Real Estate Taxes

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Introduction

This self-study courses discusses important tax implications of selling a home, as well as the investment of a second home for personal or rental purposes. This is a Basic tax course with no prerequisites, and qualifies for 2 CE credit in the Tax Law category.

Real estate is generally the largest investment most individuals will ever have. Real estate is owned for both personal and rental investment purposes. The tax treatment of real estate is dependent on a number of factors, including the use of the property. This course explores the various factors that influence the tax treatment of real estate.

Chapter 1 takes an in-depth look at the tax rules that apply when an individual sells their main home. How is the gain or loss figured? What if the disposition is due to a foreclosure or repossession? How is the basis determined? What is the $250,000 exclusion?

Chapter 2 discusses rental income and expenses. Is rental income included in an individual's gross income? What rental expenses are deductible? How is personal use of a dwelling treated? How is depreciation calculated?
These and other related questions will be answered in this course.

Chapter 1: Sale Of A Home

Chapter Objective
After completing this chapter, you should be able to:

- Recognize the tax rules that apply when an individual sells his or her home.

I. Introduction And Overview

For most Americans, the largest investment anyone will ever have is their home. It is therefore essential that accountants be able to advise their clients on the various tax implications of selling a home. This chapter explains the tax rules that apply when an individual sells his or her main home.

II. Main Home

This section explains the term “main home.” Usually, the home an individual lives in most of the time is his or her main home and can be

- House;
- Houseboat;
- Mobile home;
- Cooperative apartment; or
- Condominium.

To exclude gain, an individual generally must have owned and lived in the property as his or her main home for at least two years during the five-year period ending on the date of sale.

A. SALE OF LAND ONLY
If an individual sells the land on which his or her main home is located, but not the house itself, he or she cannot exclude any gain he or she has from the sale of the land. However, if the individual sells vacant land used as part of his or her main home, and that is adjacent to it, the individual may be able to exclude the gain from the sale under certain circumstances.

Example
Bill buys a piece of land and moves his main home to it. Then he sells the land on which his main home was located. This sale is not considered a sale of Bill’s main home, and he cannot exclude any gain on the sale of the land.

B. MORE THAN ONE HOME
If an individual has more than one home, he or she can exclude gain only from the sale of his or her main home. A taxpayer must include in income the gain from the sale of any other home. If an individual has two homes and lives in both of them, his or her main home is ordinarily the one he or she lives in most of the time during the year.

Examples
Example 1. Lisa owns two homes, one in New York and one in Florida. From 2016 through 2020, Lisa lives in the New York home for 7 months and in the Florida residence for 5 months of each year. In the absence of facts and circumstances indicating otherwise, the New York home is Lisa’s main home. She would be eligible to exclude the gain from the sale of the New York home but not of the Florida home in 2020.
Example 2. Connie owns a house, but she lives in another house that she rents. The rented house is Connie’s main home.

C. PROPERTY USED PARTLY AS MAIN HOME

If an individual uses only part of the property as his or her main home, the rules discussed in this chapter apply only to the gain or loss on the sale of that part of the property.

III. Figuring Gain Or Loss

To figure the gain or loss on the sale of an individual's main home, the owner must know the selling price, the amount realized, and the adjusted basis. Subtract the adjusted basis from the amount realized to get the individual's gain or loss.

A. SELLING PRICE

The selling price is the total amount an individual receives for his or her home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services the seller receives.

In some cases, an individual may have to sell his or her home because of a job transfer. If an employer pays an employee for a loss on the sale or for his or her selling expenses, the seller should not include the payment as part of the selling price. Rather, the employer will include the amount paid as wages in box 1 of your Form W-2, and the individual will include it in his or her income on Form 1040 or 1040-SR, line 1.

1. Option to Buy

If a buyer pays for an option to buy and later exercises the option, the amount received by the seller for the option must be added to the selling price of the home. If the option is not exercised, the seller must report the payment as ordinary income in the year the option expired. This income is reported on Schedule 1 (Form 1040), line 8.

B. AMOUNT REALIZED

The amount realized is the selling price of the home minus selling expenses. Selling expenses include all of the following:

- Commissions;
- Advertising fees;
- Legal fees; and
- Loan charges paid by the seller, such as loan placement fees or "points."

C. ADJUSTED BASIS

While the seller owned his or her home, the seller may have made adjustments (increases or decreases) to the basis. If so, this adjusted basis must be determined before the seller can figure gain or loss on the sale of the home.

D. AMOUNT OF GAIN OR LOSS

To figure the amount of gain or loss, the amount realized is compared to the adjusted basis. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part the seller can exclude, generally is taxable. If the amount realized is less than the adjusted basis, the difference is a loss. A loss on the sale of an individual's main home cannot be deducted.

1. Jointly Owned Home

If an individual and his or her spouse sell their jointly owned home and file a joint return, they will calculate their gain or loss as one taxpayer.

a. Separate Returns

If a seller files a separate return from his or her spouse, each spouse must calculate his or her own gain or loss according to his or her ownership interest in the home. Each spouse's ownership interest is determined by state law.

b. Joint Owners Not Married

If two owners who are not married sell their jointly owned home, each must calculate their own gain or loss according to their ownership interest in the home.

E. OTHER DISPOSITIONS

The following rules apply to foreclosures and repossessions, abandonments, trades, and transfers to a spouse.

1. Foreclosure and Repossession

If an individual's home was foreclosed on or repossessed, the owner is treated as having a disposition. The owner will figure his or her gain or loss in generally the same way as a normal sale. However, the amount of the gain or loss depends, in part, on whether the owner was personally liable for repaying the debt secured by the home. An individual also may realize ordinary income from cancellation of debt if the loan balance is more than the fair market value of the property.

2. Nonrecourse Debt

If an individual is not personally liable for repaying the debt (nonrecourse debt) secured by the transferred property, the amount they realize includes the full debt canceled by the transfer. The full canceled debt is included even if the fair market value of the property is less than the canceled debt.

Examples

Example 1. Chris bought a new car for $15,000. He paid $2,000 down and borrowed the remaining $13,000 from the dealer's credit company. Chris is not personally liable for the loan (nonrecourse), but pledges the new car as security. The credit company repossessed the car because he stopped making loan payments. The balance due after taking into account the payments Chris made was $10,000. The fair market value of the car when repossessed was $9,000. The amount Chris realized on the repossession is $10,000. That is the debt canceled by the repossession, even though the car's fair market value is less than $10,000. Chris figures his gain or loss on the repossession by comparing the amount realized ($10,000) with his adjusted basis ($15,000). He has a $5,000 nondeductible loss.

Example 2. Abena paid $200,000 for her home. She paid $15,000 down and borrowed the remaining $185,000 from a bank. Abena is not personally liable for the loan (nonrecourse debt), but pledges the house as security. The bank foreclosed on the loan because Abena stopped making payments. When the bank foreclosed on the loan, the balance due was $180,000, the fair market value of the house was $170,000, and Abena's adjusted basis was $175,000 due to a casualty loss she had deducted.

The amount Abena realized on the foreclosure is $180,000, the debt canceled by the foreclosure. She figures her gain or loss by comparing the amount realized ($180,000) with her adjusted basis ($175,000). She has a $5,000 realized gain.

3. Recourse Debt

If an individual is personally liable for the debt (recourse debt), the amount realized on the foreclosure or repossession does not include the canceled debt that is the individual's income from cancellation of debt. However, if the fair market value of the transferred property is less than the canceled debt, the amount realized includes the canceled debt up to the fair market value of the property. The owner is treated as receiving ordinary income from the canceled debt for the part of the debt that is more than the fair market value.

Examples

Example 1. Assume the same facts as in the previous Example 1, except Chris is personally liable for the car loan (recourse debt). In this case, the amount he realizes is $9,000. This is the canceled debt ($10,000) up to the car's fair market value ($9,000). Chris figures his gain or loss on the repossession by comparing the amount realized ($9,000) with his adjusted basis ($15,000). He has a $6,000 nondeductible loss. He also is treated as receiving ordinary income from cancellation of debt. That income is $1,000 ($10,000 - $9,000). This is the part of the canceled debt not included in the amount realized.
Example 2. Assume the same facts as in the previous Example 2, except Abena is personally liable for the loan (recourse debt). In this case, the amount she realizes is $170,000. This is the canceled debt ($180,000) up to the fair market value of the house ($170,000). Abena figures her gain or loss on the foreclosure by comparing the amount realized ($170,000) with her adjusted basis ($175,000). She has a $5,000 nondeductible loss. She also is treated as receiving ordinary income from cancellation of debt. That income is $10,000 ($180,000 - $170,000). This is the part of the canceled debt not included in the amount realized.

4. Seller's (Lender's) Gain or Loss on Repossession

If an individual or entity finances a buyer's purchase of property and later acquires an interest in it through foreclosure or repossession, he or she may have a gain or loss on the acquisition.

5. Cancellation of Debt

If property that is repossessed or foreclosed on secures a debt for which the owner is personally liable (recourse debt), he or she generally must report as ordinary income the amount by which the canceled debt is more than the fair market value of the property. This income is separate from any gain or loss realized from the foreclosure or repossession.
The individual must report this income on his or her tax return unless one of the following applies.

- The cancellation is intended as a gift.
- The debt is qualified farm debt.
- The debt is qualified real property business debt.
- An individual is insolvent or bankrupt.
- The debt is qualified principal residence indebtedness.

F. ABANDONMENT

If an individual abandons his or her home, the individual may have ordinary income. If the abandoned home secures a debt for which the owner is personally liable and the debt is canceled, the owner has ordinary income equal to the amount of the canceled debt.

G. TRADING HOMES

If an individual trades his or her old home for another home, the individual should treat the trade as a sale and a purchase.

Example
Ray owned and lived in a home that had an adjusted basis of $41,000. A real estate dealer accepted his old home as a trade-in and allowed him $50,000 toward a new home priced at $80,000. This is treated as a sale of his old home for $50,000 with a gain of $9,000 ($50,000 – $41,000). If the dealer had allowed Ray $27,000 and assumed Ray's unpaid mortgage of $23,000 on his old home, Ray's sales price would still be $50,000 (the $27,000 trade-in allowed plus the $23,000 mortgage assumed).

H. TRANSFER TO A SPOUSE

If an owner transfers his or her home to a spouse, or to a former spouse incident to a divorce, there is generally no gain or loss. This is true even if the individual receives cash or other consideration for the home. Therefore, the rules in this chapter do not apply.

Example
Linda and George purchased a home while they were married and lived there together for several years. The couple divorced. As part of the settlement, Linda received the home. Linda paid George for the value of his half of the property and retained sole title to the home. This transaction does not result in any gain to Linda based on the valuation of the house.

IV. Determining Basis

To calculate whether there has been a gain or a loss, a seller must know the basis of his or her home. In general, a seller's basis is determined by how he or she got the home. If a seller either bought or built the home, the seller's basis is generally his or her actual cost. If the seller got the home in some other way, i.e., through inheritance or as a gift, the seller's basis is generally the fair market value of the property at the time they received it, or, in the alternative, the adjusted basis of the person from whom he or she got the property.
While living in the home, the seller may have made adjustments to his or her basis. This is referred to as the adjusted basis of the home, and must also be calculated to determine gain or loss.

