of May 17, 2007. This is constructive receipt as of that date (§1.1031(k)-1(f)(3)).

Can we change to an exchange after we sign an offer-to-sell, i.e., in midstream? Yes. The IRS allows the taxpayer to change a sale to an exchange *at any time prior to closing* [see the deferred exchange regulations, §1.1031(k)-1(a)]. The Tax Court looks at the form of the transaction over its substance [*Leslie Q. Coupe,* 52 TC 394 (1969)]. As long as an exchange is "intended," most court decisions find the details of the transaction are insignificant [*Rutland v. Comm.,* 36 TCM 40 (1977); *Biggs v. Comm.,* 632 F 2d 1171 (5th Cir. 1981), *aff'g* 69 TC 905 (1978); *Garcia v. Comm.,* 80 TC 491 (1983), acq. 1984-1 CB 1].

The qualified exchange may even contain the contingency that the transaction may, at the option of the exchanger, convert back to a cash sale (*Antone Borchard*, TCM 1965-297), or, alternatively, if the buyer cannot find suitable property, the exchanger may demand cash (*Barker v. Comm.*, 74 TC 555 (1980)).

Like-Kind Exchange Failed Due to Constructive Receipt of Proceeds (*Ralph E. Crandall and Dene D. Dulin v. Comm.*, TCS 2011-14)

Taxpayer wanted an exchange but touched the cash. Ralph Crandall and Dene Dulin owned an undeveloped parcel of property in Lake Havasu City, Arizona (Arizona property) which they purchased for $8,500. They held the Arizona property for investment. Ralph and Dene desired to own investment property closer to their California residence. After receiving some limited advice concerning a tax-free exchange of properties, Ralph and Dene took steps to sell the Arizona property and purchase new property with the intention of executing a tax-free exchange. On March 4, 2005, Ralph and Dene sold the Arizona property for $76,000. The buyers of the property paid Ralph and Dene $10,000, and the remaining $66,000 was placed in an escrow account with Capital Title Agency, Inc. (Capital Title). At Ralph and Dene's direction $61,743.25 was held in the escrow account. Capital Title initially released $4,256.75 to Ralph and Dene.

At closing, sale and purchase documents were used not exchange documents. Most important, the Capital Title and Chicago Title escrow agreements did not reference a like-kind exchange under §1031, nor did they

expressly limit Ralph and Dene's right to receive, pledge, borrow, or otherwise obtain the benefits of the funds. To support their argument that is was a like-kind exchange, Ralph and Dene testified that the funds in the Capital Title escrow account were held solely for the purchase of the California property and that they received no proceeds from the sale of the Arizona property.

Court ruled that transaction was a sale and a reinvestment, not an exchange. The court concluded that the disposition of the Arizona property was a sale and the funds deposited in the Capital Title escrow account represent the receipt of the proceeds. Consequently, Ralph and Dene's transaction did not qualify for §1031 nonrecognition, and they must recognize gain for 2005. The Court noted that the tax consequences were are not what Ralph and Dene intended and the result may have been somewhat harsh. However, Congress enacted strict provisions under §1031 with which taxpayers must comply.

The court had no doubt that Ralph and Dene intended the transaction to qualify under the provisions of §1031. However, the court pointed out, it was well established that a taxpayer's intention to take advantage of tax laws did not determine the tax consequences of his transactions.

LIKE KIND PROPERTIES

The "Qualified Use" Requirement - What Property Qualifies for a Tax-free Exchange?

Requirement. As mentioned previously, *both* the property given up and the property received by the taxpayer must be held for *productive use in a trade or business* ***or*** *for investment* (§1031(A)(1)). For confusion's sake, §1031 does not define *business* or *investment*, therefore, conventional wisdom assumes that the terms have the same meaning as elsewhere in the code, which is discussed below.

> **Note:** The *qualified use* test is determined by the use of each property, both given and received, *in the taxpayer's hands*. Therefore, the use of either property in the hands of the other party involved in the exchange is irrelevant (Rev. Rul. 75-291).

"Held for productive use in trade or business." Qualifying property must be used in a trade or business in which the taxpayer is engaged (§162; §1231). For example, trade or business property would include buildings owned and used by a business, office buildings, apartment houses, machinery and equipment, business trucks, and automobiles.

Confusion reigns in this area. Rental units are business property. For tax and exchange purposes, rental units are considered to be business property, *not* investment property. Most investors think rentals are investments, which is not true. Investment property has the negative result of creating a capital loss whereas business property creates a fully deductible ordinary loss. So what is included in the very limited definition of *investment* property?

