Real Estate And Taxes, What Every Agent Should Know
6 hrs Education Credit
Required text: same title, Real Estate Education Company CE Series

Personal Income Taxation and Home Mortgage Interest Deduction

A. *Overview*
   1. Form 1040
   2. Schedule A
   3. Schedule B
   4. Schedule C
   5. Schedule SE
   6. Schedule D
   7. Schedule E

B. *Acquisition Indebtedness*
   1. Debt incurred to acquire, construct or improve principal residence
   2. Caps on total acquisition debt
   3. Refinancing issues
   4. Substantial improvements
   5. Buying out in a divorce

C. *Home Equity Indebtedness*
   1. Debt that is secured by principal or second residence
   2. Defining fair market value
   3. $100,000 Cap

D. *Defining Residence*
   1. Generally land and living quarters of taxpayer
   2. Qualified residence
   3. Principal residence
   4. Second residence
   5. Dwelling units
   6. "Use" of second home
   7. Designating the second home
      a) Owning two homes and purchasing another
      b) Converting principal home into vacation home
      c) Owning three homes and selling one in the middle of the year
   8. Residence used for business
   9. Residence under construction
   10. Time-share purchases
   11. Getting married in the middle of the year

E. *Securing Debt*
   1. Basic rules

a) Must involve security instrument
b) Qualified residence specified as security
c) Residence subject to satisfaction of debt
d) Security instrument recorded

2. Using correct collateral
3. Commercial property pledge against home loan
4. Home pledged against commercial loan
5. Effect of unrecorded mortgages
6. Unsecured liens, mechanics liens, general asset liens

F. General Requirements for Deductibility

1. Interest on existing valid, enforceable debt
2. Generally cannot deduct prepaid interest
3. Often can deduct points paid at time of purchase or refinance
4. Allocating points over life of loan
5. Expenses that are deductible points
6. Expenses that are not deductible points
7. Exception when points can be deducted in year of payment
8. Closing statement used to designate points
9. Points paid by seller for buyer
   a) Deductible by buyer
   b) Seller reduces sale price
   c) IRS requires HUD Form I
   d) Proper substantial key to deductibility
10. Points paid from earnest money deposit
11. Points paid to acquire residence with portion as rental
12. Refinancing points never currently deductible
13. Deducting points in full
    a) When home sold prior to loan payoff
    b) When loan prepaid 14. FHA requirements not deductible
    a) Points paid by seller assisting FHA buyer
    b) Mortgage insurance premium points

G. Conclusion

II. Taxation of Profit: How Gains or Losses are Computed

A. Overview

1. Reporting required whenever asset is sold, exchanged or disposed of in any income-taxable manner
2. Non-reportable transfers: property received by gift or inheritance

B. Gain or Loss Formula

1. Sale price less original price (or basis)
2. Variations
   a) Building home on empty lot
   b) Renting out the home before selling it

C. *Items Which May be Included in the Selling Price*

1. Includes amount of cash received plus fair market value of any other property received
2. Includes items which may not be itemized in sale contract
3. May include personal property
4. Buyer and seller must agree on sales/purchase price
   a) If more than one property, purchase price must be allocated appropriately
   b) IRS can change allocation to detriment of both parties
5. Depreciation
   a) Once property qualifies for depreciation, cost will decrease each year (mandatory)
   b) Accumulated depreciation results in increased gain

D. *Items Which May be Included in Selling Expenses*

1. Not recognized as selling expenses
   a) Prorated items
   b) Repairs or improvements
2. Deductible selling expenses
   a) Real estate sales commissions
   b) Title examination and insurance
   c) Closing fees
   d) Transfer fees
   e) Many others

E. *Calculating Adjusted Basis*

1. Original cost plus improvements minus depreciation and losses
2. Basis may be different from original cost
   a) Inheritance
   b) Gifts
   c) spousal transfers
   d) Exchanges
3. Adding to the basis
   a)Some purchase expenses
   b) Construction, reconstruction, capital improvements
   c) Capital improvements (not repairs)
4. Casualty losses reduce basis

F. *Taxing Options*

1. Money used to buy the option
   a) Initial receipt not taxable to seller or buyer
   b) Treated as deposit until option lapses or is exercised
2. Tax ramifications to buyer
   a) H option exercised, buyer adds cost to purchase price
   b) If option lapses, treated as a loss
3. Tax ramifications to seller
   a) 11 option exercised, fncluded in sale price
   b) If option lapses, treated as ordinary income

G. Conclusion

III. Exclusion Rule: for Gain on Sale of Principal Residence

A. Overview

1. Old rules repealed
   a) Principal residence rollover provision
   b) Over 55 $125,000 one-time gain forgiven
2. New rules applicable to principal residences

B. Definition of Principal Residence

1. Exclusion of gain only to principal residences
2. Area of most IRS controversies
3. Four major categories
   a) Types of qualified properties
   b) Ownership requirements
   c) Occupancy requirements
   d) Residences also used for business

C. Location of Principal Residence

1. Where taxpayer lives
2. Where taxpayer is employed
3. Where taxpayer spends most amount of time
4. Only one "principal" residence may be used
5. Each spouse may have separate "principal" residence
6. Examples of qualifying properties
   a) Single-family house or condominium or cooperative
   b) Mobile home
   c) Boat or houseboat
   d) House trailer or motorhome