A. COST AS A BASIS

The cost of property is the amount the owner pays for it in cash, debt, obligations, other property or services.

1. Purchase

If an individual buys his or her home, the individual's basis is its cost. This includes the purchase price and certain settlement or closing costs. Generally, the purchase price includes the down payment and any debt, such as a first or second mortgage or notes the individual gave the seller in payment for the home. If an individual builds, or contracts to build, a new home, the purchase price can include costs of construction.

2. Settlement Fees

When the seller bought the home, he or she may have paid settlement fees or closing costs in addition to the contract price of the property. A seller can include in his or her basis some of the settlement fees and closing costs he or she paid for buying the home. The seller cannot include in his or her basis the fees and costs for getting a mortgage loan. A fee paid for buying the home is any fee the individual would have had to pay even if he or she had paid cash for the home.

B. ADJUSTED BASIS

Adjusted basis is an individual's basis increased or decreased by certain amounts.

1. Increases to Basis

These include any:

- Additions and other improvements that have a useful life of more than one year;
- Special assessments for local improvements; and
- Amounts the owner spent after a casualty to restore damaged property.

a. Improvements

These add to the value of a home, prolong its useful life, or adapt it to new uses. An owner adds the cost of additions and other improvements to the basis of his or her property. Examples include putting a recreation room or another bathroom in an unfinished basement, putting up a new fence, putting in new plumbing or wiring, putting on a new roof, or paving an unpaved driveway are improvements. An addition to a house, such as a new deck, a sunroom, or a garage, is also an improvement.

b. Repairs

These maintain a home in good condition but do not add to its value or prolong its life. Owners do not add their cost to the basis of their property. Examples include repainting a house inside or outside, fixing gutters or floors, repairing leaks or plastering, and replacing broken windows.

2. Decreases to Basis

These include any:

- Discharge of qualified principal residence indebtedness that was excluded from income for discharges before January 1, 2021 or discharges after December 31, 2020, if the discharge is subject to an arrangement that was entered into and evidenced in writing before January 1, 2021.
- Some or all of the cancellation of debt income that was excluded due to bankruptcy or insolvency.
- Gain the owner postponed from the sale of a previous home before May 7, 1997.
- Deductible casualty losses.
- Insurance payments the owner received or expects to receive for casualty losses.
- Payments the owner received for granting an easement or right-of-way.
- Depreciation allowed or allowable if the owner used his or her home for business or rental purposes.
- Adoption credit the owner claimed for improvements added to the basis of his or her home.
- Nontaxable payments from an adoption assistance program of the owner's employer that he or she used for improvements added to the basis of the home.
- Energy conservation subsidy excluded from the owner's gross income because he or she received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.
- General sales taxes (beginning in 2004) claimed as an itemized deduction on Schedule A (Form 1040) that were imposed on the purchase of personal property, such as a houseboat used as your home or a mobile home.

Note: Importance of Recordkeeping

Homeowners should keep records to prove their home's adjusted basis. Ordinarily, an owner must keep records for three years after the due date for filing their return for the tax year in which the owner sold his or her home. But, if the owner sold a home before May 7, 1997, and postponed tax on any gain, the basis of that home affects the basis of the new home he or she bought. Owners should keep records proving the basis of both homes as long as they are needed for tax purposes. The records individuals should keep include:

- Proof of the home's purchase price and purchase expenses;
- Receipts and other records for all improvements, additions, and other items that affect the home's adjusted basis;
- Any worksheets that the owner used to figure the adjusted basis of the home he or she sold, the gain or loss on the sale, the exclusion, and the taxable gain;
- Any Form 982 the owner filed to report any discharge of qualified principal residence indebtedness;
- Any Form 2119, Sale of Your Home, that the owner filed to postpone gain from the sale of a previous home before May 7, 1997; and
- Any worksheets the owner used to prepare Form 2119, such as the Adjusted Basis of Home Sold Worksheet or the Capital Improvements Worksheet from the Form 2119 instructions, or other source of computations.

V. Excluding The Gain

Taxpayers may qualify to exclude from their income all or part of any gain from the sale of their main home. This means that, if they qualify, they will not have to pay tax on the gain up to the limit described later. To qualify, the taxpayer must meet the ownership and use tests described later. A taxpayer can choose not to take the exclusion. In that case, the taxpayer must include the gain from the sale in his or her gross income on his or her tax return for the year of the sale.

A. MAXIMUM EXCLUSION

1. $250,000 Exclusion

Individuals can exclude up to $250,000 of the gain on the sale of their main home if all of the following are true:

- They meet the ownership test;
- They meet the use test; and
- During the two-year period ending on the date of the sale, they did not exclude gain from the sale of another home.

2. $500,000 Exclusion

Taxpayers can exclude the entire gain on the sale of their main home up to $500,000 if all of the following are true:

- They are married and file a joint return for the year;
- Either the owner or their spouse meets the ownership test;
- Both the owner and their spouse meet the use test; and
- During the two-year period ending on the date of the sale, neither the owner nor their spouse excluded gain from the sale of another home.

B. OWNERSHIP AND USE TESTS

To claim the exclusion, an individual must meet the ownership and use tests. This means that during the five-year period ending on the date of the sale, the individual must have owned the home for at least two years (the ownership test), and lived in the home as his or her main home for at least two years (the use test).

1. Exception

If an individual owned and lived in the property as his or her main home for less than two years, he or she can still claim an exclusion in some cases. The maximum amount the individual can claim will be reduced.

Examples

Example 1. Home owned and occupied for at least 2 years.
Amanda bought and moved into her main home in September 2018. She sold the home at a gain in October 2020. During the 5-year period ending on the date of sale in October 2020, she owned and lived in the home for more than 2 years. She meets the ownership and use tests.
Example 2. Met ownership test but not use test.
Dan bought a home, lived in it for 6 months, moved out, and never occupied the home again. He later sold the home for a gain. He owned the home during the entire 5-year period ending on the date of sale. He meets the ownership test but not the use test. He cannot exclude any part of his gain on the sale, unless he qualified for a reduced maximum exclusion.

2. Period of Ownership and Use

The required two years of ownership and use during the five-year period ending on the date of the sale do not have to be continuous, nor do they have to occur at the same time. An individual can meet the tests if he or she can show that he or she owned and lived in the property as his or her main home for either 24 full months or 730 days (365 × 2) during the five-year period ending on the date of sale.

3. Temporary Absence

Short temporary absences for vacations or other seasonal absences, even if the owner rents out the property during the absences, are counted as periods of use.

Example

Professor Paul Beard, who is single, bought and moved into a house on August 19, 2017. He lived in it as his main home continuously until January 5, 2019, when he went abroad for a 1-year sabbatical leave. On February 5, 2020, one month after returning from the leave, he sold the house at a gain. Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. He cannot exclude any part of his gain because he did not use the residence for the required 2 years.

4. Ownership and Use Tests Met at Different Times

Individuals can meet the ownership and use tests during different two-year periods. However, the owner must meet both tests during the five-year period ending on the date of the sale.

Example

Beginning in 2009, Helen Jones lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on December 2, 2017. In 2018, Helen became ill, and on April 14 of that year she moved to her daughter's home. On July 7, 2020, while still living in her daughter's home, she sold her condominium.

Helen can exclude gain on the sale of her condominium because she met the ownership and use tests during the 5-year period from July 8, 2015, to July 7, 2020, the date she sold the condominium. She owned her condominium from December 2, 2017, to July 7, 2020 (more than 2 years). She lived in the property from July 8, 2015 (the beginning of the 5-year period), to April 14, 2018 (more than 2 years).

The time Helen lived in her daughter's home during the 5-year period can be counted toward her period of ownership, and the time she lived in her rented apartment during the 5-year period can be counted toward her period of use.

5. Cooperative Apartment

If an individual sold stock as a tenant-stockholder in a cooperative housing corporation, the ownership and use tests are met if, during the 5-year period ending on the date of sale, the individual:

- Owned the stock for at least 2 years; and
- Lived in the house or apartment that the stock entitles him or her to occupy as his or her main home for at least 2 years.

6. Exception for Individuals with a Disability

There is an exception to the use test if during the 5-year period before the sale of a home:

- The owner becomes physically or mentally unable to care for himself or herself; and
- He or she owned and lived in the home as his or her main home for a total of at least 1 year during the 5-year period before the sale of the home.

Under this exception, an individual is considered to live in his or her home during any time that he or she owns the home and lives in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in his or her condition. If an individual meets this exception to the use test, he or she still has to meet the 2-out-of-5-year ownership test to qualify for the exclusion.

7. Previous Home Destroyed or Condemned

For the ownership and use tests, an individual can add the time he or she owned and lived in a previous home that was destroyed or condemned to the time he or she owned and lived in the home on which he or she wishes to exclude gain. This rule applies if any part of the basis of the home the individual sold depended on the basis of the destroyed or condemned home. Otherwise, the individual must have owned and lived in the same home for 2 of the 5 years before the sale to qualify for the exclusion.

8. Married Persons

If an individual and his or her spouse file a joint return for the year of sale, he or she can exclude up to $250,000 gain if either spouse meets the ownership and use tests.

> Examples
>
> ***Example 1.*** One spouse sells a home.
>
> Emily sells her home in June 2020 for a gain of $300,000. She marries Jamie later in the year. She meets the ownership and use tests, but Jamie does not. Emily can exclude up to $250,000 of gain on a separate or joint return for 2020. The $500,000 maximum exclusion for certain joint returns does not apply because Jamie does not meet the use test.
>
> ***Example 2.*** Each spouse sells a home.
>
> The facts are the same as in Example 1 except that Jamie also sells a home in 2020 for a gain of $200,000 before he marries Emily. He meets the ownership and use tests on his home. Emily can exclude $250,000 of gain and Jamie can exclude $200,000 of gain on the respective sales of their individual homes. However, Emily cannot use Jamie's unused exclusion to exclude more than $250,000 of gain. Therefore, Emily and Jamie must recognize $50,000 of gain on the sale of Emily's home. The $500,000 maximum exclusion for certain joint returns does not apply because Emily and Jamie do not both meet the use test for the same home.

a. Sale of Main Home by Surviving Spouse

If an individual's spouse died and he or she did not remarry before the date of sale, the individual is considered to have owned and lived in the property as his or her main home during any period of time when his or her spouse owned and lived in it as a main home.

b. Home Transferred from Spouse

If a home was transferred to an individual by his or her spouse (or former spouse if the transfer was incident to divorce), the individual is considered to have owned it during any period of time when his or her spouse owned it.

c. Use of Home After Divorce

An individual is considered to have used property as his or her main home during any period when he or she owned it and his or her spouse or former spouse is allowed to live in it under a divorce or separation instrument and uses it as his or her main home.