"Held for investment." This probably refers to property held for future use or future appreciation in value (§212). Examples of investment property include unimproved raw land, recreational property, and possibly second homes and/or condominiums.

Personal residences and certain vacation homes don't qualify. A personal residence (or a vacation home not held for investment) is not qualified use property because it is being used for personal purposes, not for business or investment. *(Barry E. Moore and Deborah E. Moore v. Comm.,* TCM 2007-134)

DELAYED EXCHANGES

Time Limits Imposed on Nonsimultaneous Like-kind Exchanges

For any deferred exchanges, the following limits apply:

1. **Identified:** All properties to be received must be identified within 45 days after the taxpayer transfers the relinquished property.
2. **Received**: The exchange of titles must be completed, or properties received, within strict time limits, not more than 180 days (or, if earlier, the due date, including extensions, of the taxpayer's tax return for the tax year the relinquished property was transferred) after the transfer of the exchanged property (§1031(a)(3); §1.1031(k)-1(b)(1)).

Filing a tax return on time can make a like-kind exchange taxable! A tax trap can occur by the 180 days "or, if earlier, the due date of the tax return" requirement. For example, if a calendar-year taxpayer gives property in a like-kind exchange on December 31, the 180 days would end on June 27 of the next year. But, if the individual files on April 15, this shortens the allowable exchange period to 105 days. As corporations file on March 15, they would only have 74 days to complete an exchange! Luckily, the requirement adds "including extensions." In other words, if the taxpayer files on time, they lose the period of time from the filing date to the end of the 180 days. Investor Christensen received replacement property after filing his tax return but before the 180 days . . . *and no §1031 like-kind exchange was allowed* (*Orville E. Christensen v. Comm.*, (CA-9), 98-1 USTC ¶50,352)!

> **Planning Point.** Prudent investors participating in an exchange in the last quarter of the year should extend the filling date of their tax return to maximize the replacement period to 180 days.

Penalty for noncompliance. If the 45/180 dates are not strictly followed, any property received outside these dates is considered "not-like-kind" property. Therefore the tax-free transaction is deemed a taxable sale and a subsequent purchase (§1.1031(k)-1(a)).

Time starts when first property transferred. Once the old property is conveyed, the period for identifying the replacement property ends exactly 45 days later and the period for receiving the property ends exactly 180 days later—no extensions are available. If, as part of the same deferred exchange, the exchanger transfers more than one relinquished property and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the *earliest* date on which any of such properties are transferred and ends exactly 45/180 days (or filing date) later, even if the beginning or ending date is a Saturday, Sunday or legal holiday (§1.1031(k)-1(b)(1)(iii)).

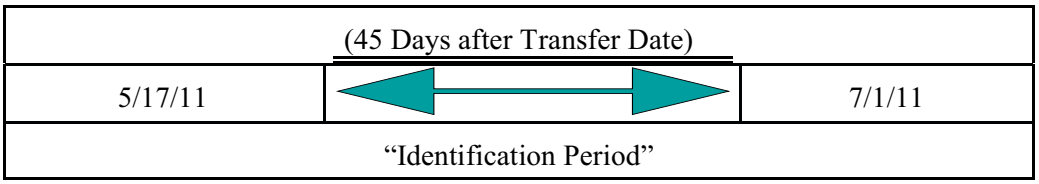
> **Planning Point**. Remember that financing or EPA problems, a death, divorce or bankruptcy may delay your exchange and disqualify it. Simultaneous or near simultaneous is always the best.

Rules to *Identify* the Replacement Property Within 45 Days

The IRS promulgated strict rules on how to properly identify the property in the 45-day period, but it does not require the filing of separate identification forms.

The identification time period. The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight 45 days thereafter (§1.1031(k)-1(b)(2)(i)).

> **Example.** Barb transfers a $100,000 fair market value rental property to Carol in a deferred exchange on May 17, 2011. On July 2, 2011, Barb hand-delivers to Carol written, signed instructions to purchase a $100,000 office building.



> **Tax result**. No §1031 exchange as the replacement property was identified outside the 45-day identification period (§1.1031(k)-1(c)(7)(Example 1)).