D. Gain May Be Free

1. Certain prerequisites
   a) Sales price was $250,000 or under ($500,000 MFJ)
   b) Cost of improvements eliminate any taxable gain
   c) Prove original cost of home (HUD Form 1)
   d) Only one home sold in previous two years
   e) No prior depreciation taken after May 7, 1997
2. Obsolete tax planning ideas
   a) No requirement to reinvest the sales proceeds
   b) Age 55 requirement eliminated
   c) Fixing up expenses no longer deductible anywhere
   d) "Moving at least 50 miles" rule eliminated
   e) Nontaxable gain need not be "rolled over" into new home
   f) Renting home while trying to sell generally will not cause tax problems
3. New exclusion eliminates most record-keeping requirements

4. Real estate closing agents relieved of transmitting Form 1099-S
   a) Home was "principal residence"
   b) No federally subsidized financing assistance
   c) No depredation recapture
5. Exclusion rule optional, not mandatory
6. Wealthy homeowners must report excess over $250,000 ($500,000 MFJ) as ordinary income
7. Exchange of personal residences not eligible for tax-deferred exchanges
8. Previous use of the "once-in-a-lifetime" exclusion eligible for new rules
9. Returns can be amended

E. New §121 Qualification Requirements

1. Own and occupy for two years
2. No more than once every two years
3. $500,000 exclusion when four requirements met
   a) Husband and wife make a joint return
   b) Either spouse owns property for two of last five years
   c) Both spouses use property as principal residence for two of last five years
   d) Neither spouse is ineligible because of using exemption in past two years

F. One Spouse Qualifies and Other Does Not Qualify

1. Owning home with "significant other"
2. Determining at least two of the last five years
3. Tacking of time prior to August 5, 1997, allowed
4. Ownership and use need not be simultaneous
5. Office-in-home
6. Occasional absences permitted
7. No exclusion for rentals

G. Two-of-last-five years rule liberalized re: physically or mentally incapacitated

H. Exclusion available only once every two years

I. If Homeowner Cannot Meet Two-Year Rule

1. Conditions under which some (if not all) of taxable gain may be tax free
   a) Change of place of employment
   b) Health problems
   c) Other unforeseen circumstances
2. Excludable gain must be prorated

J. Home Must Be Physically Occupied for Two Years

1. No excuse is acceptable
2. Purchase but not occupied not sufficient

K. Taxable Consequences Because of Death or Divorce

1. "Tacking" of deceased spouses' ownership and use permitted

2. Spousal exclusion expires the year alter death
3. Property transferred during marriage or divorce treated as gift
4. Tacking of "use" in divorce permitted when former spouse granted use of property under divorce or separation instrument

L. Rules for Cooperative Owner

1. Holding requirement applies to stock ownership
2. Use requirement applies to using the unit

M. Involuntary Conversions Tacked on to New Property

N. Sale of Remainder Interest is Eligible for Exclusion

0. Rentals Still Qualify If Used as Residence for Two of Five Years

1. Rent while trying to sell
2. Home can be depreciated while rented
3. Depreciation must be recaptured

P. Home Used for Business and Residence

1. Basis and sale price must be apportioned between business and residence
2. Business gain portion taxable in year of sale
3. Home portion eligible for exclusion

Q. Difficult to Make Losses Deductible

R. How Much Land Included with Personal Residence

1. Gain on land with personal residence generally excluded
2. Gain on land considered investment not generally excluded
3. Property use allocation must be made

S. Conclusion

IV. Applying the Passive Loss Rules to Real Estate Professionals

A. Overview

1. Pre-1986 tax shelters
2. Closing the loopholes

B. §469 Passive Loss Rules (PAL Rules)

1. Losses from passive activities may not be deducted against other income
2. Exception: up to $25,000 of rental losses from "actively managed" real estate
3. Deduct passive losses from passive income
4. Relief Provisions: RREAs (rental real estate activities)
5. Material Participation
   a) Seven tests
   b) Proving participation

c) Aggregation of rental real estate
d) Real estate owned by pass-through entities
e) Establishing involvement in a real estate business
(1) 50% test
(2) 750-hour test
f) Including spouse's hours
g) Combining real estate businesses
h) Brokerage trade or business

6. Previously suspended rental losses
a) Not easily to "trigger" prior rental losses not previously deducted
b) No easy grouping to get around rule
7. When rentals sold for large profit

V. Office-in-Home Rules

A. Overview

B. Office-in-Home Requirements

1. Used exclusively for business
2. Used regularly for business activity
3. Principally used as principal place of business, meeting clients, or in connection with taxpayer's trade

C. Employee Working at Home

1. Renting a room to employer
2. Room exclusively used for business
3. Operating two or more businesses from same home office
4. Exception: Day care and inventory storage
5. Patients, clients or customers
6. Separate structures

D. Defining Principal Place of Business

1. IRS test: where "client contact" occurs (*Soliman* case)
2. Correction: two tests
a) Home office used for administrative or management activities
b) No other fixed location of the trade or business
c) Regular and exclusive requirements still required
d) Employer convenience requirements still required

F. Transportation Expenses from Home Office

1. Commuting from home office
2. Nondeductible office-in-home
a) May still be principal place of business
b) Careful record keeping required
3. Accounting for home office expenses: Form 8829

F. Office-in-Home Calculation

1. Direct expenses

2. Indirect expenses
3. Square footage of office-in-home divided by total square footage of home
4. Deduction not allowed to create or increase net loss of business
5. Home office creates a gain when residence is sold
6. Depreciation taken after May 6, 1977, must be recaptured

G. Conclusion