C. REDUCED MAXIMUM EXCLUSION

If an individual fails to meet the requirements to qualify for the $250,000 or $500,000 exclusion, he or she may still qualify for a reduced exclusion. This applies to those who:

- Fail to meet the ownership and use tests, or
- Have used the exclusion within 2 years of selling their current home.

In both cases, to qualify for a reduced exclusion, the sale of the individual's main home must be due to one of the following reasons.

- A change in place of employment.
- Health.
- Unforeseen circumstances.

1. Unforeseen Circumstances

The sale of a main home is because of an unforeseen circumstance if the owner's primary reason for the sale is the occurrence of an event that he or she did not anticipate before buying and occupying his or her main home.

D. DEFERRAL OF GAIN

The Tax Cuts and Jobs Act provides for the temporary deferral of capital gains reinvested in a qualified opportunity fund (QOF) and permanent exclusion of capital gains from the sale or an exchange of an investment in a QOF. If a taxpayer held a qualified investment in a QOF at any time during the year, he or she must file his or her return with Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments, attached.

VI. Business Use Or Rental Of Home

Individuals may be able to exclude the gain from the sale of a home that they have used for business or to produce rental income, but the individuals must meet the ownership and use tests.

Examples

Example 1. On May 24, 2014, Amy, who is unmarried for all years in this example, bought a house. She moved in on that date and lived in it until May 31, 2016, when she moved out of the house and put it up for rent. The house was rented from June 1, 2016 to March 31, 2018. Amy claimed depreciation deductions in 2016 through 2018 totaling $10,000. Amy moved back into the house on April 1, 2018, and lived there until she sold it on January 28, 2020. During the 5-year period ending on the date of the sale (January 29, 2015 – January 28, 2020), Amy owned and lived in the house for more than 2 years as shown in the table below.

Five-Year Period	Used As Home	Used As Rental
1/29/15 – 5/31/16	16 months	
6/1/16 – 3/31/18		22 months
4/1/18 – 1/28/20	22 months	
	38 months	22 months

During the period Amy owned the house (1,826 days), her period of nonqualified use was 669 days. Amy divides 669 by 1,826 and obtains a decimal (rounded to at least three decimal places) of 0.366. To figure her gain attributable to the period of nonqualified use, she multiplies $190,000 (the gain not attributable to the $10,000 depreciation deduction) by 0.366. Because the gain attributable to periods of nonqualified use is $69,540, Amy can exclude $120,460 of her gain.

Example 2. William owned and used a house as his main home from 2014 through 2017. On January 1, 2018, he moved to another state. He rented his house from that date until April 29, 2020, when he sold it. During the 5-year period ending on the date of sale (April 30, 2015 – April 29, 2020), William owned and lived in the house for more than 2 years. He must report the sale on Form 4797 because it was rental property at the time of sale. Because the period of nonqualified use does not include any part of the 5-year period after the last date William lived in the house, he has no period of nonqualified use. Because he met the ownership and use tests, he can exclude gain up to $250,000. However, he cannot exclude the part of the gain equal to the depreciation he claimed or could have claimed for renting the house.

VII. Special Situations

The following situations may affect an individual's exclusion.

A. EXPATRIATES

An individual cannot claim the exclusion if the expatriation tax applies to them. The expatriation tax applies to certain U.S. citizens who have renounced their citizenship (and long-term residents who have ended their residency).

B. HOME DESTROYED OR CONDEMNED

If an individual's home was destroyed or condemned, any gain (for example, because of insurance proceeds he or she received) qualifies for the exclusion. Any part of the gain that cannot be excluded (because it is more than the maximum exclusion) may be postponed.

C. SALE OF REMAINDER INTEREST

Individuals can exclude gain from the sale of a remainder interest in their home. If an individual makes this choice, he or she cannot choose to exclude gain from the sale of any other interest in the home that he or she sells separately.
However, individuals cannot exclude gain from the sale of a remainder interest in their home to a related person. Related persons include brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.). Related persons also include certain corporations, partnerships, trusts, and exempt organizations.

VIII. Recapturing A Federal Mortgage Subsidy

If an individual financed his or her home under a federally subsidized program (loans from tax-exempt qualified mortgage bonds or loans with mortgage credit certificates), the individual may have to recapture (pay back) all or part of the benefit he or she received from that program when he or she sells or otherwise disposes of his or her home. An individual recaptures the benefit by increasing his or her federal income tax for the year of the sale. The recapture applies to loans that came from the proceeds of qualified mortgage bonds or were based on mortgage credit certificates. The recapture rule also applies to assumptions of these loans.
The recapture of the federal mortgage subsidy applies only if an individual meets both of the following conditions:

- The individual sells or otherwise disposes of his or her home at a gain and during the first 9 years after the date he or she closed his or her mortgage loan; and
- The individual's income for the year of disposition is more than that year's adjusted qualifying income for his or her family size for that year (related to the income requirements a person must meet to qualify for the federally subsidized program).

The recapture does not apply if the mortgage loan was a qualified home improvement loan of not more than $15,000 used for alterations, repairs, and improvements that protect or improve the basic livability or energy efficiency of his or her home, the home is disposed of as a result of the owner's death, the individual disposes of the home more than 9 years after the date they closed his or her mortgage loan, the individual transfers the home to his or her spouse, or to his or her former spouse incident to a divorce, where no gain is included in his or her income, the individual disposes of a home at a loss, the home is destroyed by a casualty, and the owner repairs it or replaces it on its original site within 2 years after the end of the tax year when the destruction happened, or the owner refinances his or her mortgage loan.

CHAPTER 1: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CP credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. Which of the following requirements must a taxpayer meet in order to be able to exclude the gain on the sale of a home:

A. the taxpayer must have lived in the property for at least 18 months immediately prior to the sale
B. the taxpayer must have lived in the home for at least two years immediately prior to the sale
C. the taxpayer must have lived in the home for two out of the five years immediately prior to the time of the sale
D. the taxpayer must not own any other real estate

2. How is a foreclosure of real estate treated for tax purposes:

A. the owner is given a tax loss equal to the fair market value of the real estate at the time of the foreclosure
B. in the case of a nonrecourse loan, the owner has a gain equal to the amount of the canceled debt
C. whether or not the loan is a recourse loan, the individual has a gain equal to the amount of the debt still owed on the property
D. the owner is given a tax credit to help them secure a new home

3. For a taxpayer that qualifies, what is the maximum amount of gain an individual may exclude from income taxes for the sale of his or her home:

A. $250,000
B. $500,000
C. $750,000
D. $1,000,000

CHAPTER 1: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. Incorrect. The time required is two years, not 18 months.
B. Incorrect. The two years need to have been within five years of the sale.
C. CORRECT. In addition, the property must have served as the primary home of the taxpayer.
D. Incorrect. The home must have been the primary home of the taxpayer. However, that does not preclude them from owning other residential or commercial real estate in order to qualify for the exclusion.

2.

A. Incorrect. If anything, the taxpayer must be stuck with a gain. The taxpayer is not given a loss under such circumstances.
B. CORRECT. This is because the debt is in essence forgiven. It does not matter whether or not the amount owed was more or less than the value of the home at the time of the repossession.
C. Incorrect. This is only the rule in the case of a nonrecourse loan.
D. Incorrect. There is no such tax credit.

3.

A. CORRECT. This is the maximum exclusion for individual taxpayers; the exclusion is higher for a married couple.
B. Incorrect. A couple filing a joint return can exclude up to $500,000, but a single taxpayer is limited to $250,000.
C. Incorrect. The limit for a single taxpayer or an individual filing as married filing separately is only $250,000.
D. Incorrect. The maximum exclusion for a single taxpayer is $250,000.

Chapter 2: Rental Income And Expenses

Chapter Objective
After completing this chapter, you should be able to:

- Identify some of the tax implications of owning a second home, whether or not for rental purposes.

Many individuals buy second homes either for their own use and enjoyment or to rent and produce income as part of their financial plan. Even if an individual chooses to use a second home solely for his or her own use and not as a rental, there are important tax implications to understand. This chapter discusses rental income and expenses. It covers topics including rental income, rental expenses, personal use of a dwelling unit, including vacation homes, depreciation and limits on rental loss.

I. Rental Income And Expenses

A. PASS-THROUGH DEDUCTION FOR QUALIFIED TRADE OR BUSINESS

> **Note**
> Rental properties generally qualify as qualified business income (QBI).

The TCJA provides for a deduction of up to 20% of a pass-through business' qualified business income. The deduction, depending upon the amount of qualified business income and other factors affecting it, may reduce the taxpayer's income tax liability significantly. However, the "other factors" that affect the deduction include:

- Whether the business is a qualified trade or business;
- The taxpayer's taxable income if the business is a specified service trade or business;
- The amount of W-2 wages paid; and
- The value of qualified property.

The amount of the pass-through deduction is equal to the ***lesser of*** A or B, where:

A. Is 20% of qualified business income; and
B. Is the greater of:
   - 50% of W-2 wages paid; or
   - 25% of W-2 wages paid + 2.5% of unadjusted basis of qualified property.

A pass-through business is a business organized and taxed as other than a regular corporation. The term "qualified business income" means the net amount of qualified items of:

- Income;
- Gain;
- Deduction; and
- Loss

with respect to any qualified trade or business of the taxpayer to the extent they—the income, gain, deduction and loss—are effectively connected with the conduct of a trade or business within the United States and included or allowed in determining taxable income for the taxable year.

1. Qualified Trade or Business

A qualified trade or business, as the term is used with respect to the pass-through deduction, means any trade or business ***other than***:

- A specified service trade or business, (generally one in which the principal asset is the reputation or skill of one or more of its employees); or

- The trade or business of performing services as an employee. (In other words, an employee of a business would not be considered a “qualified trade or business” whose income from such employment would qualify for the pass-through deduction.)

a. Exception for Specified Service Businesses Based on Taxpayer’s Income

The disqualification does not apply to individuals engaged in a specified trade or business whose taxable income is less than the threshold amount1 ($329,800 for joint filers and $164,900 for all others in 2021) plus $100,000 in the case of a joint return and $50,000 for all others.
The specified service business of an individual whose taxable income is less than the threshold amount plus $50,000 or $100,000, as applicable, will be treated as a qualified trade or business for purposes of the pass-through deduction. However, if the individual’s taxable income exceeds the threshold amount but not the amount at which he or she would be disqualified for the deduction the qualified business income is reduced by the ratio of the taxpayer’s taxable income in excess of the threshold amount to $50,000 (or $100,000 in the case of a joint return).

B. RENTAL INCOME

Taxpayers must generally include in their gross income all amounts received as rent. Rental income is any payment the owner receives for the use or occupation of property. In addition to amounts received as normal rent payments, there are other amounts that may be rental income.

1. Time for Reporting

For cash basis taxpayers, rental income should be reported on the return for the year the owner actually or constructively received it, regardless of when it was earned. Income is constructively received when it is made available to the recipient, i.e., when it is credited to the owner’s bank account. For an accrual basis taxpayer, rental income should be reported when earned, rather than when received. Expenses can generally be deducted when incurred, rather than when paid.