Not Timely Identifying Replacement Property Kills Tax-Free Swap (*Terry D. Smith v. Internal Revenue*; (CA-4) 97-2 USTC ¶50,928)

An accountant sold two properties, intending to do a tax-free swap pursuant to the like-kind rules under §1031. Sales proceeds were held in an escrow account, and two weeks later, he found a building that needed renovation but otherwise suited his needs. However, he was too busy to carry on the necessary negotiations for acquisition of the building and never formally identified it as the replacement before eventually buying it more than 45 days later. Worse yet, on the IRS Form 8824, he "mistakenly" (or so he said), inserted an identification date more than 45 days after the date the property was transferred. The Tax Court ruled that the exchange did not qualify under the like-kind rules. Even though he bought the building withing the overall 180-day limitation period, he did not otherwise satisfy the 45-day identification rule, thus making the transaction taxable.

How to Properly Identify Property within the 45 Days

The identification must be in a written document, signed and delivered. Property must be designated as replacement property in writing, signed and delivered (either by hand or mailed, faxed or otherwise sent) to the person obligated to transfer the replacement property *or* to any other person involved in the exchange (other than the taxpayer or a "disqualified person") such as any of the other parties to the exchange, an accommodator, an escrow agent or a title company. A document signed by all parties prior to the end of the 45 days is also sufficient (§1.1031(k)-1(c)(2)).

The Property Description must Be Unambiguous

- **Describing real property.** Exchanger may use legal description, street address or distinguishable name (e.g., Trump Tower).
- **Describing personal property**. Description must be specific (e.g., truck must designate make, model, and year) (§1.1031(k)-1(c)(3))

  Example. Barb transfers a $100,000 fair market value rental property to Carol in a deferred exchange on May 17, 2009. On July 1, 2009, Barb hand-delivers to Carol written, signed instructions to purchase "unimproved land located in Powder River County with a fair market value not to exceed $100,000."

  Tax result: No §1031 exchange, as the property description is not specific enough (§1.1031(k)-1(c)(7)(Example 3)).

Extreme Care Must Be Taken When Selecting Qualified Intermediary

Because the exchanger is not allowed to hold any cash received from the buyer of the relinquished property, the services of a qualified intermediary (QI) are almost always used. In a typical exchange transaction, the exchanger transfers property to a QI who then sells the property for cash. Once the exchanger identifies replacement property, the QI uses the cash to purchase the property and then transfers the property to the exchanger, completing the nonsimultaneous exchange.

Taxpayers using fees as only criteria for selecting Qualified Intermediary do so at their own peril. Recently, there have been several well-publicized cases where QI's have gone into bankruptcy, essentially stranding their deferred exchange customers (see *LandAmerica 1031 Exchange Services; Ed Okun and the 1031 Tax Group LLC; Southwest Exchange Inc.; and Nation-Wide Exchange Services, Inc.*). The problem is that once the QI goes into bankruptcy, all of the QI's assets, including exchange funds, are controlled by the bankruptcy trustee, not by the QI. In addition, ***recent bankruptcy court cases have held that an exchanger's rights to assets held in bankruptcy are those of unsecured creditors***, meaning that an exchanger's cash can be used to pay off secured creditors first and then, any remaining assets are disbursed to unsecured creditors on a pro rata basis. If that weren't enough, any assets paid to creditors shortly before declaring bankruptcy (90 days in some cases) are required to be paid back to the bankruptcy court!

Caution imperative when selecting a Qualified Intermediary. Instead of focusing only on fees and tax issues, taxpayers should consider other criteria when selecting a QI, such as:

1. What is the financial condition of the QI;
2. are there affiliated businesses and, if so, are funds commingled;
3. is the QI bonded;
4. how are exchange funds invested by the QI;
5. how liquid is the QI;
6. are other exchanger funds kept separate or commingled;
7. are background checks completed for employees;
8. what credentials does QI staff have (attorneys, CPAs, etc.);

9. does an outside auditor audit QI's records;
10. how liquid is the QI; and
11. does the QI have errors and omissions insurance and, if so, who is the carrier and what are the policy limits?

Using a Qualified Accommodator's Participation

The use of a qualified accommodator prevents the taxpayer from constructively receiving the money from the sale of the relinquished property in a tax-deferred exchange. The IRS has announced that both simultaneous and deferred exchanges are permitted (but not required) to be facilitated by the use of a *qualified intermediary if* the exchanger's rights to receive the money or other property held by the accommodator are *substantially limited or restricted*. In this case the qualified accommodator is not considered the agent of the taxpayer (an agent is normally a disqualified person). The accommodator may actually purchase the property (even from money advanced directly by the exchanger) and then effect an exchange or simply assign the contractual right to purchase the property desired (see subsequent discussion on direct deeding) (§1.1031(k)-1(g)(4)(i)&(vi)).