2. Types of Income

a. Advance Rent

Advance rent is any amount received by the owner before the period that it covers. Owners should include advance rent in their rental income in the year it was received, regardless of the period covered or the method of accounting they use.

> **Example**
> On March 18, 2020, Steve signs a 10-year lease to rent his property. During 2020, he received $9,600 for the first year’s rent and $9,600 as rent for the last year of the lease. Steve must include $19,200 in his rental income in 2020.

b. Security Deposits

Owners should not include a security deposit in their income when they receive it if they intend to return it to the tenant at the end of the lease. But if the owner keeps part or all of the security deposit during any year because the tenant does not live up to the terms of the lease, the amount the owner keeps should be included as income in that year. If an amount called a “security deposit” is to be used as a final payment of rent, it is advance rent and should be included as income when it is received.

c. Payment for Canceling a Lease

If a tenant pays an owner to cancel a lease, the amount received is rent. It should be included as income in the year received regardless of the owner’s method of accounting.

d. Expenses Paid by Tenant

If a tenant pays any of the owner's expenses, the payments are rental income. They can be deducted to the extent they meet the requirements of deductible rental expense.

e. Property or Services

If an owner receives property or services instead of money as rent, the fair market value of the property or services received should be included as 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.

f. Rental of Property Also Used as a Home

If an owner rents property that he or she also uses as his or her home and he or she rents it fewer than 15 days during the tax year, they do not need to include the rent received as income and likewise may not deduct rental expenses. However, they can deduct on Schedule A (Form 1040) the interest, taxes, and casualty and theft losses that are allowed for nonrental property.

C. RENTAL EXPENSES

This section discusses repairs and certain other expenses of renting property that an owner can ordinarily deduct from his or her rental income. Such expenses can normally be deducted in the year they are paid.

1. Types of Expenses

a. Vacant Rental Property

If an individual holds property for rental purposes, he or she may be able to deduct his or her ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant. However, the individual cannot deduct any loss of rental income for the period the property is vacant.

b. Pre-Rental Expenses

Owners can deduct their ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time they make it available for rent.

c. Depreciation

Owners can begin to depreciate rental property when it is ready and available for rent.

d. Expenses for Rental Property Sold

If an individual sells property that he or she held for rental purposes, the individual can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold. If the property is not held out as available for rent while listed for sale, the expenses are not deductible rental expenses.

2. Personal Use of Rental Property

If an owner sometimes uses his or her rental property for personal purposes, the owner must divide his or her expenses between rental and personal use. Also, the rental expense deductions may be limited.

D. REPAIRS AND IMPROVEMENTS

Owners can deduct the cost of repairs or mainenance to his or her rental property. On the other hand, the cost of improvements is not deductible. The cost of improvements is recovered through depreciation, discussed later. An individual who owns rental property must therefore separate the cost of repairs and improvements and keep accurate records showing which is which.

1. Repairs

A repair is something that keeps the property in good operating condition. It does not materially add to the value of the property or substantially prolong its life. Repainting property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs. If an owner makes repairs as part of an extensive remodeling or restoration of the property, the whole job is an improvement.

2. Improvements

An improvement adds to the value of the property, prolongs its useful life, or adapts it to new uses. Improvements include the following items:

- Putting a recreation room in an unfinished basement;
- Paneling a den;
- Adding a bathroom or bedroom;
- Putting decorative grillwork on a balcony;
- Putting up a fence;
- Putting in new plumbing or wiring;
- Putting in new cabinets;
- Putting on a new roof; or
- Paving a driveway.

The cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were separate property.

> Note: Safe Harbor Election for Small Taxpayers
>
> You are not required to capitalize as an improvement, and therefore may deduct, the costs of work performed on owned or leased buildings, e.g., repairs, maintenance, improvements or similar costs, that fall into the safe harbor election for small taxpayers. The requirements of the safe harbor election for small taxpayers are:
>
> - Average annual gross receipts less than $10 million; and
> - Owns or leases building property with an unadjusted basis of less than $1 million; and
> - The total amount paid during the taxable year for repairs, maintenance, improvements, or similar activities performed on such building property doesn't exceed the lesser of:
>   - Two percent of the unadjusted basis of the eligible building property; or
>   - $10,000; and
> - You make the election to use the safe harbor for each taxable year in which qualifying amounts are incurred.
>   - The election is made by attaching a statement to your income tax return for the taxable year.

3. Other Expenses

Other expenses an owner can deduct from rental income include advertising, cleaning and maintenance services, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, and ordinary and necessary travel and transportation. For example, an owner can deduct the cost of traveling away from home if the primary purpose is to collect rental income or manage or maintain rental property.

E. PROPERTY CHANGED TO RENTAL USE

If an owner changes his or her home or other property (or a part of it) to rental use at any time other than at the beginning of his or her tax year, the owner must divide yearly expenses, such as taxes and insurance, between rental use and personal use. The owner can deduct as rental expenses only the part of the expense that is for the part of the year the property was used or held for rental purposes. Property should be treated as having been placed in service on the conversion date for purposes of depreciation.

An owner cannot deduct depreciation or insurance for the part of the year the property was held for personal use. However, the owner can include the home mortgage interest and real estate tax expenses for the part of the year the property was held for personal use as an itemized deduction on Schedule A (Form 1040).

Example
Robert's tax year is the calendar year. He moved from his home in May and started renting it on June 1. Robert can deduct as rental expenses seven-twelfths of his yearly expenses, such as taxes and insurance. Starting with June, he can deduct as rental expenses the amounts he pays for items generally billed monthly, such as utilities.

F. RENTING PART OF PROPERTY

If an owner rents part of his or her property, the owner must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes as though he or she actually had two separate pieces of property.

The owner can deduct the expenses related to the part of the property used for rental purposes, such as home mortgage interest and real estate taxes, as rental expenses on Schedule E (Form 1040). The owner can deduct the expenses for the part of the property used for personal purposes, subject to certain limitations, only if he or she itemizes his or her deductions on Schedule A (Form 1040). The owner can also deduct as a rental expense a part of other expenses that normally are nondeductible personal expenses, such as expenses for electricity or painting the outside of the house. The owner cannot deduct any part of the cost of the first phone line even if his or her tenants have unlimited use of it.

An owner does not have to divide the expenses that belong only to the rental part of his or her property. For example, if an owner paints a room that he or she rents, or if he or she pays premiums for liability insurance in connection with renting a room in his or her home, the entire cost is a rental expense. If an owner installs a second phone line strictly for his or her tenants' use, all of the cost of the second line is deductible as a rental expense.

If an expense is for both rental use and personal use, such as mortgage interest or heat for the entire house, the owner must divide the expense between the rental use and the personal use. The owner can use any reasonable method for dividing the expense. It may be reasonable to divide the cost of some items (for example, water) based on the number of people using them. However, the two most common methods for dividing an expense are one based on the number of rooms in the home and one based on the square footage of the home.

II. Personal Use Of A Dwelling (Vacation Homes)

If an individual has any personal use of a dwelling unit (including vacation home) that he or she rents, the individual must divide his or her expenses between rental use and personal use.

If the owner used his or her dwelling unit for personal purposes long enough during the tax year, it will be considered a dwelling unit used as a home. If so, the owner cannot deduct rental expenses that exceed rental income for that property. If the dwelling unit is not considered a dwelling unit used as a home, the owner can deduct rental expenses that exceed rental income for that property subject to certain limits.

If an owner uses the dwelling unit as a home and rents it fewer than 15 days during the year, the owner does not include any of the rent in his or her income and does not deduct any of the rental expenses.

A. DWELLING UNIT

A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities.

A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment. Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Example
Linda rents a room in her home that is always available for short-term occupancy by paying customers. She does not use the room herself, and she allows only paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

B. DWELLING UNIT USED AS A HOME
The tax treatment of rental income and expenses for a dwelling unit that the owner also uses for personal purposes depends on whether the owner uses it as a home. An owner is considered to use a dwelling unit as a home during the tax year if he or she uses it for personal purposes more than the greater of:

- 14 days; or
- 10% of the total days it is rented to others at a fair rental price.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, the owner cannot count that day as a day of rental in determining if he or she has used it for 10 percent of the total days. Instead, the owner should count it as a day of personal use in applying both of the above. This rule does not apply when dividing expenses between rental and personal use.
A fair rental price for your property generally is an amount that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property. The following examples show how to determine whether an owner used their rental property as a home.

Examples
Example 1. Joe converted the basement of his home into an apartment with a bedroom, a bathroom, and a small kitchen. He rented the basement apartment at a fair rental price to college students during the regular school year. Joe rented to them on a 9-month lease (273 days). During June (30 days), Joe's brother stayed with him and lived in the basement apartment rent free. The basement apartment was used as a home because Joe used it for personal purposes for 30 days. Rent-free use by his brother is considered personal use. Joe's personal use (30 days) is more than the greater of 14 days or 10% of the total days it was rented (27 days).
Example 2. Carol rented the guest bedroom in her home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Her sister-in-law stayed in the room, rent free, for the last 3 weeks (21 days) in July. The room was used as a home because Carol used it for personal purposes for 21 days. That is more than the greater of 14 days or 10% of the 27 days it was rented (3 days).
Example 3. Rebecca owns a cottage in a resort area. She rented it at a fair rental price for a total of 170 days during the year. For 12 of those days, the tenant was not able to use the cottage and allowed Rebecca to use it even though she did not refund any of the rent. Her family actually used the cottage for 10 of those days. Therefore, the cottage is treated as having been rented for 160 (170 - 10) days. Rebecca's family also used the cottage for 7 other days during the year. Rebecca used the cottage as a home because she used it for personal purposes for 17 days. That is more than the greater of 14 days or 10% of the 160 days it was rented (16 days).

C. USE AS A MAIN HOME BEFORE OR AFTER RENTING
For purposes of determining whether a dwelling unit was used as a home, owners do not count as days of personal use the days they used the property as their main home before or after renting it or offering it for rent in either of the following circumstances:

- They rented or tried to rent the property for 12 or more consecutive months; or

- They rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because they sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

D. FIGURING DAYS OF PERSONAL USE

A day of personal use of a dwelling unit is any day that it is used by any of the following persons:

- The owner or any other person who has an interest in it, unless the owner rents it to another owner as his or her main home under a shared equity financing agreement;
- A member of the owner's family or a member of the family of any other person who has a financial interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.);
- Anyone under an arrangement that lets the owner use some other dwelling unit; or
- Anyone at less than a fair rental price.

If the other person or member of the family has more than one home, his or her main home is ordinarily the one lived in most of the time.

Examples

Example 1. Jan and her neighbor are co-owners of a condominium at the beach. Jan rents the unit to vacationers whenever possible. The unit is not used as a main home by anyone. Jan's neighbor uses the unit for two weeks every year. Because her neighbor has an interest in the unit, both of them are considered to have used the unit for personal purposes during those 2 weeks.

Example 2. Rick and his neighbors are co-owners of a house under a shared equity financing agreement. Rick's neighbors live in the house and pay him a fair rental price. Even though the neighbors have an interest in the house, the days his neighbors live there are not counted as days of personal use by Rick. This is because his neighbors rent the house as their main home under a shared equity financing agreement.

Example 3. Lisa owns a rental property that she rents to her son. Her son has no interest in this dwelling unit. He uses it as his main home. He pays a fair rental price for the property. The son's use of the property is not personal use by Lisa because her son is using it as his main home, he has no interest in the property, and he is paying a fair rental price.

E. DONATION OF USE OF PROPERTY

An owner uses a dwelling unit for personal purposes if:

- The owner donates the use of the unit to a charitable organization; and
- The organization sells the use of the unit at a fundraising event; and
- The "purchaser" uses the unit.

III. Depreciation

Owners recover their cost in income producing property through yearly tax deductions. This is done by depreciating the property; that is, by deducting some of the cost on each year's tax return. Three basic factors determine how much depreciation an owner can deduct. They are:

- The owner's basis in the property;
- The recovery period for the property; and
- The depreciation method used.

An owner cannot simply deduct his or her mortgage or principal payments, or the cost of furniture, fixtures and equipment, as an expense. The owner can deduct depreciation only on the part of their property used for rental purposes. Depreciation reduces the owner's basis for figuring gain or loss on a later sale or exchange.

Note also that an owner can never depreciate the cost of land because land does not wear out, become obsolete, or get used up. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and are not depreciable.

A. CLAIMING THE CORRECT AMOUNT OF DEPRECIATION

Owners should claim the correct amount of depreciation each tax year. Even if an owner did not claim depreciation that he or she was entitled to deduct, the owner must still reduce his or her basis in the property by the full amount of depreciation that he or she could have deducted.

If an owner claimed less depreciation than allowable in an earlier year, he or she can change his or her accounting method to take a deduction in the current year for the unclaimed depreciation. To change an accounting method, a taxpayer must have the consent of the IRS. In some instances, automatic consent is available.

B. DEPRECIATION METHODS

There are three ways to figure depreciation. The depreciation method a taxpayer uses depends on the type of property and when the property was placed in service. For property used in rental activities, an owner will use one of the following:

- MACRS (Modified Accelerated Cost Recovery System) for property placed in service after 1986;
- ACRS (Accelerated Cost Recovery System) for property placed in service after 1980 but before 1987; or
- Useful lives and either straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

Also, remember that an owner's total of all his or her yearly depreciation deductions cannot be more than the cost or other basis of the property. For this purpose, an individual's yearly depreciation deductions include any depreciation that he or she was allowed to claim, even if it was not actually claimed.

C. MACRS

Most business and investment property placed in service after 1986 is depreciated using MACRS. MACRS consists of two systems that determine how an owner depreciates their property – the General Depreciation System (GDS) and the Alternative Depreciation System (ADS). GDS is used to figure depreciation deduction for property used in most rental activities, unless the owner elects the ADS.

To figure their MACRS deduction, the owner needs to know the following information about his or her property:

- Recovery class;
- Applicable recovery period;
- Convention placed-in-service date;
- Basis for depreciation; and
- Depreciation method.

1. Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class, determined by its class life. The property class generally determines the depreciation method, recovery period, and convention. The property classes under GDS are:

- 3-year property;
- 5-year property;
- 7-year property;
- 10-year property;
- 15-year property;
- 20-year property;
- Nonresidential real property; and

- Residential rental property.

Recovery periods for property used in rental activities are shown in Table 6-1, later. The class to which property is assigned is determined by its class life.

2. Additions or Improvements to Property

Property owners should treat depreciable additions or improvements they make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement to property begins on the later of:

- The date the addition or improvement is placed in service; or
- The date the property to which the addition or improvement was made is placed in service.

The class and recovery period of the addition or improvement is the one that would apply to the original property if it were placed in service at the same time as the addition or improvement.

Example

Cal owns a residential rental house that he has been renting since 1986 and is depreciating under ACRS. Cal puts an addition onto the house and he placed it in service in 2020. He must use MACRS for the addition. Under GDS, the addition would be depreciated as residential rental property over 27.5 years.

3. Placed-in-Service Date

An owner can begin to depreciate property when he or she places it in service in his or her trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

4. Depreciable Basis

To deduct the proper amount of depreciation each year, an owner must first determine his or her basis in the property he or she intends to depreciate. The basis used for figuring depreciation is the owner's original basis in the property increased by any additions or improvements made to the property. The original basis is usually the property's cost. However, if an individual acquired the property in some other way, such as by inheriting it, getting it as a gift, or building it, the individual may have to figure his or her original basis in another way. Other adjustments could also affect basis.

5. Conventions

Under MACRS, conventions establish when the recovery period begins and ends. The convention an owner uses determines the number of months for which he or she can claim depreciation in the year he or she places property in service and in the year he or she disposes of the property.

a. Mid-month Convention

A mid-month convention is used for all residential rental property and nonresidential real property. Under this convention, an owner treats all property placed in service, or disposed of, during any month as placed in service, or disposed of, at the midpoint of that month.

b. Mid-quarter Convention

A mid-quarter convention must be used if the mid-month convention does not apply and the total depreciable basis of MACRS property placed in service in the last 3 months of a tax year (excluding nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) is more than 40% of the total basis of all such property the owner placed in service during the tax year.

c. Half-year Convention

The half-year convention is used if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, an owner treats all property placed in service, or disposed of, during a

tax year as placed in service, or disposed of, at the midpoint of that tax year. If this convention applies, the owner deducts a half-year of depreciation for the first year and the last year that he or she depreciates the property. The owner deducts a full year of depreciation for any other year during the recovery period.

TABLE 2-1. MACRS RECOVERY PERIODS FOR PROPERTY USED IN RENTAL ACTIVITIES

Type of Property	General Depreciation System	Alternate Depreciation System
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as: Typewriters, Calculators, Copiers	5 years	6 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Appliances, such as: Stoves, Refrigerators	5 years	9 years
Carpets	5 years	9 years
Furniture used in rental property	5 years	9 years
Office furniture and equipment, such as: Desks, Files	7 years	10 years
Any property that does not have a class life and that has not been designated by law as being in any other class	7 years	12 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Fences	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc.	27.5 years	30 years
Additions and improvements, such as a new roof	The same recovery period of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the addition or improvement.	

Example

During the tax year, Jordan purchased the following items to use in his rental property.

- A dishwasher for $400 that he placed in service in January.
- Used furniture for $100 that he placed in service in September.
- A refrigerator for $800 that he placed in service in October.

Jordan uses the calendar year as his tax year. The total basis of all property placed in service in that year is $1,300. The $800 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds $520 (40% × $1,300). Jordan must use the mid-quarter convention instead of the half-year convention for all three items.

TABLE 2-2–A. MACRS 5-YEAR PROPERTY

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68

5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

TABLE 2-2–B. MACRS 7-YEAR PROPERTY

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73
7	8.93	8.75	8.87	8.86	8.73
8	4.46	1.09	3.33	5.53	7.64

TABLE 2-2–C. MACRS 15-YEAR PROPERTY

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48
7	5.90	5.90	5.91	5.90	5.90
8	5.90	5.91	5.90	5.90	5.90

TABLE 2-2–D. RESIDENTIAL RENTAL PROPERTY (27.5-YEAR)

	Use the row for the month of the taxable year placed in service					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
January	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
February	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
April	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
August	1.364	3.636	3.636	3.636	3.636	3.636
September	1.061	3.636	3.636	3.636	3.636	3.636
October	0.758	3.636	3.636	3.636	3.636	3.636
November	0.455	3.636	3.636	3.636	3.636	3.636
December	0.152	3.636	3.636	3.636	3.636	3.636

Examples

Example 1. Bernie purchased a stove and refrigerator and placed them in service in June. His basis in the stove is $600 and his basis in the refrigerator is $1,000. Both are 5-year property. Using the half-year convention column in Table 2-2–A, Bernie finds the depreciation percentage for year 1 is 20%. For

that year, his depreciation deduction is $120 ($600 × .20) for the stove and $200 ($1,000 × .20) for the refrigerator. For year 2, Bernie finds his depreciation percentage is 32%. That year's depreciation deduction will be $192 ($600 × .32) for the stove and $320 ($1,000 × .32) for the refrigerator.
Example 2. Assume the same facts as in Example 1, except Bernie buys the refrigerator in October instead of June. He must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The refrigerator was placed in service in the last 3 months of the tax year and its basis ($1,000) is more than 40% of the total basis of all property placed in service during the year ($1,000 × .40 = $640). Because Bernie placed the refrigerator in service in October, he uses the fourth quarter column of Table 2-2–A and finds that the depreciation percentage for year 1 is 5%. His depreciation deduction for the refrigerator is $50 ($1,000 × .05). Because he placed the stove in service in June, he uses the second quarter column of Table 2-2–A and finds that the depreciation percentage for year 1 is 25%. For that year, his depreciation deduction for the stove is $150 ($600 × .25).

D. OTHER RULES ABOUT DEPRECIABLE PROPERTY

In addition to the rules about what methods an owner can use, there are other rules individuals should be aware of with respect to depreciable property.

1. Gain from Disposition

If an individual disposes of depreciable property at a gain, he or she may have to report, as ordinary income, all or part of the gain.

2. Limits on Rental Losses

Rental real estate activities are generally considered passive activities, and the amount of loss an individual can deduct is limited. Generally, an individual cannot deduct losses from rental real estate activities unless he or she has income from other passive activities. However, an individual may be able to deduct rental losses without regard to whether he or she has income from other passive activities if he or she "materially" or "actively" participated in the rental activity. This topic is discussed below.
Losses from passive activities are first subject to the at-risk rules. At-risk rules limit the amount of deductible losses from holding most real property placed in service after 1986. Likewise, this subject is discussed later.

IV. Passive Activity Limitations

Passive income and at-risk rules affect the losses that a taxpayer can use to offset income from other sources, such as capital gains on the sale of stocks or bonds. In general, taxpayers can deduct passive activity losses only from passive activity income. Taxpayers carry any excess loss forward to the following year or years until used, or until deducted in the year they dispose of their entire interest in the activity in a fully taxable transaction. Before applying this limit on passive activity losses, taxpayers must first determine the amount of their loss disallowed under the at-risk rules, explained later in this chapter.

A. PERSONS SUBJECT TO RULES

The passive activity rules apply to:

- Individuals;
- Estates;
- Trusts (other than grantor trusts);
- Personal service corporations; and
- Closely held corporations.

Even though the rules do not apply to grantor trusts, partnerships, or S corporations directly, they do apply to the owners of these entities.

B. PASSIVE ACTIVITIES

1. Types of Activities

There are two kinds of passive activities:

- Trade or business activities in which individuals do not materially participate during the year; and
- Rental activities, even if the individual does materially participate in them, unless he or she is a real estate professional.

2. Former Passive Activities

A former passive activity is an activity that was a passive activity in any earlier tax year, but is not a passive activity in the current tax year. A taxpayer can deduct a prior years' disallowed loss from the activity up to the amount of their current year net income from the activity. Any remaining prior year disallowed loss should be treated like any other passive loss.