IRS Grants Relief for Delayed Exchange Participants with Bankrupt Qualified Intermediaries (Rev. Proc. 2010-14)

LandAmerica 1031 Exchange Services, Inc., a qualified intermediary, filed for bankruptcy protection at a time when it held $420 million for 450 customers who had deposited funds in anticipation of acquiring replacement property to complete their exchange.

What happens to the hapless taxpayer who cannot complete his §1031 exchange because of the bankruptcy of the qualified intermediary? It certainly looked like a big tax bill would result until the IRS stepped in with its new Revenue Procedure 2010-14.

Qualifying taxpayer. A new safe harbor applies for delayed exchanges if the taxpayer (1) identified replacement property, (2) did not complete the like-kind exchange solely because the qualified intermediary defaulted when the QI became subject to a bankruptcy proceeding or a receivership, (3) did not have actual or constructive receipt of the proceeds from the disposition of the relinquished property.

No gain recognized until payment received. If the QI defaults on its obligation to acquire and transfer replacement property, gain is recognized as the taxpayer receives payments attributable to the relinquished property using a safe harbor gross profit ratio.

Safe harbor gross profit ratio method. Under the safe harbor gross profit ratio method, the portion of any payment attributable to the relinquished property that is recognized as gain is determined by multiplying the payment by a fraction, the numerator of which is the taxpayer's gross profit and the denominator of which is the taxpayer's contract price.

> **Example.** Sharon owns investment property (Property 1) with a fair market value of $150,000 and an adjusted basis of $50,000. Sharon enters into an agreement with Fast Exchange Inc., a qualified intermediary, to facilitate a deferred like-kind exchange. On May 6, 2010, Sharon transfers Property 1 to Fast Exchange Inc. and it transfers the rproperty to a third party in exchange for $150,000.

Sharon intends that the $150,000 held by her qualified intermediary be used to acquire her replacement property. On June 1, 2010, Sharon identifies Property 2 as replacement property. On June 15, 2010, Fast Exchange Inc. notifies Sharon that it has filed for bankruptcy protection and cannot acquire replacement property. Consequently, Sharon fails to acquire Property 2 or any other replacement property within the exchange period. As of December 31, 2010, Fast Exchange Inc.'s bankruptcy proceedings are on-going and Sharon has received none of the $150,000 proceeds from the intermediary or any other source. On July 1, 2011, Fast Exchange Inc. exits from bankruptcy and the bankruptcy court approves the trustee's final report, which shows that A will be paid $130,000 in full satisfaction of Fast Exchange Inc.'s obligation under the exchange agreement. Sharon receives the $130,000 payment on August 4, 2010.

Because of this revenue procedure, Sharon is not required to recognize gain in 2010 because She did not receive any payments attributable to the relinquished property in 2010. She recognizes gain in 2011. Sharon 's selling price is $130,000 (the payment received during the year.) Sharon 's contract price also is $130,000 because there is no satisfied or assumed indebtedness. Her gross profit is $80,000 (the selling price ($130,000) minus the adjusted basis ($50,000)). Sharon's gross profit ratio is 80/130 (the gross profit over the contract price). She must recognize gain in 2011 of $80,000 (the payment attributable to the relinquished property ($130,000) multiplied by her gross profit ratio (80/130)). Furthermore, even though the payment attributable to the relinquished property ($130,000) is less than the $150,000 proceeds received by the intermediary, Sharon is not entitled to a §165 loss deduction because the payment exceeds her adjusted basis in the relinquished property ($50,000).

RELATED PARTY EXCHANGES

Related Party Exchanges

Disposition within two years of exchange triggers deferred gain. If a taxpayer exchanges property with a related party (as defined below), the original exchange will not qualify for tax deferral if either of the exchanged properties is sold or disposed of within two years of the transfer. Interestingly, the postponed gain becomes taxable at the time of the disqualifying disposition and applies to both parties. It is important to note that exchanges between related parties may still use the tax-free benefits of §1031, provided the two-year waiting period and other requirements listed below are met (§1031(f) and (g)).

Who Is a Related Party?

Related parties include:

1. **Family members.** Brothers, sisters, spouse, ancestors and lineal descendants as well as C or S Corporations and over 50% shareholders, corporate controlled members, and grantors and fiduciaries of trusts (§267(b)).
2. **Partnership–partner.** The related party definition also includes over 50% partner-to-partnership attribution rules (§707(b)).