In addition, any prior year disallowed passive activity credits from a former passive activity offsets the allocable part of a taxpayer's current year tax liability. The allocable part of a taxpayer's current year tax liability is that part of this year's tax liability that is allocable to the current year net income from the former passive activity. You figure this after you reduce your net income from the activity by any prior year unallowed loss from that activity (but not below zero).

3. Trade or Business Activities

A trade or business activity is an activity that:

- Involves the conduct of a trade or business (that is, deductions would be allowable under § 162 of the Internal Revenue Code if other limitations, such as the passive activity rules, did not apply);
- Is conducted in anticipation of starting a trade or business; or
- Involves research or experimental expenditures that are deductible under Internal Revenue Code § 174 (or that would be deductible if the taxpayer chose to deduct rather than capitalize them).

A trade or business activity does not include a rental activity or the rental of property that is incidental to an activity of holding the property for investment.

4. Rental Activities

A rental activity is a passive activity even if an individual materially participated in that activity, unless he or she materially participated as a real estate professional. An activity is a rental activity if tangible property (real or personal) is used by customers or held for use by customers, and the gross income (or expected gross income) from the activity represents amounts paid (or to be paid) mainly for the use of the property. It does not matter whether the use is under a lease, a service contract, or some other arrangement.

An activity is not a rental activity if any of the following apply:

- The average period of customer use of the property is seven days or less. The average period of customer use is calculated by dividing the total number of days in all rental periods by the number of rentals during the tax year. If the activity involves renting more than one class of property, multiply the average period of customer use of each class by a fraction. The numerator of the fraction is the gross rental income from that class of property and the denominator is the activity's total gross rental income. The activity's average period of customer use will equal the sum of the amounts for each class;
- The average period of customer use of the property, as figured above, is 30 days or less and the individual provides significant personal services with the rentals. Significant personal services include only services performed by individuals. To determine if personal services are significant, all relevant facts and circumstances are taken into consideration, including the

frequency of the services, the type and amount of labor required to perform the services, and the value of the services relative to the amount charged for use of the property. Significant personal services do not include the following:
  - Services needed to permit the lawful use of the property;
  - Services to repair or improve property that would extend its useful life for a period substantially longer than the average rental; and
  - Services that are similar to those commonly provided with long-term rentals of real estate, such as cleaning and maintenance of common areas or routine
  - repairs.
- An individual provides extraordinary personal services in making the rental property available for customer use. Services are extraordinary personal services if they are performed by individuals and the customers' use of the property is incidental to their receipt of the services;
- The rental is incidental to a non-rental activity. The rental of property is incidental to an activity of holding property for investment if the main purpose of holding the property is to realize a gain from its appreciation and the gross rental income from the property is less than 2% of the smaller of the property's unadjusted basis or fair market value. The unadjusted basis of property is its cost not reduced by depreciation or any other basis adjustment. The rental of property is incidental to a trade or business activity if all of the following apply:
  - An individual owns an interest in the trade or business activity during the year;
  - The rental property was used mainly in that trade or business activity during the current year, or during at least 2 of the 5 preceding tax years;
  - The individual's gross rental income from the property is less than 2% of the smaller of its unadjusted basis or fair market value. Lodging provided to an employee or the employee's spouse or dependents is incidental to the activity or activities in which the employee performs services if the lodging is furnished for the employer's convenience.
- The individual customarily makes the rental property available during defined business hours for nonexclusive use by various customers; or
- The individual provides the property for use in a non-rental activity in his or her capacity as an owner of an interest in the partnership, S corporation, or joint venture conducting that activity.

If an individual meets any of the exceptions listed above, see the instructions for Form 8582 for information about how to report any income or loss from the activity.

If a taxpayer or his or her spouse actively participated in a passive rental real estate activity, the taxpayer can deduct up to $25,000 of loss from the activity from his or her non-passive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. Similarly, an individual can offset credits from the activity against the tax on up to $25,000 of non-passive income after taking into account any losses allowed under this exception.

If a taxpayer is married, filing a separate return, and lived apart from his or her spouse for the entire tax year, the taxpayer's special allowance cannot be more than $12,500. If an individual lived with his or her spouse at any time during the year and is filing a separate return, he or she cannot use the special allowance to reduce his or her non-passive income or tax on non-passive income. The maximum special allowance is reduced if an individual's modified adjusted gross income exceeds certain amounts.

Example
Kate, a single taxpayer, has $70,000 in wages, $15,000 income from a limited partnership, a $26,000 loss from rental real estate activities in which she actively participated, and is not subject to the modified adjusted gross income phaseout rule. She can use $15,000 of her $26,000 loss to offset her $15,000 passive income from the partnership. She actively participated in her rental real estate activities, so she can use the remaining $11,000 rental real estate loss to offset $11,000 of her non-passive income (wages).

5. Active Participation

Active participation is a less stringent standard than material participation. For example, an individual may be treated as actively participating if he or she makes management decisions in a significant and bona fide sense. Management decisions that count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

Only individuals can actively participate in rental real estate activities. However, a decedent's estate is treated as actively participating for its tax years ending less than 2 years after the decedent's death, if the decedent would have satisfied the active participation requirement for the activity for the tax year the decedent died. A decedent's qualified revocable trust can also be treated as actively participating if both the trustee and the executor (if any) of the estate choose to treat the trust as part of the estate. The choice applies to tax years ending after the decedent's death and before:

- Two years after the decedent's death if no estate tax return is required; or
- Six months after the estate tax liability is finally determined if an estate tax return is required.

The choice is irrevocable and cannot be made later than the due date for the estate's first income tax return (including any extensions). Limited partners are not treated as actively participating in a partnership's rental real estate activities.

An individual is not treated as actively participating in a rental real estate activity unless his or her interest in the activity (including a spouse's interest) was at least 10% (by value) of all interests in the activity throughout the year. Active participation is not required to take the low-income housing credit, the rehabilitation investment credit, or commercial revitalization deduction from rental real estate activities.

Example

Mike, a single taxpayer, had the following income and loss during the tax year:

Salary	$42,300
Dividends	300
Interest	1,400
Rental loss	(4,000)

The rental loss came from a house Mike owned. He advertised and rented the house to the current tenant himself. He also collected the rents and either did the repairs or hired someone to do them. Even though the rental loss is a loss from a passive activity, Mike can use the entire $4,000 loss to offset his other income because he actively participated.

6. Phaseout Rule

The maximum special allowance of $25,000 ($12,500 for married individuals filing separate returns and living apart at all times during the year) is reduced by 50% of the amount of an individual's modified adjusted gross income that is more than $100,000 ($50,000 if a taxpayer is married filing separately). If a taxpayer's modified adjusted gross income is $150,000 or more ($75,000 or more if they are married filing separately), he or she generally cannot use the special allowance.

Modified adjusted gross income for this purpose is an individual's adjusted gross income figured without the following:

- Taxable social security and tier 1 railroad retirement benefits;
- Deductible contributions to individual retirement accounts (IRAs) and § 501(c)(18) pension plans;
- The exclusion from income of interest from qualified U.S. savings bonds used to pay qualified higher education expenses;
- The exclusion from income of amounts received from an employer's adoption assistance program;
- Passive activity income or loss included on Form 8582;
- Any rental real estate loss allowed because you materially participated in the rental activity as a real estate professional;
- Any overall loss from a publicly traded partnership;

- The deduction allowed for the deductible part of self-employment tax;
- Foreign-derived intangible income and global intangible low-taxed income;
- The deduction allowed for interest on student loans; or
- The deduction for qualified tuition and related expenses.

Example

During 2020, John was unmarried and was not a real estate professional. For 2020, he had $120,000 in salary and a $31,000 loss from his rental real estate activities in which he actively participated. His modified adjusted gross income is $120,000. When he files his 2020 return, he may deduct only $15,000 of his passive activity loss. He must carry over the remaining $16,000 passive activity loss to 2021. He figures his deduction and carryover as follows:

Adjusted gross income, modified as required	$120,000
Minus amount not subject to phaseout	100,000
Amount subject to phaseout rule	$20,000
Multiply by 50%	× 50%
Required reduction to special allowance	$10,000
Maximum special allowance	$25,000
Minus required reduction (see above)	10,000
Adjusted special allowance	$15,000
Passive loss from rental real estate	$31,000
Deduction allowable/Adjusted special allowance (see above)	15,000
Amount that must be carried forward	$16,000

A higher phaseout range applies to rehabilitation investment credits from rental real estate activities. For those credits, the phaseout of the $25,000 special allowance starts when a taxpayer's modified adjusted gross income exceeds $200,000 ($100,000 if the taxpayer is a married individual filing a separate return and living apart at all times during the year).

There is no phaseout of the $25,000 special allowance for low-income housing credits or for the commercial revitalization deduction (CRD).

If a taxpayer has more than one of the exceptions to the phaseout rules in the same tax year, he or she must apply the $25,000 phaseout against his or her passive activity losses and credits in the following order:

- The portion of passive activity losses not attributable to the CRD.
- The portion of passive activity losses attributable to the CRD.
- The portion of passive activity credits attributable to credits other than the rehabilitation and low-income housing credits.
- The portion of passive activity credits attributable to the rehabilitation credits.
- The portion of passive activity credits attributable to the low-income housing credit.

C. ACTIVITIES THAT ARE NOT PASSIVE

The following are not passive activities:

- Trade or business activities in which an individual materially participates for the tax year;
- A working interest in an oil or gas well held directly or through an entity that does not limit the investor's liability (such as a general partner interest in a partnership). It does not matter whether the individual materially participated in the activity for the tax year. However, if the individual's liability was limited for part of the year (for example, the individual converted his or her general partner interest to a limited partner interest during the year) and he or she had a net loss from the well for the year, some of the individual's income and deductions from the working interest may be treated as passive activity gross income and passive activity deductions;

- The rental of a dwelling unit that an individual also used for personal purposes during the year for more than the greater of 14 days or 10% of the number of days during the year that the home was rented at a fair rental;
- An activity of trading personal property for the account of those who own interests in the activity; or
- Rental real estate activities in which an individual materially participated as a real estate professional.

1. Material Participation

A trade or business activity is not a passive activity if an individual materially participated in the activity. An individual is considered to have materially participated in a trade or business activity for a tax year if he or she satisfies any of the following tests:

1) The individual participated in the activity for more than 500 hours;
2) His or her participation was substantially all the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity;
3) The individual participated in the activity for more than 100 hours during the tax year, and participated at least as much as any other individual (including individuals who did not own any interest in the activity) for the year;
4) The activity is a significant participation activity, and the individual participated in all significant participation activities for more than 500 hours. A significant participation activity is any trade or business activity in which an individual participated for more than 100 hours during the year and in which he or she did not materially participate under any of the material participation tests, other than this test;
5) The individual materially participated in the activity for any five (whether or not consecutive) of the ten immediately preceding tax years;
6) The activity is a personal service activity in which the individual materially participated for any three (whether or not consecutive) preceding tax years. An activity is a personal service activity if it involves the performance of personal services in the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor; or
7) Based on all the facts and circumstances, the individual participated in the activity on a regular, continuous, and substantial basis during the year.