Exceptions Exist to the Two-year Rule

1. **Certain dispositions within two years of an exchange will not invalidate §1031 treatment (§1031(f)(2)).** This includes dispositions:

   - after the earlier of the death of the taxpayer or the death of the related person;
   - in an involuntary conversion if the exchange occurred before the threat or imminence of such conversion; and
   - that the taxpayer can establish to the satisfaction of the Secretary that the exchange had as one of its principal purposes the avoidance of Federal income tax. The Conference Report gives three examples of this non-tax-avoidance exception: (1)transactions involving certain exchanges of undivided interests in different properties that result in each taxpayer's holding either the entire interest in a single property or a larger undivided interest in any of the properties; (2) dispositions of property in non recognition transactions (e.g., §1033); and (3) transactions that do not involve the shifting of basis between properties.

2. **If risk of loss is diminished (§1031(g)).** The running of the two-year holding period will be suspended during any period when a party's risk of loss with respect to the property is substantially diminished, such as: (1) the holding of a put with respect to the property; (2) the holding by another person of a right to acquire the property; or (3) a short sale or any other transaction.

Holding Replacement Property More Than 2 Years and Using A Qualified Intermediary Not Enough to Save Related Party Exchange (*Ocmulgee Fields, Inc. v. Comm.*, (11th Cir.) 09-13395, Aug. 13, 2010 aff. *Ocmulgee Fields, Inc. V. Comm.*, 132 TC No. 6, March 31, 2009; see also *Teruya Brothers, Ltd. & Subsidiaries v. Comm.*, CA-9, No. 05-73779, Sept. 8, 2009)

Substance over form, not taxpayer intent, is deciding factor. Commercial real estate developer Ocmulgee Fields, Inc. (OFI), a Georgia corporation, agreed to sell real estate, Wesleyan Station Shopping Center, to an unrelated party for $7,250,000. OFI's basis in Wesleyan Station was $716,000, and, after selling expenses, OFI realized a gain of $6,123,000. In anticipation of completing a like-kind exchange, OFI contracted with Security Bank of Macon Georgia to serve as a qualified intermediary. OFI transferred Wesleyan Station to Security Bank, who, on Oct. 10, 2003, completed the sale of Wesleyan Station to the unrelated party.

OFI originally intended to purchase replacement property from an unrelated party; however, they were unable to find suitable replacement property within the 45 day replacement period. OFI did, however, timely identify the Rivergate commercial property as replacement property. The Rivergate property was owned by Treaty Fields, LLC, a related party to OFI as defined by §1031(f)(3). Security Bank completed the purchase and transfer of the Rivergate property from Treaty Fields within the requisite time constraints of §1031.

Even though OFI sold the Wesleyan Station property to an unrelated third party, the court found that the transaction was economically equivalent to a direct exchange of the Wesleyan Station and Rivergate properties between OFI and Treaty Fields, LLC, followed by the sale of the Wesleyan Station property by Treaty Fields, LLC to the unrelated third party. The interposition of a qualified intermediary in this transaction, and the fact that OFI held the replacement Rivergate property for more than two years, did not obscure the end result.

Basis shifting final blow to OFI's case. Once the court concluded that the transaction was essentially a sale of the exchanged property by a related party within two years, the only matter left to decide was whether or not an exception to the two year rule was met. OFI argued that the exchange did not have as one of its principal purposes the avoidance of Federal income tax. The court countered, and OFI conceded, that there was significant basis shifting between OFI and Treaty Fields, LLC. Treaty Fields, LLC's basis in the Rivergate property was $2,555,000 and it recognized a gain of $4,186,000 from the sale to OFI. OFI's basis was only $716,000 and the related gain was $6,123,000. Because the recognized gain would have been reduced by $1,937,000 to the related parties due to the shift in basis, the court concluded that the transaction was structured to avoid the purposes of §1031(f) and, consequently OFI was not entitled to defer the gains that it realized on the exchange of the Wesleyan Station property.

> **Note**. The result is that both sales are now taxable. In the above case, OFI is not allowed §1031 deferred tax treatment, resulting in taxable income of $6,123,000. In addition, Treaty Fields, LLC still has to recognize the gain of $4,186,000 from the sale of its Rivergate property. Quite a nasty tax result!

Ouch - Related Parties Who Exchange Must File IRS Form 8824 for the Next Two Years!

If the exchange is made with a related party, the taxpayer must file Exchange Form 8824 in the year of the exchange *and for the two following years* (Tax Management, Inc. (BNA) Portfolio, Vol. 61-5th, page C&A-2, A-31).