An individual did not materially participate in the activity under the last test if he or she participated in the activity for 100 hours or less during the year. An individual's participation in managing the activity does not count in determining whether he or she materially participated under this test if:

- Any other person received compensation for managing the activity; or
- Any other person spent more hours than the individual during the tax year managing the activity (regardless of whether the individual was compensated for the management services).

In general, any work an individual does in connection with an activity in which he or she owns an interest is treated as participation in the activity. A taxpayer may not treat the work he or she does in connection with an activity as participation in the activity if both of the following are true:

- The work is not work that is customarily done by the owner of that type of activity; and
- One of the individual's main reasons for doing the work is to avoid the disallowance of any loss or credit from the activity under the passive activity rules.

An investor does not treat the work he or she does in his or her capacity as an investor in an activity as participation unless he or she is directly involved in the day-to-day management operations of the enterprise. Work conducted by an investor generally includes:

- Studying and reviewing financial statements or reports on operations of the activity;

- Preparing or compiling summaries or analyses of the finances or operations of the activity for his or her own use; and
- Monitoring the finances or operations of the activity in a nonmanagerial capacity.

An individual's participation in an activity includes his or her spouse's participation. This applies even if the spouse did not own any interest in the activity and the couple did not file a joint return for the tax year in question.

Taxpayers can generally use any reasonable method to prove their participation in an activity for the year. It is not necessary to keep contemporaneous daily time reports, logs, or similar documents if an individual can establish his or her participation in some other way. For example, individuals can show the services they performed and the approximate number of hours spent by using an appointment book, calendar, or narrative summary.

If an individual owned an activity as a limited partner, he or she generally is not treated as materially participating in the activity. However, the individual can be considered to have materially participated if he or she met test (1), (5), or (6) discussed above, for the tax year. An individual is not treated as a limited partner, however, if he or she was a general partner in the partnership at all times during the partnership's tax year ending with or within his or her tax year (or, if shorter, during that part of the partnership's tax year in which he or she directly or indirectly owned his or her limited partner interest).

A closely held corporation or a personal service corporation is treated as materially participating in an activity only if one or more shareholders holding more than 50% by value of the outstanding stock of the corporation materially participated in the activity.

V. At-Risk Rules

The at-risk rules limit the losses from most activities to the amount an individual has at risk in the activity. Any loss that is disallowed because of the at-risk limits is treated as a deduction from the same activity in the next tax year. If a taxpayer's losses from an at-risk activity are allowed, they are subject to recapture in later years if the individual's amount at risk is reduced below zero. The at-risk rules must be applied before the passive activity rules discussed in the previous section.

A. ACTIVITIES COVERED BY THE AT-RISK RULES

Persons involved in one of the following activities as a trade or business or for the production of income are subject to the at-risk rules:

- Holding, producing, or distributing motion picture films or video tapes;
- Farming;
- Leasing § 1245 property, including personal property and certain other tangible property that is depreciable or amortizable;
- Exploring for, or exploiting, oil and gas;
- Exploring for, or exploiting, geothermal deposits (for wells started after September 1978); or
- Any other activity that is carried on as a trade or business or for the production of income.

1. Section 1245 Property

Section 1245 property includes any property that is or has been subject to depreciation or amortization and is:

- Personal property;
- Other tangible property (other than a building or its structural components) that is:
    - Used in manufacturing, production, extraction or furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services;
    - A research facility;
    - A facility used in any of the activities for the bulk storage of fungible commodities;
- Real property (other than property described above) with an adjusted basis that was reduced by certain amortization deductions listed in section 1245(a)(3)(C) of the Internal Revenue Code;

- A single purpose agricultural or horticultural structure; or
- A storage facility (other than a building or its structural components) used for the distribution of petroleum.

2. Exception for Holding Real Property Placed in Service Before 1987

The at-risk rules do not apply to the holding of real property placed in service before 1987. They also do not apply to the holding of an interest acquired before 1987 in a pass-through entity engaged in holding real property placed in service before 1987. This exception does not apply to holding mineral property.

Personal property and services that are incidental to making real property available as living accommodations are included in the activity of holding real property. For example, making personal property, such as furniture, and services available when renting a hotel or motel room or a furnished apartment is considered incidental to making real property available as living accommodations.

3. Exception for Equipment Leasing by a Closely Held Corporation

If a closely held corporation is actively engaged in equipment leasing, the equipment leasing is treated as a separate activity not covered by the at-risk rules. A closely held corporation is actively engaged in equipment leasing if 50% or more of its gross receipts for the tax year are from equipment leasing. Equipment leasing means the leasing, purchasing, servicing, and selling of equipment that is § 1245 property.

However, equipment leasing does not include the leasing of master sound recordings and similar contractual arrangements for tangible or intangible assets associated with literary, artistic, or musical properties, such as books, lithographs of artwork, or musical tapes. A closely held corporation cannot exclude these leasing activities from the at-risk rules nor count them as equipment leasing for the gross receipts test.

The equipment leasing exclusion also is not available for leasing activities related to other at-risk activities, such as motion picture films and video tapes, farming, oil and gas properties, and geothermal deposits. For example, if a closely held corporation leases a video tape, it cannot exclude this leasing activity from the at-risk rules under the equipment leasing exclusion.

4. Special Exception for Qualified Corporations

A qualified corporation is not subject to the at-risk limits for any qualifying business carried on by the corporation. Each qualifying business is treated as a separate activity. A qualified corporation is a closely held corporation that is not:

- A personal holding company; or
- A personal service corporation.

B. "LOSS" DEFINED

A "loss" is the excess of allowable deductions from the activity for the year (including depreciation or amortization allowed or allowable and disregarding the at-risk limits) over income received or accrued from the activity during the year. Income does not include income from the recapture of previous losses.

IRS Form 6198 is used to figure how much loss from an activity can be deducted. The form must be filed with a tax return if a taxpayer has a loss from any part of an activity that is covered by the at-risk rules, and the individual is not at risk for some of his or her investment in the activity.

C. WHO IS AFFECTED

The at-risk limits apply to individuals (including partners and S corporation shareholders), estates, trusts, and certain closely held C corporations.

For the at-risk rules, a C corporation is a closely held corporation if at any time during the last half of the tax year, more than 50% in value of its outstanding stock is owned directly or indirectly by or for

five or fewer individuals. To determine whether more than 50% in value of the stock is owned by five or fewer individuals, apply the following rules:

1. Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by its shareholders, partners, or beneficiaries.
2. An individual is considered to own the stock directly or indirectly by or for his or her family. Family includes only brothers and sisters (including half-brothers and half-sisters), a spouse, ancestors, and lineal descendants.
3. If a person holds an option to buy stock, he or she is considered to be the owner of that stock.
4. When applying rule (1) or (2), stock considered owned by a person under rule (1) or (3) is treated as actually owned by that person. Stock considered owned by an individual under rule (2) is not treated as owned by the individual for again applying rule (2) to consider another the owner of that stock.
5. Stock that may be considered owned by an individual under either rule (2) or (3) is considered owned by the individual under rule (3).

D. AT-RISK AMOUNTS

An individual is considered at risk in any activity for:

- The money and adjusted basis of property he or she contributes to the activity; and
- Amounts he or she borrows for use in the activity if:
    - The individual is personally liable for repayment, or
    - The individual pledges property (other than property used in the activity) as security for the loan.

1. Amounts Borrowed

An individual is considered at risk for amounts borrowed to use in the activity if he or she is personally liable for repayment. An individual is also at risk if the amounts borrowed are secured by property other than property used in the activity. In this case, the amount considered at risk is the net fair market value of the individual's interest in the pledged property. The net fair market value of property is its fair market value (determined on the date the property is pledged) less any prior (or superior) claims to which it is subject. However, no property will be taken into account as security if it is directly or indirectly financed by debt that is secured by property the individual contributed to the activity.

If an individual borrows money to finance a contribution to an activity, he or she cannot increase the amount at risk by the contribution and the amount borrowed to finance the contribution. A taxpayer may increase his or her at-risk amount only once.

Even if an individual is personally liable for the repayment of a borrowed amount or he or she secures a borrowed amount with property other than property used in the activity, the individual is not considered at risk if he or she borrowed the money from a person having an interest in the activity or from someone related to a person having an interest in the activity. This does not apply to:

- Amounts borrowed by a corporation from a person whose only interest in the activity is as a shareholder of the corporation;
- Amounts borrowed from a person having an interest in the activity as a creditor; or
- Amounts borrowed after May 3, 2004, secured by real property used in the activity of holding real property (other than mineral property) that, if nonrecourse, would be qualified nonrecourse financing.

E. AMOUNTS NOT AT RISK

An individual is not considered at risk for amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

1. Nonrecourse Financing

Nonrecourse financing is financing for which an individual is not personally liable. If an individual borrows money to contribute to an activity and the lender's only recourse is to their interest in the activity or the property used in the activity, the loan is a nonrecourse loan.
An individual is not considered at risk for his or her share of any nonrecourse loan used to finance an activity or to acquire property used in the activity unless the loan is secured by property not used in the activity. However, an individual is considered at risk for qualified nonrecourse financing secured by real property used in an activity of holding real property.
Qualified nonrecourse financing is financing for which no one is personally liable for repayment and that is:

- Borrowed in connection with the activity of holding real property;
- Secured by real property used in the activity;
- Not convertible from a debt obligation to an ownership interest; and
- Loaned or guaranteed by any federal, state, or local government, or borrowed from a qualified person.

The rules below apply to any financing incurred after August 3, 1998. Individuals can also choose to apply these rules to financing obtained before August 4, 1998. If an individual elects to do this, he or she must reduce the amounts at risk as a result of applying these rules to years ending before August 4, 1998, to the extent they increase the losses allowed for those years.
In determining whether qualified nonrecourse financing is secured only by real property used in the activity of holding real property, disregard property that is incidental to the activity of holding real property. Also disregard other property if the total gross fair market value of that property is less than 10% of the total gross fair market value of all the property securing the financing.
For this purpose, individuals should treat themselves as owning directly their proportional share of the assets in any partnership in which they own, directly or indirectly, an equity interest.
A qualified person is a person who actively and regularly engages in the business of lending money. The most common example is a bank.

2. Other Loss Limiting Arrangements

Any capital an individual contributed to an activity is not at risk if he or she is protected against economic loss by an agreement or arrangement for compensation or reimbursement. For example, an individual is not at risk if he or she will be reimbursed for part or all of any loss because of a binding agreement between themselves and another person.

Examples

Example 1. Some commercial feedlots reimburse investors against any loss sustained on sales of the fed livestock above a stated dollar amount per head. Under such stop loss orders, the investor is at risk only for the portion of the investor's capital for which the investor is not entitled to a reimbursement.
Example 2. Bill is personally liable for a mortgage, but he separately obtains insurance to compensate him for any payments he must actually make because of his personal liability. Bill is considered at risk only to the extent of the uninsured portion of the personal liability to which he is exposed. He can include in the amount he has at risk the amount of any premium he paid from his personal assets for the insurance. However, if Bill obtains casualty insurance or insurance protecting himself against tort liability, it does not affect the amount he is otherwise considered to have at risk.

F. REDUCTIONS OF AMOUNTS AT RISK

The amount an individual has at risk in any activity is reduced by any losses allowed in previous years under the at-risk rules. It may also be reduced because of distributions an individual received from the activity, debts changed from recourse to nonrecourse, or the initiation of a stop loss or similar agreement. If the amount at risk is reduced below zero, the individual's previously allowed losses are subject to recapture, as explained next.

G. RECAPTURE RULE

If the amount an individual has at risk in any activity at the end of any tax year is less than zero, he or she must recapture at least part of the previously allowed losses. This is done by adding to the individual's income from the activity for that year the lesser of the following amounts:

- The negative at-risk amount (treated as a positive amount); or
- The total amount of losses deducted in previous tax years beginning after 1978, minus any amounts the individual previously added to his or her income from that activity under this recapture rule.

The recapture income is not used to reduce any net loss from the activity for the tax year. Instead, the recaptured amount is treated as a deduction for the activity in the next tax year.

CHAPTER 2: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CP credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. How does federal tax law treat security deposits received by landlords:

A. security deposits are never considered to be income to the landlord
B. security deposits are always considered to be income to the landlord when received
C. security deposits are not income at the time received if it is the landlord's intent to return them to the tenant at the time the tenant vacates the property
D. 50% of the security deposit is considered income

2. Property owners can deduct which of the following expenses incurred for their rental property:

A. repairs but not improvements
B. all repairs and improvements
C. improvements but not repairs
D. any expense in excess of $500

3. Under which of the following circumstances is the owner of a dwelling deemed to have used it for personal use:

A. if the owner used it for at least 10 days within the year
B. if the owner used it for at least 14 days within the year
C. it is used personally for 10% or more of the total days that it is rented to others at a fair rental price
D. either B or C above

4. The depreciation amount that a property owner can deduct on his or her tax return is determined by all of the following factors <u>except</u>:

A. the owner's basis in the property
B. the amount financed by the seller
C. the recovery period for the property
D. the depreciation method used

5. Which of the following is true regarding passive activity losses:

A. they can be offset against any type of gains
B. they can be offset only against passive activity gains

C. they can be carried over if there is an insufficient amount of passive activity income against which to offset the losses
D. both B and C above

6. Income from rental activities is considered passive for federal tax purposes unless which of the following is true:

A. the tenant(s) does not have a long-term lease
B. the taxpayer participated in the investment as a real estate professional
C. the taxpayer owns at least five properties
D. the rental income is a significant part of the taxpayer's total income

7. Which of the following people will be considered to have "materially" participated in a business for the tax year:

A. Bill, who co-owned a consulting business in which he worked an average of 15 hours per week cultivating new business
B. Thomas, a shareholder in a closely-held corporation that produced electronic equipment at which he attended monthly management meetings but did little more
C. Mike, co-owner of a software development company who, along with his partner and the only other owner of the business, worked about five hours per week on the company
D. both A and C above

CHAPTER 2: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. Incorrect. Deposits are generally not considered income, but it depends on other factors including the intent of the landlord.
B. Incorrect. In some cases deposits are considered income, but there is no such categorical rule. Indeed, the presumption seems not to treat deposits as income.
C. CORRECT. To the extent the landlord intends to refund the deposit at the end of the leasehold, it is not income.
D. Incorrect. Deposits are either income or not; there is no such percentage.

2.

A. CORRECT. Any money spent on actual repairs to rental property is deductible as a business expense associated with that rental. A repair is something needed to keep up the property, i.e., patching a leaking roof or fixing a fallen fence.
B. Incorrect. Improvements, things which add value to the property, are generally not deductible as the owner is able to recoup such investments through depreciation.
C. Incorrect. Repairs, not improvements, are subject to a deduction while improvements must be depreciated.
D. Incorrect. There is no such minimum expenditure. The question is whether the item is a repair, which is deductible, or an improvement which must be depreciated.

3.

A. Incorrect. The owner must use it for 14 days for it to be considered as a personal use dwelling, in which case certain costs must be allocated for tax purposes.
B. Incorrect. An owner who uses a dwelling for at least 14 days will be considered to have had some personal use for tax purposes. However, this is not the most correct answer.

C. Incorrect. Under this circumstance, the dwelling will be considered to have had personal use for tax purposes. However, this is not the most correct answer.
D. CORRECT. Under either scenario, a taxpayer will be deemed to have used the property for personal use. If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, the owner cannot count that day as a day of rental in determining if he or she has used it for 10 percent of the total days. Instead, the owner should count it as a day of personal use in applying both of the above. This rule does not apply when dividing expenses between rental and personal use.

4.
A. Incorrect. The owner's basis in an investment property is one of the numerical factors needed to calculate an appropriate depreciation amount.
B. CORRECT. Amounts financed, if any, by a property's seller has no bearing on the amount of depreciation that the new buyer will calculate and use.
C. Incorrect. The recovery period for a specific type of property is one of the numerical factors needed to calculate a deductible depreciation amount.
D. Incorrect. The depreciation method selected will affect the specific amount of an investor's depreciation deduction.

5.
A. Incorrect. Federal law limits the offset of passive activity losses to be offset only against passive activity income.
B. Incorrect. Although they can only be offset against passive activity gains, this is not the best answer.
C. Incorrect. To the extent there is insufficient passive activity income against which to offset passive activity losses, it can be carried forward. However, this is not the most accurate answer.
D. CORRECT. Both B and C are correct. Passive activity losses can only be offset against passive activity income. However, excess losses can be carried forward to subsequent tax years.

6.
A. Incorrect. There is no affect of whether a lease is short or long term, or whether there is a lease at all, on whether income is considered to be from an active or a passive activity.
B. CORRECT. Unless the taxpayer acted as a professional in the transaction, i.e., he used his real estate license to acquire the property, rents and other income are considered passive.
C. Incorrect. The income is passive in this case regardless of the number of properties owned by the taxpayer unless he or she was involved as a real estate professional.
D. Incorrect. The fact that rental income is a significant part of a taxpayer's total income does not make the income active, rather than passive.

7.
A. CORRECT. In this case, Bill participated for more than 500 hours during the year in active management of the business, and therefore his income from the business would not be classified as passive. The other men do not meet the test.
B. Incorrect. Even regular attendance at meetings is not sufficient given the relatively small amount of time he devoted to the activity.
C. Incorrect. Since neither partner put significant time into the business, it will be considered passive participation since the firm has employees putting in significantly more time.
D. Incorrect. Only one of the responses is considered to have active or material involvement.

GLOSSARY

Adjusted basis: The cost of property plus the value of any capital expenditures for improvements to the property minus any depreciation taken.
At-risk rules: Rules that limit the amount of loss you may deduct to the amount you risk losing in the activity.
Basis: Basis is the amount of your investment in property for tax purposes. The basis of property you buy is usually the cost. Basis is used to figure gain or loss on the sale or disposition of investment property.
Dwelling Unit: A single unit providing complete independent living facilities for one (1) or more persons, including permanent provisions for living, sleeping, eating, cooking, and sanitation, limited to only one kitchen. Includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property.
Fair Market Value: The price at which an item can be sold at the present time between two unrelated people, neither under compulsion to buy or sell.
Joint Tenancy: A form of property ownership in which two people co-own property with an automatic right of survivorship. If one of the owners dies, the surviving owner automatically receives the deceased's owner's interest. This allows real property to pass without going through probate.
Passive activity: An activity involving the conduct of a trade or business in which you do not materially participate and any rental activity. However, the rental of real estate is not a passive activity if both of the following are true: (1) More than one-half of the personal services you perform during the year in all trades or businesses are performed in real property trades or businesses in which you materially participate; and (2) You perform more than 750 hours of services during the year in real property trades or businesses in which you materially participate.
Settlement Fees: Fees and expenses, over and above the price of the property, incurred by the buyer and/or the seller in the property ownership transfer, such as title searches, lawyer's fees, survey charges, and deed filing fees.

Final Exam

Real Estate Taxes

The following exam is attached only for your convenience. To access the official exam for this self-study course, please log into your account online and take the Final Exam from the course details page. A passing score of 70 percent or better will receive course credit and a Certificate of Completion.

1. If an individual has more than one home, when can he or she exclude the gain from its sale:
    A. only if the home was a condominium and owned for one year
    B. only if the home was a houseboat and owned for less than two years
    C. only if the home was a vacation home and sometimes rental property
    D. only if the home was the main home, owned and lived in for at least two of the last five years

2. Which of the following is <u>not</u> true regarding the gain or loss on the sale of a home:
    A. the selling expenses can be subtracted from the selling price when calculating the amount realized
    B. if the sellers are married and file separate returns, either spouse can report the entire gain or loss on his or her return
    C. a loss on the sale of an individual's main home is not deductible
    D. if two owners who are not married sell their jointly-owned home, each must calculate their own gain or loss according to their ownership interest in the home

3. Which of the following would an individual add to the basis of his or her property:
    A. putting on a new roof
    B. repainting the outside of a house
    C. replacing broken windows
    D. repairing plastering

4. Regarding the exclusion of a taxable gain from the sale of a taxpayer's main home, which statement is <u>not</u> correct:
    A. to qualify for the exclusion, certain ownership and use tests must be met
    B. the maximum exclusion amount for a married couple filing jointly is $500,000
    C. if they qualify, all taxpayers must take the allowable exclusion
    D. the maximum exclusion amount for an individual equals $250,000

5. Which of the following is <u>not</u> true regarding the ownership and use tests as they relate to the allowable $250,000 exclusion of the gain on the sale of an individual's main home:
    A. the individual must have owned the home for at least two years of the five-year period ending on the date of the sale
    B. the individual must have lived in the home as their main home for at least two years of the five-year period ending on the date of the sale
    C. the years of ownership and use must be continuous during the five-year period prior to the date of sale
    D. the years of ownership and use do not have to cover the same period of time as long as they are within the five-year period immediately preceding the date of sale

6. Which of the following should <u>not</u> be included in rental income in the year it was received:
    A. rental income for the year the owner actually or constructively received it by cash basis taxpayers

B. advance rent
C. security deposits (intended to be returned at the end of the lease)
D. payments made by the tenant to cancel a lease

7. If an individual holds property for rental purposes, he or she may be able to deduct all of the following except:

A. depreciation expenses when it is ready and available to rent
B. ordinary and necessary costs for maintaining the property while vacant
C. ordinary and necessary costs for managing the property until it is sold
D. the loss of rental income for the period the property is vacant

8. Most investment property placed in service after 1986 is depreciated using which of the following methods:

A. straight-line method
B. declining balance method
C. ACRS method
D. MACRS method

9. The passive activity loss rules apply to all of the following except:

A. individuals
B. partnerships
C. personal service corporations
D. closely held corporations

10. Which of the following is correct regarding active participation:

A. it includes limited partners in a partnership's rental real estate activities
B. it is less stringent than material participation
C. it is more stringent than material participation
D. it is the same as material participation